Company accounts

1. Introduction

1.1. Chapter overview

There is a legal requirement for companies to prepare financial statements or 'accounts'. Accounts summarise the results of transactions entered into by a company during a defined period of time (the 'period of account'). Accounts have many users, including investors, who use them to assess the company's financial position.

This chapter takes you through the three major financial statements that a company is required to prepare:

- The **balance sheet**: a snapshot of the company's assets and liabilities at the end of the accounting period
- The **income statement**: shows all the income and expenditure relating to a company's accounting period
- The **cash flow statement**: shows the cash received and cash paid by the company during the accounting period

This chapter summarises the main elements of these statements, including the legislation and the rules governing their preparation. Although you will be expected to know the laws and rules, you will not be tested on the section numbers themselves.

The chapter finishes with a short section on group accounts which explains terms such as 'parent', 'subsidiary' and 'minority interests'.

For the purposes of the IMC Investment Practice exam, accounting standards will not be referenced by number alone (i.e. IAS 39) and the number of the standard will not be the subject of a question.

1.2. Learning outcomes

On completion you will:

Financial statements: framework

- 10.1.1 Explain the legal requirement to prepare financial statements
- 10.1.2 Explain the concept of a company being a separate legal entity, and the purpose of the preparation of the accounts
- 10.1.3 Define 'small companies' for the purpose of financial statement preparation and explain the relevance of this definition to financial reporting requirements
- 10.1.4 Explain when accounts may be required to be prepared under International Financial Reporting Standards (IFRS) rather than Generally Accepted Accounting Practice in the UK (UK GAAP)
- 10.1.5 Explain the role of the auditor and identify, in outline, the reasons for auditors issuing a qualified report

Balance sheet

- 10.2.1 Explain the purpose of a balance sheet

- 10.2.2 Identify and explain the key balance sheet categories and content
- 10.6.4 Explain how goodwill arises in acquisition accounting
- 10.6.5 Explain the treatment of goodwill and intangible assets in the group accounts, including amortisation, useful lives and the requirement for impairment reviews
- 10.2.16 Identify and explain the main types of reserve found in the balance sheet
- 10.2.9 Identify the types of current and non-current liabilities that typically appear in financial statements
- 10.2.10 Explain the concept of a provision
- 10.2.11 Explain the treatment of contingent liabilities within financial statements
- 10.2.12 Describe the treatment of pension costs in financial statements
- 10.2.14 Distinguish among authorised, issued, paid up and called up share capital
- 10.2.15 Explain the effect of the following on a balance sheet: rights issue, bonus / scrip issue, stock split, share repurchases
- 10.3.1 Identify the various classifications of financial instrument and describe the accounting treatment of each

Balance sheet: further issues

- 10.2.4 Explain the valuation of non-current assets
- 10.2.5 Calculate depreciation under the straight-line and reducing balance methods
- 10.2.6 Calculate the profit or loss on disposal of a non-current asset
- 10.2.7 Explain the principles behind the valuation of inventories
- 10.2.8 Explain the effects of first-in-first-out and last-in-first-out valuations on inventory values and profits
- 10.2.13 Explain what is meant by a post-balance sheet event

Income statement

- 10.4.3 Identify the following different levels of profit and which classes of expenses are considered in arriving at each level: gross profit, trading (or operating) profit, and net profit
- 10.4.1 Identify and explain the classification of expenses based on nature or function
- 10.4.2 Explain the principle of revenue recognition
- 10.2.3 Distinguish between capitalising costs and expensing costs

Statement of changes in equity

- 10.4.4 Explain the objective of and identify the information to be reported in a statement of changes in equity

Cash flow statement

- 10.5.1 Explain the purpose of a cash flow statement

- 10.5.2 Identify the classification of cash flow activities
- 11.3.15 Explain the basics of Free cash-flow based valuation methods (FCFF, FCFE) and Residual Income Valuation methods

Cash flow statement: further issues

- 10.5.3 Calculate net cash flow from operations given operating profit (or vice versa) and the relevant balance sheet movements

Group accounts

- 10.6.2 Explain the purpose of group accounts
- 10.6.1 Define and distinguish between corporate investments, associated companies and subsidiaries
- 10.6.3 Define a minority interest and explain how it is represented in the financial statements

2. Financial statements: framework

2.1. Background

Financial statements (or **accounts**) summarise all transactions entered into by a company during its **accounting period**. This is important for the company owners – generally the shareholders – to assess the success (or failure) in the directors' abilities to run the company well.

There are three main financial statements: balance sheet, income statement and cash flow statement.

We saw in the equity types and feature chapter the concept of a company being a separate legal entity. Producing a set of accounts is the responsibility of the company directors. The accounts must then be audited by an independent firm of accountants (appointed by the shareholders) before they are approved by the shareholders at the company's annual general meeting.

Balance sheet

The balance sheet is a 'snap-shot' of a company taken on the last day of the accounting period (also known as the **year end** or **balance sheet date**). The balance sheet lists the assets and liabilities of a company, and provides a picture of the company's financial health at the year end.

If, at the year end, assets exceed liabilities, then the company has net assets. If the reverse is true, the company has net liabilities.

Income statement

The income statement shows all the income and expenditure relating to a company's period of account, usually lasting one year. It summarises income and expenditure for the whole 12-month period.

If income for a given period of account exceeds expenditure, a profit is made. If the reverse is true, a company will be loss-making.

Cash flow statement

The cash flow statement shows the cash received and paid by a company during the accounting period. It is similar to a bank statement and shows the reasons for the movements in cash in the period.

2.2. Companies Act 2006 (CA '06)

Introduction

The directors of a company are required to produce accounts annually. Those accounts must show a 'true and fair view', and must therefore be audited.

Large companies must also provide shareholders annually with:

- An income statement for the accounting reference period, normally 12 months
- A balance sheet relating to the end of the accounting reference period
- A directors' report
- An auditors' report
- A cash flow statement

- A statement of changes in equity

These documents must be delivered to the Registrar of Companies.

More stringent criteria are imposed on listed companies by the London Stock Exchange. These continuing obligations are contained in the Listing Rules, and include:

- The directors' reasons for any significant departure from standard accounting practice
- Particulars of companies in which the group holds 20% or more of the voting shares
- A statement as to whether or not the company is a close company (under the control of its directors or five or fewer persons)
- Particulars of any authority for the company to purchase its own shares

Listed companies also have to produce half-yearly (or interim) accounts

Exemptions

Bodies sole consist of sole traders and partnerships, and these entities have no legal requirement to produce accounts.

Companies that qualify as small or medium sized do not have to deliver full annual financial statements to the Registrar of Companies.

