

Class: MSc

Subject : Business Finance

Chapter: Unit 3 Chapter 4(part 2)

Chapter Name: Management Accounting

Today's Agenda

1. Trial Balance
2. Accounts prepared by firm
 1. Statement of financial position
 1. Format
 2. Components
 2. Statement of comprehensive income
 1. Format
 2. Component
 3. Cashflow statement
 1. Why is the cashflow statement needed?
 2. Format
 3. Component
 4. Statement of changes in equity
 1. Components
 5. Notes to the accounts
3. Limitations of historical cost accounting

1 Trial Balance



- A trial balance is a bookkeeping worksheet in which the balance of all ledgers are compiled into debit and credit account column totals that are equal.
- Trial Balance is the report of accounting in which ending balances of different general ledger of the company are available;

1.1 Example

The trial balance of NSB Handicraft as per the transactions shown in below table for the firm on March 31st, 2019.

Particular	Amount (INR)	Particular	Amount (INR)	Particular	Amount (INR)
Bill Payable	5,000/-	Rent	15,000/-	Drawings	2,000/-
Insurance Charges	5,000/-	Outstanding Salaries	5,000/-	Equipment	20,000/-
Owner Investments	80,000/-	Machinery	30,000/-	Maintenance Expenses	3,000/-
Unearned Revenue	4,000/-	Prepaid Rent	4,000/-	Accrued Expenses	1,000/-
Bank Loan	25,000/-	Sundry Debtors	15,000/-	Misc Expenses	2,000/-
Marketable Security	10,000/-	Accrued Revenue	20,000/-	Sales	42,250/-
Accrued Depreciation – Equipment	14,000/-	Unexpired Insurance	10,000/-	Purchases	30,000
Depreciation Expenses- Equipment	3,000/-	Vendor Payable	4,000/-	Taxes	11,250/-

1.1 Discuss :

1. Can you infer the financial position of the company looking at the trial balance?
2. Is the company profitable?
3. Is the company having sufficient assets?
4. Is the company having enough credit turnover?

Since it is not possible to answer these questions by just looking at the trial balance the company has to prepare some statements.

2 Accounts prepared by a firm

- Statement of financial position
- Statement of comprehensive income
- Cash flow statement
- Statement of changes in equity

2.1 Statement of Financial Position



The statement of financial position summarizes the company's financial position at a specific time.

The statement consists of two lists:

1. everything owned by the business
2. the various sources of finance used to fund these acquisitions.

Everything of value which is owned by a business is called an '**asset**'.

Finance provided by the owners of the business is called '**equity**'

Finance provided by third parties is called '**liabilities**'



A simple relationship between assets, liabilities and equity:

Assets = Equity + Liabilities

This is called the 'accounting equation'.

2.1.1 Format

Assets	Amount	Amount
Non-current assets		xx
Property, plant & equipment	x	
Intangible assets	x	
Current assets		xx
Inventories	x	
Trade receivables	x	
Other current assets	x	
Cash	x	
Total assets	x	

2.1.1 Format

Equity & Liabilities	Amount	Amount
Share capital	x	
Other reserves	x	
Retained earnings	x	
Total equity		xx

Non-current liabilities	Amount	Amount
Long-term borrowings	x	
Long-term provisions	x	
Total non-current liabilities		xx
Current liabilities	Amount	Amount
Trade and other payables	x	
Short-term borrowings	x	
Current portion of long-term borrowings	x	
Current tax payable	x	
Short-term provisions	x	
Total current liabilities		xx

2.1.2 Components

Non – Current Assets:

Non-current assets usually have long lives and are bought with the intention of using them in the business.

1. **Tangible Assets:** Tangible assets exist in physical form ; they include cash, inventory, vehicles, equipment, buildings and investments. Tangible assets are valued at cost less depreciation.
2. **Intangible Assets:** Intangible assets do not exist in physical form and include things like research and development costs concessions, trade marks ,brand names, patents and goodwill.
3. **Investments:** Non –current asset investments consists of interests in other companies in the form of shares, loan stocks, debentures or conventional loans. They are shown at market value.

2.1.2 Components

Current Assets:

A current asset is an item on an entity's balance sheet that is either cash, a cash equivalent, or which can be converted into cash within one year.

1. **Inventories (Stocks):** In accounts, the term inventories (or stocks) includes raw materials, consumables, work in progress and finished goods awaiting sale. Inventories are shown in the statement of financial position at the lower of cost and net realizable value (i.e. expected sale value)
2. **Trade receivables (Debtors):** Trade receivables (or debtors) are the amounts which the company is owed by its customers. The trade receivable heading may also include amounts due under bills of exchange receivable.
3. **Cash and other current assets:** Under current assets, the other current assets heading might include, for example, money held on short-term deposit.

2.1.2 Components

Equity:

Equity represents the shareholders' stake in the company, identified on a company's balance sheet.

1. Share capital: Share capital is the money a company raises by issuing common or preferred stock.
2. Other reserves: Reserves refer to a component of shareholders' equity, the amount kept apart for estimated claims or creation of contra asset accounts for bad debts.
3. Retained earnings: The amount of net income left over for the business after it has paid out dividends to its shareholders.



Equity = Share capital + Other reserves + Retained Earnings

2.1.2 Components

Current Liabilities:

Balances which are due within one year are classified as 'current'.

1. Trade payables (or creditors): Trade payables constitute the money a company owes its vendors for inventory-related goods, such as business supplies or materials that are part of the inventory.
2. Short-term borrowings: Short-term loans are defined as borrowings undertaken for a short period to meet immediate monetary requirements
3. Current portion of long-term borrowings
4. Current tax payable

2.1.2 Components

Non-current liabilities:

Liabilities which are not due within one year are classified as non-current (or long-term).

1. Long-term borrowings: Long-term borrowing consists of a long application process where repayments are made for several years in order to pay off the loan.
2. Long-term provisions: It is an amount that is kept aside to meet future liability with an amount that is difficult to ascertain but may be estimated and only in case if liability will arise after 12 months or after the period of operating cycle.
3. Contingent liabilities: A contingent liability is a liability that may occur depending on the outcome of an uncertain future event.

2.2 Statement of Comprehensive Income

 The statement of profit or loss (formerly known as the income statement) provides an insight into a company's trading activities. It compares the income generated from trading with the costs associated with earning that income, the difference being the profit or loss for the year.

2.2.1 Format

Revenue	x
- Cost of sales	x
Gross Profit	xx
- Other operating income	x
- Distribution costs	x
- Administrative expenses	x
Operating profit	xx
Finance income	x
- