Chapter 2 revision notes

Financial statements of limited companies – balance sheet

Financial statements of limited companies
Limited companies are required to periodically prepare three main financial statements: balance sheet; profit and loss account; cash flow statement.

Balance sheet
The balance sheet summarises the financial position of the business; it is a financial snapshot at a moment in time.
The balance sheet comprises a number of categories, within the three main elements, which are labelled assets, liabilities or shareholders equity (equity). The assets are debit balances and the liabilities and shareholders equity are credit balances.

total assets (TA) = equity (E) + total liabilities (TL)

Profit and loss account
Profit (or loss) may considered in two ways, which both give the same result.
The profit and loss account shows the change in wealth of the business over a period. The wealth of the business is the amount it is worth to the owners, the shareholders. The accumulation of the total change in wealth since the business began up to a particular point in time is reflected within the equity section of the balance sheet under the heading retained profits.
The profit and loss account may also be considered in its measurement of the trading performance of the business. The profit and loss account calculates whether or not the company has made a profit or loss on its operations during the period, through producing and selling its goods or services. The result, the net earnings or net profit (or loss), is derived from deducting expenses incurred from revenues derived throughout the period.

Cash flow statement
Between them, the balance sheet and profit and loss account show a company's financial position at the beginning and at the end of an accounting period and how the profit or loss has been achieved during that period.
The cash flow statement goes further in answering the questions like:

- how much capital expenditure (for example, equipment, machinery and buildings) has the company made, and how did it fund the expenditure?
- what was the extent of new borrowing and how much debt was repaid?
- how much did the company need to fund new working capital (which includes, for example, an increase in debtors and stock requirements as a result of more business activity)
- how much of the company's funding was met by funds generated from its trading activities, and how much met by new external funding (for example, from banks and other lenders, or new shareholders)?

The aim of the cash flow statement is to summarise the cash inflows and outflows and calculate the net change in the cash position for the company throughout the period.

What does the balance sheet tell us?
In theory the balance sheet of a private limited company or a public limited company should be able to tell us all about the company’s financial structure, and liquidity, the extent to which its assets and liabilities are held in cash or in a near cash form (for example, bank accounts and deposits). It should also tell us about the assets held by the company, the proportion of current assets and the extent to which they may be used to meet current obligations.
An element of caution should be noted in analysing balance sheet information. The balance sheet is an historical document. It may have looked entirely different six months or a year ago, or even one week ago. There is not always consistency between the information included in one company’s balance sheet with that

of another company. Two companies even within the same industry are usually very difficult to compare. Added to that, very often, different analysts use the same ratios in different ways.

Structure of the balance sheet

Categories within the balance sheet are classified into shareholders equity, liabilities, and assets.

Assets are acquired by a business to generate future benefits, for example from trading or whatever activities the business has been set up to provide. To acquire assets the business must first raise the necessary funds. In doing so the claims or obligations are created in the form of shareholders' equity or liabilities.

Shareholders equity and both long-term and current liabilities represent claims, or obligations, on the company to provide cash or other benefits to a third party. Equity, or capital, represents a claim by the owners, or shareholders, of the business against the business.

Liabilities represent claims by other than the owners of the business, against the business. These claims arise from transactions relating to the provision of goods or services, or lending money to the business.

Capital and reserves (or shareholders' equity)

- capital
- premiums
- retained earnings

Liabilities

current, or short-term, liabilities:

- short-term financial debt
- trade creditors (or accounts payable)
- accruals

long-term liabilities:

- long-term financial debt
- long-term trade creditors (or accounts payable)
- provisions

Assets

fixed assets:

- tangible fixed assets
- intangible fixed assets
- financial assets

current assets:

- stocks
- debtors (or accounts receivable)
- cash
- prepayments

Balance sheet formats

The horizontal format, now rarely used in practice within businesses, clearly illustrates how total assets equal the total of liabilities (and equity).

total assets (TA) = equity (E) + total liabilities (TL)

$$TA = E + TL$$

or

fixed assets (FA) + current assets (CA)
= equity (E) + long-term liabilities (LTL) + current liabilities (CL)

$$FA + CA = E + LTL + CL$$

The more commonly used format is the vertical format, which rearranges the above equation to become

$$FA + (CA - CL) - LTL = E$$

Each element in the equation is represented vertically with total assets less total liabilities equal to, or represented by the equity of the company.

The Companies Act requires comparative figures for the previous year for each line in the balance sheet. These are normally shown in a column to the right of the current year's figures.
The Companies Acts 1985/1989 require group accounts to be prepared for the holding company in addition to the accounts that are required to be prepared for each of the individual companies within the group. These 'consolidated accounts' exclude all transactions between companies within the group, for example, inter-company sales and purchases to avoid double counting of transactions. In most other respects, the group consolidated accounts reflect an amalgamation of each of the components of the balance sheets of all the companies within the group.

Valuation of assets

Valuation of the various items within the balance sheet is covered by the Companies Act 1985/1989, accounting concepts and standards. Within the rules, alternative methods may be used to value the different categories of assets (and liabilities) within the balance sheet, that support the fundamental requirement to give a true and fair view.
Differences between the methods chosen to value various assets (and liabilities) at the end of accounting periods may have a significant impact on the results reported in the profit and loss account for those periods. Examples of this may be seen in:

- fixed assets and depreciation
- stocks valuations and cost of sales
- valuations of accounts payable and accounts receivable denominated in foreign currencies
- provisions for doubtful debts

The Companies Acts 1985/1989, accounting concepts, and the accounting standards (SSAPs and FRSs) lay down certain rules for the valuation of balance sheet items, including:

- fixed assets
- brand names
- goodwill
- research and development costs
- stocks
- debtors
- foreign currency transactions

Balance sheet limitations

There are limitations to the conventional balance sheet arising not only from the fact that it is an historical document, but from inconsistencies in its preparation between companies and industries, the employment of various asset valuation methods, off-balance sheet financing, and window dressing.