To be small or medium sized, a company must satisfy at least two of the following criteria:

Table 19. Criteria for exemption

	Small	Medium
Turnover	< £6.5m	< £25.9m
Total Assets	< £3.26m	< £12.9m
Employees	< 50	< 250

The auditor's report

Auditors are appointed by shareholders at company meetings. The role of the auditor is to report to shareholders on whether the accounts:

- Have been properly prepared (in accordance with the Companies Act and all relevant accounting standards)
- Give a 'true and fair view'

If both of these conditions are met, then the auditor will issue a 'clean' audit report. If not, then the auditor will 'qualify' the audit report.

Audit qualifications

There are two categories of qualified report:

- Limitation in scope: an opinion cannot be formed due to a lack of audit evidence
- Disagreement: the auditor disagrees with information in, or view given by, the financial statements

For each category of qualification, there are two possible magnitudes:

- Material: likely to influence a user of the financial statements
- Fundamental: so important as to undermine the financial statements as a whole

There are four types of qualification: fundamental uncertainty, material uncertainty, fundamental disagreement and material disagreement.

Exemptions

Only small companies are exempt from the need to have their accounts audited.

2.3. International Financial Reporting Standards

Introduction

From 1 April 2001 the International Accounting Standards Board (IASB) assumed responsibility for setting accounting standards from its predecessor, the International Accounting Standards Committee. International Financial Reporting Standards are the new numbered standards issued by the IASB.

The IASB issues International Financial Reporting Standards (IFRSs).

Impact on UK companies

The IASB does not have the authority to enforce compliance with the standards. However, regulations issued by the European Parliament stated that companies governed by laws in EU states, for financial years starting on or after 1 January 2005, must prepare their consolidated financial statements in line with IFRSs if they are a company whose shares trade on a regulated market in an EU member state.

This requirement only applies to the **consolidated** accounts of listed companies. In the UK, however, the DTI (now BIS) stated that listed companies can also use IFRSs in their individual accounts. Other companies in the UK can use them in both their individual and consolidated accounts.

UK companies not using IFRSs are expected to continue to comply with UK standards of the Financial Reporting Council (FRC) which has stated its intention not to issue any new standards that are more restrictive than IFRSs in the future.

The new standards, taking mandatory effect for accounting periods beginning after 1st January 2015, are being referred to as new UK Generally Accepted Accounting Policies (UK GAAP). This brings together various accounting standards:

- FRS 100 – Application of Financial Reporting Requirements
- FRS 101 – Reduced Disclosure Framework
- FRS 102 – Financial Reporting Standards applicable in the UK and Republic of Ireland

Luckily, we are not explicitly tested on the contents of these standards in the IMC.

European issues

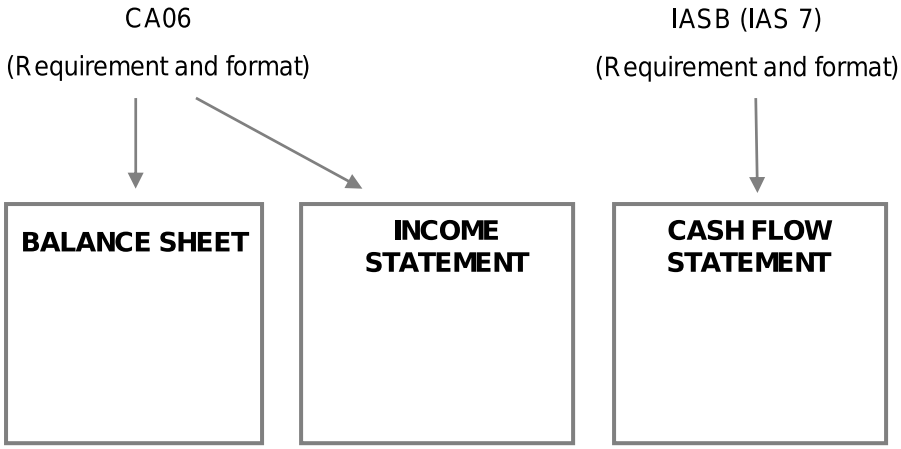
In the EU the main accounting directives (Fourth Council Directives) will continue to be the main regulations for entities not preparing their accounts in accordance with adopted IFRSs.

The EU has proposed that any conflicts between these European Directives and the IFRSs are eliminated and is committed to EU input into the development of further standards by the IASB. As a result the Accounting Review Committee has been set up to facilitate adoption of IFRSs in EU states whilst the European Financial Reporting Advisory Group will undertake the technical reviews.

2.4. Accounts: UKLA Listing Rules

The requirement to produce a set of yearly accounts is a **statutory** one for companies incorporated under UK law. In addition, listed companies are required by the UKLA (UK Listing Authority - the FCA) to produce financial information at six-monthly intervals (interim accounts).

2.5. Accounts: summary



3. Balance sheet

3.1. Introduction

The balance sheet is a list of the assets and liabilities of a company at its year-end.

It breaks down into two distinct halves: the top half reflects the total assets owned by the company; the bottom half reflects equity and liabilities, i.e. amounts paid in (or left in) by shareholders and creditors.

The total assets of a company (the top half) always equal equity and liabilities (the bottom half), i.e. the balance sheet balances.

Therefore, **total assets = equity + liabilities**. This is the **accounting equation**.

Note that net asset value can be calculated from the balance sheet.

Net assets = total assets - total liabilities.

3.2. Balance sheet: example

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**
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 borrowing	891
Total current liabilities	25,237
Total liabilities	54,161
TOTAL EQUITY AND LIABILITIES	**121,058**

3.3. Non-current assets (NCAs)

Introduction

NCAs are the long-term assets of a company. Long-term is generally taken to mean a life of longer than one year.

NCAs break down into three distinct categories: intangible, tangible and investments.

Money spent by a company on NCAs is referred to as **capital expenditure**. Any other expenditure is classed as **revenue expenditure**, and is charged against profit in the income statement.

Intangible non-current assets

Intangible NCAs are items that will generate future revenue but have no physical substance. Examples include goodwill, brand names, patents and copyrights.

Most intangible NCAs have a limited life, and so, over time, they wear out. As a result, their values in subsequent balance sheets need to be reduced.

For intangible NCAs the loss of value over their useable lives is reflected in the accounts through amortisation. However, goodwill is not amortised, instead the value is tested for **impairment** each year.

An impairment test will be applied to:

- All goodwill
- Intangible assets with an indefinite useful life
- Whenever there is an indication of impairment

Goodwill

Features

Goodwill is the combination of reasons why a buyer of a company might pay more than the sum total of the assets of that company.

The reasons might include reputation, brand loyalty, quality of products and staff.

Measurement of goodwill

Goodwill is measured as the difference between:

- The fair value of purchase consideration paid
- The fair value of the acquired business' identifiable assets and liabilities

Goodwill is the difference between the amount paid for a business and the assets acquired.

Example

P Ltd purchases all of the share capital of S Ltd for cash consideration of £100m. If the net assets of S Inc are worth £80m at the date of acquisition, the goodwill on acquisition is as follows:

	£m
Fair value of purchase consideration	100
Fair value of net assets acquired	(80)
Goodwill	20

Tangible non-current assets

Tangible NCAs are long-term assets with physical substance. They are items bought by a company to use to generate profit for the long-term.

Examples include land and buildings, motor vehicles, computers and fixtures and fittings.

Like intangible NCAs, tangible NCAs may wear out over time. The process by which the values of tangible NCAs are reduced as they wear out is known as **depreciation**.

Freehold land does not normally wear out over time. Therefore the Companies Act does not require it to be depreciated.

Non-current assets investments

NCA investments are usually shares purchased in other companies which are held for more than one year.

The NCA investment will be termed a **subsidiary** where the shareholding is greater than 50% or **associate** if between 20% and 50%.

NCA investments might also include loans made to other companies which are repayable in more than one year.

3.4. Current assets

Introduction

Current assets are the short-term assets of a company. They are held for conversion into cash, usually within one year of the balance sheet date.

There are three common types of current asset: inventory, receivables and cash.

Inventory

Inventory is the company's inventory held at the balance sheet date, e.g. a mobile phone retailer will have mobile phones in stock at the year end.

For a manufacturing company, inventory includes raw materials, work-in-progress (half finished goods) as well as finished goods.

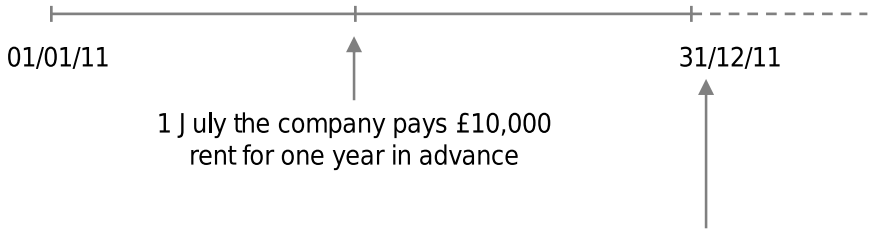
Inventory is valued prudently at the **lower** of cost and net realisable value. Net realisable value is the amount the company would receive if the item of inventory were sold today **less** any incidental costs of sale.

Receivables

Receivables are amounts owed to a company at the year end.

Although there may be several types of receivables, for the majority of companies the largest component of total debtors is **trade receivables**.

Trade receivables arise when sales are made on credit, and represent amounts owed to a company by its customers at the balance sheet date.



When the company comes to compile its balance sheet for 31/12/11 it has six months' worth of rent that it has paid for, but not used.

This **prepayment** of £5,000 will be recorded as an asset on the balance sheet.

Cash

Cash represents physical notes and coins and any credit balances in company bank accounts.

3.5. Equity

Reserves

Introduction

The reserves of a company represent amounts belonging to shareholders that have been retained by a company. The two most common types of reserve are the revaluation reserve and the profit and loss reserve.

Revaluation reserve

Companies have a choice over how they value tangible NCAs in the top half of the balance sheet.

They can either state them at cost (the amount originally paid for the assets) or at market value.

The process by which a company restates the values of its NCAs from cost to market value is known as **revaluation**.

Consider a company which revalues its properties. If market value is greater than cost (which is usually the case), then asset values in the top half of the balance sheet will increase. Since the top half of a balance sheet always equals the bottom half, the increase in asset values in the top half will have to

be matched by an associated increase in the bottom half. The line which increases in the bottom half is the **revaluation reserve**.

Thus, the revaluation reserve represents the cumulative amount by which asset values have increased as a result of revaluations.

This profit is not realised until the asset is sold and hence is non-distributable and cannot be used to pay dividends.

Profit and loss reserve

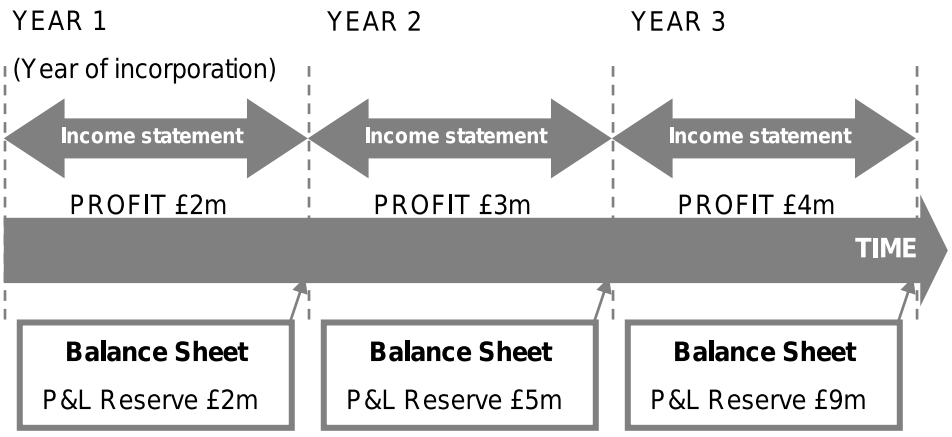
Retained profit is the profit left in a company to fund growth. The running total of retained profit to date is represented by the profit and loss reserve figure in the balance sheet.

Each year, the retained profit from the income statement is added to the profit and loss reserve in the balance sheet.

The company can use retained profit to fund the payment of dividends. The profit and loss reserve is therefore distributable. Scrip issues can also be made from the profit and loss reserve.

A negative balance on the profit and loss reserve is possible, and would usually indicate a poor trading history from incorporation.

Summary



Post balance sheet event

FRS 21 specifies the accounting treatment to be adopted (including the disclosures to be provided) by entities for events occurring between the balance sheet date and the date when the financial statements are authorised for issue. FRS 21 is virtually identical to the IASB's IAS 10 and therefore has the effect of implementing that IAS in the UK and Republic of Ireland.

