FACTFILE:
GCE PROFESSIONAL BUSINESS SERVICES

UNIT AS 3: FINANCIAL DECISION MAKING – FINANCIAL STATEMENTS

Rewarding Learning

Learning Outcomes

Students should be able to:

- Analyse and interpret the following elements of financial statements:

  1. Income statement, including:

  - sales revenue;
  - cost of goods sold;
  - gross profit;
  - expenses; and
  - net profit.

  2. Statement of financial position, including:

  - non-current assets;
  - current assets;
  - equity;
  - liquidity;
  - non-current liabilities; and
  - current liabilities;
    (Students do not need to construct a set of financial statements.)

Financial statements

All businesses are required to produce summary statements periodically (usually on an annual basis), which indicate the net profit or loss for the accounting period and summarise the financial position.

Income Statement - summarises income/expenses and details the profits/losses made by the business in the accounting period.

Statement of Financial Position - details in summary format, the financial position of the business.

Notes to the financial statements - provide more detail on the relevant items contained within the financial statements.

Accounting Terminology

Main terminology used in preparation of financial statements:

Sales Revenue is income earned in the accounting period from trading activities.

Cost of Sales is a subsidiary calculation required to determine the actual cost of selling products – a mathematical calculation using the following formula:

Cost of sales = opening inventory + purchases – closing inventory

Gross Profit or Loss is the difference between Sales Revenue and Cost of Sales.

Expenses are costs of running the business during the accounting period. Typically used in the period to which the financial statements relate (e.g. electric used to generate energy/rates of the business premises).

Net Profit or loss is the total income in the period less the total expenses incurred in the accounting period.

Income Statement – summarises income/expenses and details the profits/losses made by the business in the accounting period.

Statement of Financial Position – details in summary format, the financial position of the business.

Collectively, these two financial statements are known as the 'final accounts'.

The preparation and presentation of final accounts or financial statements is more commonly associated with the discipline of 'financial reporting', which is distinct from other accounting disciplines such as management accounting and financial management.

Statement of Financial Position:

Asset: an item of value held by a business which is likely to generate future income. Such income may come from the sale of the asset or from its usage in the business. The descriptions below describe the various types of asset commonly found in business and reported upon in the financial statements.

- **Tangible assets:**
  - **Property/premises, plant/machinery and equipment:** items that may be physically viewed and of a tangible nature (e.g. a vehicle, factory, office furniture)
- **Intangible assets:**
  - **Intellectual rights/property:** items of value but which may not physical in nature.

Non-Current Assets:
Assets that the business expects to retain ownership of, for a period of at least one year (e.g. factory/vans).

Current Assets:
Assets that the business expects to turn to cash within a one-year period (closing inventories/trade receivables/prepayments/cash).

Inventories:
Goods that have been purchased for resale but remain unsold as at the year end.

Trade receivables:
Money that is owed from customers to the business (i.e. goods sold on credit or provided in advance of the business receiving money for such goods/services).

Liabilities:
Liabilities are also presented within the Statement of Financial Position according to the length of time a business expects the liability to be outstanding for payment.

Non-Current Liabilities:
Debts/obligations that the business is required to meet in a future accounting period, thus by definition are expected to be due for payment beyond a one-year accounting period. Examples include bank loans and debentures.

Current Liabilities:
Liabilities that the business expects to pay within a one-year accounting period (examples include trade payables/bank overdraft/accruals).

Trade payables:
Money that is owed from a business to a supplier who provided goods/services on credit.

Equity:
Term used to define the value of funds within the business which can be attributed to the owner.

Summary formats:

Income Statement	**£'000**
Sales Revenue	100
Cost of Sales	(30)
Gross Profit	70
Expenses	(80)
Net Loss	(10)

Statement of Financial Position	**£'000**
Non-Current Assets	
Premises	20
Equipment	10
Total Non-current Assets	30
Current Assets	
Inventories	1
Trade Receivables	2
Cash/Bank	3
Total Current Assets	6
Total Assets	**36**
Owners Capital	20
Less Net Loss	(10)
Owners Equity	10
Non-Current Liabilities	
Loans	15
Current Liabilities	
Trade Payables	10
Bank Overdraft	1
Total Current Liabilities	11
Total Equity & Liabilities	**36**

Financial Statements of Limited Companies

Limited company financial statements tend to be more complex. They differ from sole trader/ partnership businesses in that they tend to:

- Adopt a slightly different layout (as determined by relevant company legislation)
- Present some items differently (e.g. expenses are often summarised into two main headings – Selling & Distribution Expenses and Administration Expenses)
- Provide separate disclosure about specific items including interest (finance) costs, dividends and tax payments
- Show profits before and after tax
- Show data for the previous ac-counting period for comparison purposes

See sample layout in Appendix 1 – the disclosures are required to provide information to a range of stakeholders e.g. tax authorities, lenders, shareholders.

Definitions of key terms in company accounts:

Profit Before Interest and Tax: This is the amount of profit the business earned prior to the payment of expenses such as interest and tax.

Interest (Finance) costs: this is the amount of interest paid by a company on loans/debentures. A company may also receive interest income from investments.

Taxation: A limited company pays Corporation Tax on the profits earned.

Profit After Tax (Retained earnings c/fwd): this is the amount of profit the company has earned for the accounting period, after the deduction of expenses for the accounting period. It is transferred to Profit/Loss Reserve as part of shareholders funds (equity). The Profit/Loss Reserve is the accumulation of profits/losses from previous accounting periods.

Dividends: These are payments to shareholders representing a return on their investment. Dividends are usually on an annual basis (although some companies opt to pay an Interim Dividend, part of the way through the financial period). This also represents a distribution of profits by the company. Dividends can only be paid if sufficient profits are available and funds permit.

Shareholders Funds (Owners Equity): this is the amount of money invested in the company by shareholders, represented by their initial investment (number of shares and the value) and the retained earnings accrued since the start of trading (Profit/Loss Reserve). Other reserves may be included in this section (e.g. Share Premium, Revaluation Reserve) which also form part of equity.

Users of Final Accounts:

The following stakeholders are likely to be interested in the final accounts of a business:

- Owners
- Consultants
- Government (HMRC)
- Staff
- Lenders

Each stakeholder group will have their own specific reasons for their interest in such information.

Usefulness of Financial Statement Information:
The extent to which the financial statements are used will determine how useful they. Common examples in which this information is used are:

- Summarising the financial position at the end of the accounting period – useful to determine profits/losses and overall financial position.

- Using the data to obtain debt finance – useful for the lender to determine potential revenues, costs, cash flows and assess ability of business or owners to repay debt.

- Using the data to collect and report taxes – HMRC often require copies of the final accounts to verify that all taxes (e.g. income taxes and VAT) have been correctly calculated and paid by the business.

- Planning for the future – a professional business services provider or consultant may use the final accounts to assist owners in planning for the future or identify weaknesses in the financial position of a business in order to plan for improvement in the future.

Summary

The Financial Statements summarise the financial position of a business, using the Income Statement and Statement of Financial Position and are used by a range of stakeholders for a variety of different reasons.

Revision Questions

1. Explain what is meant by the term 'Financial Statements'.

2. Evaluate the extent to which the financial statements are useful to four different stakeholder groups for decision making

APPENDIX 1: WORKED EXAMPLES

purposes.

Example 1: Financial Statements of a sole trader

Income Statement of G Grantley Consulting for year ended 31st December 2017

		£	£
Sales Revenue			195,000
Opening Inventory		4,200	
Add Purchases		154,000	
		158,200	
Less Closing Inventory		5,200	
Cost of Sales (Goods Sold)			153,000
Gross Profit			42,000
Less Expenses			
Wages and Salaries		15,000	
Interest payments		600	
Rent		9,400	
Electricity		5,000	30,000
Net Profit			12,000

Statement of Financial Position of G Grantley Consulting as at 31st December 2017

			£
Non-Current Assets			
Premises			120,000
Fixtures and Fittings			4,000
Vehicles			8,000
Total Non-Current Assets			132,000
Current Assets			
Inventory			5,200
Trade Receivables			1,900
Cash			150
Total Current Assets			7,250
Total Assets			139,250
Equity			
Capital			70,000
Add Net Profit			12,000
			82,000
Less Drawings			5,000
Closing Capital			77,000
Non-Current Liabilities			
Bank Loan			60,000
Total Non-Current Liabilities			60,000
Current Liabilities			
Trade Payables			1,500
Bank Overdraft			750
Total Current Liabilities			2,250
Total Equity and Liabilities			139,250

Example 2: Financial Statements of a Public Limited Company

Income Statement of SSG Professional Services plc for year ended 31st December

		2017	2016
		£m	**£m**
Sales Revenue/Turnover		195	190
Cost of Sales		(100)	(90)
Operating Profit		95	100
Selling and Distribution Expenses		(4)	(4)
Administration Expenses		(5)	(5)
Profit Before Interest and Tax		86	91
Interest (Finance Costs)		(6)	(6)
Profit Before Tax		80	85
Taxation		(7)	(7)
Profit After Tax (Retained Earnings c/fwd)		73	78

Statement of Financial Position of SSG Professional Services plc as at 31st December

		2017 (£m)	**2016 (£m)**
Non-Current Assets			
Premises		220	200
Fixtures and Fittings		4	24
Vehicles		8	8
Total Non-Current Assets		232	232
Current Assets			
Inventory		5	4
Trade Receivables		2	3
Cash		1	1
Total Current Assets		8	8
Total Assets		240	240
Equity			
Ordinary Share Capital (140,000,000 50p shares)		70	70
Add Profit/Loss Reserve (Retained Earnings)		140	78
Shareholders Funds		210	148
Non-Current Liabilities			
Bank Loan		20	80
Total Non Current Liabilities		230	228
Current Liabilities			
Trade Payables		2	2
Dividends Proposed		4	6
Bank Overdraft		4	4
Total Current Liabilities		10	12
Total Equity and Liabilities		240	240