FRS 21 sets out the recognition and measurement requirements for two types of event after the balance sheet date:

- Those that provide evidence of conditions that existed at the balance sheet date for which the entity shall adjust the amounts recognised in its financial statements or recognise items that were not previously recognised (**adjusting events**). For example, the settlement of a court case that confirms the entity had a present obligation at the balance sheet date
- Those that are indicative of conditions that arose after the balance sheet date for which the entity does not adjust the amounts recognised in its financial statements (**non-adjusting events**). For example, a

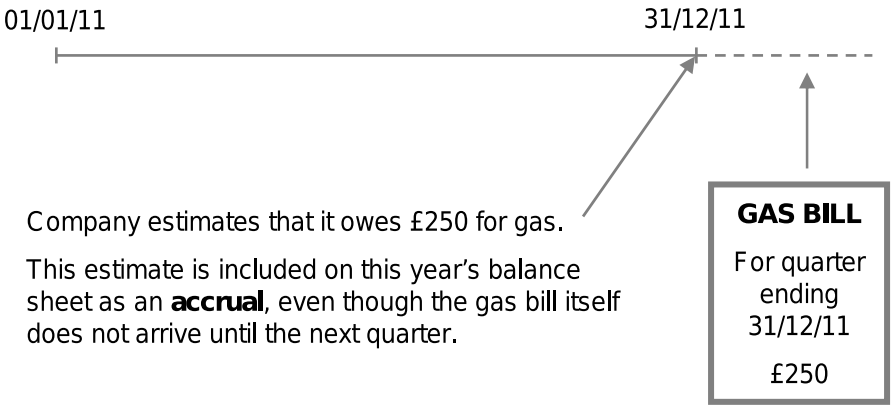
decline in market value of investments between the balance sheet date and the date when the financial statements are authorised for issue. **If a company declares dividends after the balance sheet date, then that is a non-adjusting event and the company will not recognise those dividends as a liability at the balance sheet date**

3.6. Current liabilities

Current liabilities are the opposite of current assets. They are amounts of money **owed** by a company and due for payment within one year of the balance sheet date.

A major component of current liabilities are usually **trade payables**. Trade payables are amounts owed to suppliers for purchases made on credit. Current liabilities also includes dividends, tax and overdraft payable.

Current liabilities will also include **accruals** (or more formally, 'accrued expenses'). Accruals are expenses that have been incurred by the year end, but not invoiced by the supplier. Examples include gas, electricity and telephone costs.



3.7. Non-current liabilities

Non-current liabilities are amounts owed by a company and due for payment **more** than one year from the balance sheet date.

Non-current liabilities tend to reflect the outstanding elements of any debt finance raised by a company. For example, the amount outstanding at the balance sheet date on a long-term bank loan would be a long-term liability.

If a company issued debentures or loan stock in order to raise money, then amounts owed to the debt holders would be included in non-current liabilities.

3.8. Provisions for liabilities and charges

If an organisation has a liability due to a past event, for example, as the result of losing a court case that will require compensation to be paid at a future date it may create a provision on their balance sheet to take into account this future liability. In order to meet the requirements for a provision the event must result in an outflow of resources to settle a liability; and the amount of the obligation needs to be reliably estimated.

3.9. Contingent liabilities

Sometimes a company may be faced with uncertain liabilities, referred to as contingent liabilities. For example, at the production of the accounts the company could be facing court action, or on a more everyday level, the company may have issued guarantees or warranties with their goods. Each of these could give rise to a contingent liability.

The general treatment of contingent liabilities is that they are regarded as not sufficiently predictable to warrant any specific provision being set aside for them in the accounts. However, a company should disclose in a note to the accounts the nature of the liability and any of the company's assets committed to covering the liability.

3.10. Accounting for occupational pension schemes (OPSs)

Defined benefit pension schemes run by a company on behalf of employees create an obligation on the sponsoring company to meet the liabilities set out in the scheme. The scheme's assets and liabilities will be assessed and the result will have a direct impact on the sponsoring company's balance sheet.

It is possible that this treatment could lead to volatility on the company's balance sheet, and in order to reduce this IAS19 allows the company to set a threshold of increase or decrease in the net asset value of the fund that needs to be recognised on the balance sheet (10%). Anything beyond that threshold can be charged through the income statement.

3.11. Share capital and share premium

Introduction

Share capital and share premium together represent a running total of amounts paid into a company by its shareholders. The distinction between the two is considered below.

Called up share capital is the total amount of issued capital for which the shareholders are required to pay. This may be less than the subscribed capital as the company may ask shareholders to pay by instalments

Paid up share capital is the amount of share capital paid by the shareholders. This may be less than the called up capital as payments may be in instalments ('calls-in-arrears')

Share capital

The **nominal value** of shares issued is recorded in the share capital line. It represents the minimum amount a company is legally permitted to accept for the shares it issues.

Share capital is therefore **nominal value x number of shares issued.**

For example, if a company issues 1m £1 ordinary shares for £1.50 each, share capital will increase by £1m, being the nominal value of the shares issued (1m shares x £1).

Share premium

Any excess over nominal value a company receives when issuing shares is recorded in the share premium account.

For example, if a company issues 1m £1 ordinary shares for £1.50 each, share premium will increase by £0.5m; the excess, over nominal value of the shares issued (1m shares x £0.50).

The uses of share capital and share premium are restricted by the Companies Act 2006.

The share premium account may be used in a limited manner as follows:

- Capitalised as part of a scrip issue (i.e. transferred from share premium to share capital)
- To write off preliminary expenses on formation of the company
- To write off costs associated with the issue of new shares
- To write off the premium or discount on the issue or redemption of debentures

3.12. Alterations in share capital

Introduction

Rights issues, scrip issues, stock splits, consolidations and company share buybacks all have an impact on the number of shares in issue. This will have to be accounted for in the balance sheet where the 'called up share capital' and 'share premium reserve' are recorded.

Equity

Called up share capital reflects the total nominal value of the shares in issue. If a company has 10m 10p shares in issue, the called up share capital will reflect £1m. However, it is unlikely that the company will have issued their shares for the nominal value; they will have attempted to raise as much as possible during the issue. Let's say they sold each 10p share for £1. This would create a surplus of 90p per share raised by the company. This surplus, £9m in total, would be shown in the share premium account.

Summary

Table 20. 10m 10p nominal value shares issued at £1 each

Assets	£m
Cash	10
Total assets	10
Equity	£m
Called-up share capital	1
Share premium reserve	9
Shareholders' funds	10

Bonus/Scrip issue

Now imagine the company performs a 1:1 scrip issue. This will lead the company to issue 10m additional 10p nominal value shares, causing the called up share capital to increase by £1m to £2m in total. The company, however, has raised no new capital, so this will need to be taken from the share premium reserve.

Summary

Table 21. After the 1:1 scrip issue

Assets	£m
Cash	10

Assets	£m
Total assets	10
Equity	£m
Called-up share capital	2
Share premium reserve	8
Shareholders' funds	10

Rights issue

Next, let's consider a rights issue. If the company chooses to perform a 1:2 rights issue at a subscription cost of 75p, this would lead to a 10m increase in the number of shares. Remember after the scrip issue the company now has 20m shares in issue. This would increase the called up share capital by a further £1m. On this issue the company does raise new capital - £7.5m – which can be used to fund the increase in the called up share capital, but will also increase the share premium reserve.

Summary

Table 22. After the 1.2 rights issue at a subscription cost

Assets	£m
Cash	17.5
Total assets	17.5
Equity	£m
Called-up share capital	3
Share premium reserve	14.5
Shareholders' funds	17.5

Share buyback

The treatment of a share buyback would lead to the cancellation of the value in equity and the reduction of cash. For this we will need to take our company on a little in its life and assume that it has been making a profit from whatever business it conducts. Let’s assume a profit of £10m. This profit, for simplicity, will be reflected in assets as cash.

Table 23. Company makes £10m in profits

Assets	£m
Cash	27.5
Total assets	27.5
Equity	£m
Called-up share capital	3
Share premium reserve	14.5
Retained earnings	10
Shareholders' funds	27.5

Rather than pay out high dividends, the company chooses to reduce the issued shares through a buy-back and provide a capital return to its investors. If, for example, our company now buys back 10m shares for 80p each, this will cost the company £8m in cash. It will also reduce the called up share

capital by £1m. The surplus spent on the shares - £7m - will be taken from the retained earnings or profit and loss reserve.

Summary

Table 24. Company buys back 10m shares at 80p each

Assets	£m
Cash	19.5
Total assets	19.5
Equity	£m
Called-up share capital	2
Share premium reserve	14.5
Retained earnings	3
Shareholders' funds	19.5

The effect on the underlying value of the company should be neutral because although the net assets of the firm have reduced (i.e. surplus cash has been spent or debt has been increased), the reduced number of shares in issue should counterbalance this.

Stock split/consolidation

Finally, if a company chooses to perform a stock split or a consolidation, there will be no change to the share capital of the company, instead the nominal value of the share is adjusted to reflect the increase or decrease in the number of shares.

For example, if the company performs a stock split where each share is split in two, not only will this double the number of shares but it will also halve the nominal value of the share. This will result in the called up share capital remaining constant, so no adjustment in the balance sheet would be needed.

If the company performed a consolidation, the number of shares reduces, but the nominal value increases, so again there is no change to the called up share capital.

3.13. Classification of financial instruments

Introduction

The objective of IAS32 is to establish principles for classifying financial instruments, from the perspective of the issuer, into financial assets, financial liabilities and equity instruments. It also considers the treatment of shares repurchased by the company and situations in which the company can net off financial assets and liabilities. The principles in this standard complement the principles for recognising and measuring financial assets and financial liabilities in IAS 39.

Definitions

Financial instrument

A financial instrument is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

Financial asset

This category includes cash, equity instruments in other companies and the debt instruments, including convertibles, of another company.

Financial assets are:

- Cash
- An equity instrument of another entity
- A contractual right to receive cash or another financial asset from another entity; or to exchange financial instruments with another entity under conditions that are potentially favourable to the entity
- A contract that will or may be settled in the entity's own equity instruments

Financial liability

This category includes loans and debt instruments, including convertibles, issued by the company.

Financial liabilities are:

- Contractual obligations
- To deliver cash or another financial asset to another entity
- To exchange financial instruments with another entity under conditions that are potentially unfavourable
- A contract that will or may be settled in the entity's own equity instruments

Equity or liability

According to IAS32 an equity instrument is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities. Equity must not involve any further contract or obligation on the issuing company. Any instrument that does not fall within this broad criterion would be a liability.

For example, a standard preference share issued by a company receives payment in the case of liquidation only when all creditors have been paid. It also exposes that company to no further obligations. The company will pay out the dividend at its discretion and there will be no future repurchase of the share. This share will be classified as equity.

A redeemable preference share, however, binds the company to a repurchase of the share at nominal value on a future date. This further obligation, under IAS32, classifies a redeemable preference share as a liability and the dividends would be considered an interest expense.

Recognition

IAS32 also considers when the financial instrument should be recognised on the financial statement. This is simple to assess with the purchase of a share or a bond for example, as the instrument can be recognised on payment of receipt of the monies due. However, for some derivative investments where there is no net initial outflow of cash, the obligations may not become visible until the maturity date. For this reason, IAS32 states that the recognition should occur when the contract is agreed, rather than when the asset is paid for.

Repurchased shares

In the UK, if a company buys back its own shares, those shares will be deducted from the company's equity on the balance sheet. Any gain or loss will not be recognised in profit or loss.

Types of Financial Asset

Under IAS 39, a company is required to classify its financial assets into one of the following four categories:

Financial assets at fair value through profit or loss (FVTPL)

Derivatives will be placed in this category, unless it is considered as part of a hedge, as will any assets held for the pure purpose of trading. In this way they are marked-to-market at the time of producing the financial statements and any profit or loss, realised or unrealised, is reflected in the profit and loss account.

Loans and receivables

These are non-derivative financial assets with fixed or determinable payments that are not quoted on an active market. Accounts receivable or loans to customers could be included in this section.

Held-to-maturity investments (HTM)

Financial assets with fixed or determinable payments and fixed maturity that the company has the positive intent and ability to hold to maturity (that is the company is indifferent to profit opportunities arising from changes in the fair value). These would normally include tradable debt instruments such as corporate or government bonds.

Available-for-sale financial assets

These would be non-derivative assets not classified in any of the other categories. For example, if the company holds equity as a long-term investment, rather than for trading, then the equity would fall into this category.

Derecognition

This occurs when either:

- The contractual rights to the cash flows of the financial asset have expired
- The financial asset has been transferred (e.g. sold)

Types of Financial Liability

IAS 39 recognises two classes of financial liabilities:

- Financial liabilities at fair value through profit or loss
- Other financial liabilities measured at amortised cost using the effective interest method

Financial liabilities at fair value through profit or loss

The category of financial liability at fair value through profit or loss has two subcategories:

- Designated. a financial liability that is designated by the entity as a liability at fair value through profit or loss upon initial recognition
- Held for trading. a financial liability classified as held for trading, such as an obligation for securities borrowed in a short sale, which have to be returned in the future

Initially, financial assets and liabilities should be measured at fair value (including transaction costs, for assets and liabilities not measured at fair value through profit or loss.

Other financial liabilities measured at amortised cost using the effective interest method

If a fair value cannot be derived the liability should be valued at amortised cost. For many companies the majority of liabilities are valued in this way. Amortised cost is calculated using the effective interest method.

The following financial assets and financial liabilities are normally measured at fair value in the balance sheet:

- Financial assets at fair value through profit or loss
- Available-for-sale financial assets
- Financial liabilities at fair value through profit or loss

4. Balance sheet: further issues

4.1. Depreciation of tangible non-current assets

Introduction

Depreciation accounts for the 'wearing out' of tangible NCAs over time.

Each year, an amount for depreciation is deducted from the value of tangible NCAs in the balance sheet, and also charged to the income statement (to represent the cost of using the assets).

At any point in time, the value of tangible NCAs in the balance sheet (or 'net book value') is the original cost less the total cumulative depreciation to date (or 'accumulated depreciation').

Net book value = Cost of asset - Accumulated depreciation

Calculation of depreciation

The requirement to depreciate tangible NCAs with limited useful lives comes from CA '06. The rationale is to represent the part of the cost of the asset used to generate revenues in that year.

There is no set method for calculating depreciation, and a variety of methods are used in practice. The most common of these are 'straight line' and 'reducing balance'.

Straight line method of depreciation

This is the most common (and most straightforward) method of calculating depreciation.

$$\text{Annual depreciation} = \frac{\text{Original cost} - \text{Expected residual value}}{\text{Expected useful life}}$$

Expected useful life is an estimate of how long a company will **use** an asset.

Expected residual value is an estimate of the future resale or scrap value.

Example

A Ltd buys a van with an expected useful life of four years for £20,000. Expected residual value is £4,000. What is the annual depreciation charge, using the straight line method, and what impact will this have on the financial statements of A Ltd?

Annual depreciation

$$\text{Straight line depreciation} = \frac{\text{Cost} - \text{Residual value}}{\text{Life}}$$

$$\text{Straight line depreciation} = \frac{£20{,}000 - £4{,}000}{4 \text{ years}} = £4{,}000 \text{ per year}$$

Impact on financial statements

	Year 1	Year 2	Year 3	Year 4
Balance sheet	**£**	**£**	**£**	**£**
Cost	20,000	20,000	20,000	20,000
Depreciation	(4,000)	(8,000)	(12,000)	(16,000)
NBV	16,000	12,000	8,000	4,000
Income statement				
Expense	4,000	4,000	4,000	4,000

Reducing balance method of depreciation

This method calculates annual depreciation as a constant percentage of the previous period's net book value.

In decimal terms, the constant percentage is calculated as:

$$\text{Annual depreciation} = 1 - \sqrt[n]{\frac{\text{Expected residual value}}{\text{Original cost}}}$$

Example

A Ltd buys a van with an expected useful life of four years for £20,000. Expected residual value is £4,000. What is the annual depreciation in decimal terms, using the reducing balance method, and what impact will this have on the financial statements of an Ltd?

Annual depreciation in decimal terms

$$\text{Annual depreciation} = 1 - \sqrt[n]{\frac{\text{Expected residual value}}{\text{Original cost}}}$$

$$\text{Annual depreciation} = 1 - \sqrt[4]{\frac{£4,000}{£20,000}}$$

$$\text{Annual depreciation} = 0.3313 \text{ (or } 33.13\%)$$

Impact on financial statements

	Year 1	Year 2	Year 3	Year 4
Balance sheet	**£**	**£**	**£**	**£**
Cost	20,000	20,000	20,000	20,000
Depreciation	(6,625)	(11,056)	(14,019)	(16,000)
NBV	13,375	8,944	5,981	4,000
Profit and loss account				
Expense	6,625	4,431	2,963	1,981

4.2. Disposals of non-current assets

When assets are disposed of, the profit or loss on disposal is calculated as the sales' proceeds less the balance sheet value of the asset at the date of disposal.

This profit or loss will appear in the income statement for the period.

4.3. Valuation of inventory

For retail companies, trading inventory comprises goods for resale (e.g. mobile phones in the case of a mobile phone retailer).

For a manufacturing company, there are three categories of inventory:

- Raw materials
- Work-in-progress
- Finished goods

When placing a value on inventory, the ideal is actual cost. However, particularly with large manufacturing companies, problems in identifying actual cost arise when materials are bought in batches and stored in common areas.

The solution is to adopt an appropriate 'cost flow assumption'; the three most common being:

- First in first out (FIFO) - under FIFO, old inventory purchases are sold first, leaving new items in year end inventory
- Last in first out (LIFO) - under LIFO, new inventory purchases are sold first, leaving old items in year end inventory
- Weighted average - inventory is drawn proportionally from units held

Example

The following information relates to A plc for its first year of trading to 31 March 2001.

Purchases

Date	Quantity	Price	Total
		£	£
30/6/00	35,000	2.00	70,000
30/9/00	27,000	2.10	56,700
31/12/00	45,000	2.20	99,000
31/3/01	32,000	2.30	73,600
	139,000		299,300
Sales	89,000		267,000

Value the closing inventory of 50,000 units using:

(1) Weighted average

$$\text{Weighted average price} = \frac{\text{Total cost of purchases}}{\text{Total number of units purchased}}$$

$$= \frac{£299{,}300}{139{,}000} = £2.15$$

Profit

	£
Sales 89,000 @ £3	267,000
Cost of sales 89,000 @ £2.15	(191,638)
Profit	75,362

Closing stock

50,000 @ £2.15	107,662

(2) First in first out – FIFO

Profit

		£
Sales 89,000 @ £3		267,000
Cost of sales	35,000 @ £2.00	
	27,000 @ £2.10	
	27,000 @ £2.20	(186,100)
Profit		80,900

Closing stock

18,000 @ £2.20	
32,000 @ £2.30	113,200

(3) Last in first out – LIFO

Profit

		£
Sales 89,000 @ £3		267,000
Cost of sales	32,000 @ £2.30	
	45,000 @ £2.20	
	27,000 @ £2.10	(197,800)
Profit		69,200

Closing stock

15,000 @ £2.10	
35,000 @ £2.00	101,500

4.4. Provisions for doubtful debtors

Introduction

Debtors are amounts owed to a company and are current assets. They form part of the ‘receivables’ balance under current assets on the balance sheet.

Debtors generally arise from sales made on credit terms. With credit sales, there is always a risk that the customer cannot or will not pay. This is termed 'credit risk'.

Bad debts

If a company is certain that a customer is not going to pay, the associated debt is termed 'bad'.

'Bad debts' are written off to the income statement as an expense to the business. They are also removed from receivables in the balance sheet (as they no longer form part of the list of amounts owed, and expected to be paid, to the company).

Doubtful debts

If there is doubt over the recovery of certain debts (but not sufficient for them to be classed as bad), a provision is set up against them.

4.5. Post-balance sheet events

There is a distance in time between the balance sheet date and the date on which the directors approve the accounts. During this time events that will have an impact on the balance sheet will obviously occur. These are called post-balance sheet events.

IAS 10 identifies two types of post-balance sheet event: adjusting events and non-adjusting events.

Adjusting events relate to events that arise from conditions existing at the balance sheet date, such as the insolvency of a debtor or the obsolescence of inventory. In these cases, the accounts should be adjusted.

Non-adjusting events are those that stem from new conditions that did not exist on the balance sheet date, such as the acquisition of a large non-current asset or disclosure of a dividend. Although the event will not be included on the balance sheet itself, it may be necessary to disclose it if the company believes that the information is necessary for proper valuations of the company.

5. Income statement

5.1. Background

The income statement records the items of income and expenditure relating to a company's accounting period.

The **income statement** shows the profit from trading (**operating profit**) and how that profit is used, i.e. the payment of interest, tax and dividends.

If the company has any profit left after all items of expenditure have been incurred, it is called **retained profit**, and is added to the profit and loss reserve in the balance sheet.

5.2. Example

XYZ plc.

Income statement for the year ended

31 March 20X2

	Discontinued operations	Continuing operations	Total
	20X2 £000	20X2 £000	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

5.3. Capital and revenue expenditure

The day-to-day running costs of business (staff wages, purchase of trading stock, rent of business premises, and so on) are referred to as revenue expenditure.

Capital expenditure (goodwill, the purchase of business premises, plant and machinery used in the business process and so on) generally results in a non current asset.

5.4. Turnover/Revenue

Turnover consists of sales the company has made. It represents the income generated by a company from selling its products or services. Both cash and credit sales are included.

Turnover is usually recognised when the production process is complete and recoverability of the associated revenue is certain. This normally equates to recognition at a 'critical point' in the sales process, like despatch of goods for a manufacturing company or point of sale for a retail outlet.

Where companies undertake long-term contracts which span more than one accounting period, e.g. construction of major assets like roads or bridges, it may be appropriate to apportion revenues, costs and profits over the life of the projects and recognise a proportion in each of the accounting periods affected.

5.5. Cost of sales and operating costs

Cost of sales includes all the costs directly associated with producing a product or providing a service. For example, a car manufacturer would include all the raw material, labour and other costs directly associated with car production.

Selling and distribution covers getting the goods to the customer such as advertising and transportation.,

Direct and indirect costs

In manufacturing companies, costs are often classified as 'direct' or 'indirect'.

Direct costs are those costs directly attributable to production of a particular good, like raw materials, depreciation of production machinery and wages paid to production workers.

Indirect costs (or 'overheads') are general expenses like heat, light, power and insurance.

5.6. Operating/trading profit

Turnover less the costs of producing the product and running the business gives operating profit. This is the profit from trading.

Other ways of referring to operating profit are **trading profit**, **profit before interest and tax** (PBIT) or **earnings before interest and tax** (EBIT).

5.7. Extraordinary items

Under IAS 1 unusually large items of income or expense must be highlighted in the **income statement** to assist the reader in determining profit from normal operations. These should be classed as **material items**.

Examples of material items might include the costs of a redundancy programme, unusually large bad debts, settlement of a law suit or sizeable profit on the disposal of a fixed asset. IAS 1 specifically **bans the term 'extraordinary items'** although it makes no reference to the use of the term 'exceptional items'.

5.8. Interest and tax

If a company has debt finance it will be required to service that finance by paying interest.

Interest is paid out of operating profit.

Corporation tax is paid out of operating profit less interest.

5.9. Dividends

If a company has profit remaining after the payment of interest and tax, it can reward shareholders by paying out dividends.

Dividends paid and proposed in relation to an accounting period will be reduce the amount that can be added to retained profit.

5.10. Retained profit

Any profit remaining after **all** payments have been made is retained by the business.

The retained profit is added to the profit and loss reserve in the balance sheet.

6. Statement of changes in equity

We mentioned that the balance sheet contains details on the equity of the company, including called up share capital, premium reserve, revaluation reserve and retained earnings. However, the balance sheet is a static image of the capital and reserves that amount to the shareholders' funds and any changes may be difficult to identify.

IAS 1 requires an entity to present a statement of changes in equity as a separate component of the financial statements. A statement of changes in equity is an important component of financial statements since it explains the composition of equity and how has it changed over the year. The statement must show:

- The amount of new share capital issued
- The amount of dividend paid during the year to shareholders
- The amount by which property, plant and equipment is valued up or valued down
- The amount of net income retained during the year
- Any movement in the unrealised loss or gain reserve and reserve for changes in foreign exchange gain or loss

7. Cash flow statement

7.1. Introduction

The balance sheet and income statement are prepared on an accruals basis, matching income and expenditure in the period to which they relate, irrespective of underlying cash movements.

Profit is a key performance measure, but it is not necessarily supported by cash generation, as not all income statement items have an immediate cash effect. For example:

- Depreciation is charged against profit but has no associated cash outflow: it is a non-cash item
- Sales and purchases may be made on credit, leading to differences between recognition in the income statement and the associated cash receipt or payment

Since cash is vital to the ongoing viability of a company, we need a statement showing how much cash a company has generated, what other sources of cash have been used, and what applications of cash the company has made. This is the role of the cash flow statement.

Most UK companies are required to prepare a cash flow statement. However, the exam requires you to know the format of the cash flow statement under International Accounting Standard 7 (IAS 7).

7.2. Categories of cash flow

IAS 7 requires companies to group cash flows under three main headings:

- Operating: cash flows resulting from the business activities of a company
- Investing: cash flows in relation to the acquisition and disposal of non-current assets
- Financing: cash flows resulting from the issue or redemption/repayment of equity and debt

7.3. Cash flow statement 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

7.4. Definitions of cash flow

Free cash flow

Free cash flow quantifies the 'surplus' cash that a company has available. In its simplest form, free cash flow is the cash remaining once a company has covered all 'compulsory' (non-discretionary) payments.

Two common versions are enterprise cash flow and equity cash flow.

Enterprise cash flow (free cash flow to the firm - FCFF)

Enterprise cash flow is the total cash flow generated by a company that is available to all providers of capital; both lenders and equity holders. It gives a measure of cash flow which is comparable across companies irrespective of capital structure, as no payments to providers of capital have been deducted.

Free Cash Flow to the Firm (FCFF)

- Net cash from operating activities (Net income + non cash charges – working capital expenditure)
- - Capital expenditure
- + Net interest payments
- = FCFF

Equity cash flow (free cash flow to equity - FCFE)

Equity cash flow represents the cash flow generated by a business that is available to equity shareholders only. This will exclude the cash owed to lenders and simply looks at the free cash flow before the shareholders receive dividends.

FCFE =

- Net cash from operating activities
- - Capital Expenditure
- + Net borrowing

Therefore FCFE = FCFF – Net interest + Net borrowing

8. Cash flow statement: further issues

8.1. Reconciling Net Cashflow from Operating Activities with Operating Profits

The derivation of the line in a cash flow statement, 'net cash flow from operating activities', is often disclosed in the financial statements by way of a separate note.

The note reconciles 'operating profit' (from the income statement) to the actual cash generated from trading activities ('net cash inflow from operating activities' - the top line in the cash flow statement).

The main adjustments are:

- Depreciation charges: add to trading profit
- Increase in provisions: add to trading profit
- Increase/decrease in inventory (‘stock’): deduct from/add to trading profit
- Increase/decrease in debtors (‘receivables’): deduct from/add to trading profit
- Increase/decrease in creditors (‘payables’): add to/deduct from trading profit

Example

DEF Plc

Reconciliation of operating profit to operating cash flow

	2010
	£m
Group operating profit	29.1
Depreciation charges	5.4
Increase in stocks	(1.0)
Decrease in debtors	0.4
Increase in creditors	3.5
Net cash inflow from operating activities	37.4

9. Group accounts

9.1. Introduction

If a company is a **parent** company, then **group accounts** have to be prepared in addition to the parent company's individual accounts.

Group accounts are intended to report the performance of a group of companies which operate under the control of a parent company.

9.2. Parent company

A company is a **parent** of another company (a **subsidiary**) if it holds the majority of the voting rights in that company.

9.3. Group

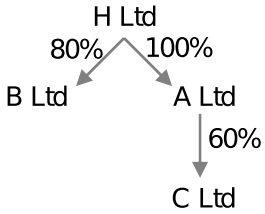
A group consists of a **parent company** and its **subsidiary/subsidiaries**. Ownership of over 50% creates a subsidiary and requires the preparation of group accounts.

An **associate company** (or associate) in accounting and business valuation is a company in which another company owns a significant portion of voting shares, usually 20–50%. In this case, an owner usually does not consolidate the associate's financial statements.

UK and international accounting standards state that control of a company by another can still occur where the parent company owns less than 50% of the share capital of the subsidiary. Control can be evidenced by power:

- Over more than half of the voting rights by virtue of an agreement with other investors
- To govern the financial and operating policies of the other enterprise under a statute or an agreement
- To appoint or remove the majority of the members of the board of directors
- To cast the majority of votes at a meeting of the board of directors

9.4. Group: example

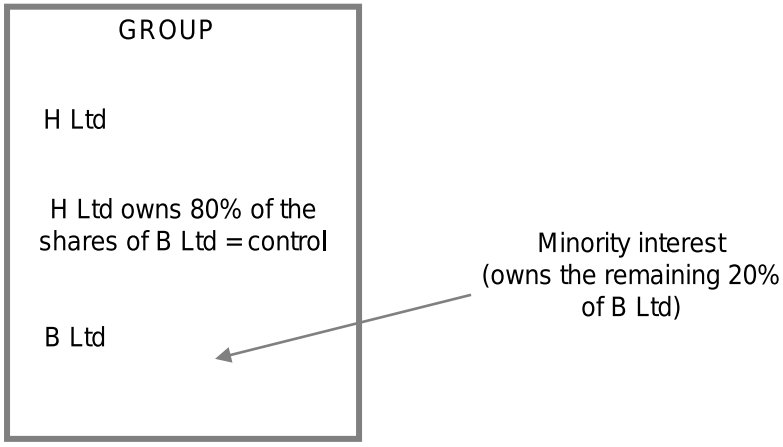


The group consists of:

- 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)

9.5. Minority interest

In the diagram, H Ltd owns 80% of the shares in B Ltd. A holding of more than 50% represents legal control, so H Ltd controls B Ltd. As such, B Ltd is a subsidiary of H Ltd and together they represent a group.



Despite the fact that H Ltd controls B Ltd, it does not have a 100% holding. The remaining 20% represents the minority interest in B Ltd.

The minority interest is legally entitled to 20% of the profits and assets of B Ltd.

In group accounts:

- The results and assets of both entities are added together, as H Ltd **controls** them all
- The minority interest's share of profit (in the income statement) and assets (in the balance sheet) is taken out of the group results via a **minority interest** line

10. Company accounts: summary

10.1. Key concepts

Financial statements: framework

- 10.1.1 Explain the legal requirement to prepare financial statements
- 10.1.2 Explain the concept of a company being a separate legal entity, and the purpose of the preparation of the accounts
- 10.1.3 Define ‘small companies’ for the purpose of financial statement preparation and explain the relevance of this definition to financial reporting requirements
- 10.1.4 Explain when accounts may be required to be prepared under International Financial Reporting Standards (IFRS) rather than Generally Accepted Accounting Practice in the UK (UK GAAP)
- 10.1.5 Explain the role of the auditor and identify, in outline, the reasons for auditors issuing a qualified report

Balance sheet

- 10.2.1 Explain the purpose of a balance sheet
- 10.2.2 Identify and explain the key balance sheet categories and content
- 10.6.4 Explain how goodwill arises in acquisition accounting
- 10.6.5 Explain the treatment of goodwill and intangible assets in the group accounts, including amortisation, useful lives and the requirement for impairment reviews
- 10.2.16 Identify and explain the main types of reserve found in the balance sheet
- 10.2.9 Identify the types of current and non-current liabilities that typically appear in financial statements
- 10.2.10 Explain the concept of a provision
- 10.2.11 Explain the treatment of contingent liabilities within financial statements
- 10.2.12 Describe the treatment of pension costs in financial statements
- 10.2.14 Distinguish among authorised, issued, paid up and called up share capital
- 10.2.15 Explain the effect of the following on a balance sheet: rights issue, bonus / scrip issue, stock split, share repurchases
- 10.3.1 Identify the various classifications of financial instrument and describe the accounting treatment of each

Balance sheet: further issues

- 10.2.4 Explain the valuation of non-current assets
- 10.2.5 Calculate depreciation under the straight-line and reducing balance methods

- 10.2.6 Calculate the profit or loss on disposal of a non-current asset
- 10.2.7 Explain the principles behind the valuation of inventories
- 10.2.8 Explain the effects of first-in-first-out and last-in-first-out valuations on inventory values and profits
- 10.2.13 Explain what is meant by a post-balance sheet event

Income statement

- 10.4.3 Identify the following different levels of profit and which classes of expenses are considered in arriving at each level: gross profit, trading (or operating) profit, and net profit
- 10.4.1 Identify and explain the classification of expenses based on nature or function
- 10.4.2 Explain the principle of revenue recognition
- 10.2.3 Distinguish between capitalising costs and expensing costs

Statement of changes in equity

- 10.4.4 Explain the objective of and identify the information to be reported in a statement of changes in equity

Cash flow statement

- 10.5.1 Explain the purpose of a cash flow statement
- 10.5.2 Identify the classification of cash flow activities
- 11.3.15 Explain the basics of Free cash-flow based valuation methods (FCFF, FCFE) and Residual Income Valuation methods

Cash flow statement: further issues

- 10.5.3 Calculate net cash flow from operations given operating profit (or vice versa) and the relevant balance sheet movements

Group accounts

- 10.6.2 Explain the purpose of group accounts
- 10.6.1 Define and distinguish between corporate investments, associated companies and subsidiaries
- 10.6.3 Define a minority interest and explain how it is represented in the financial statements

Now you have finished this chapter you should attempt the chapter questions.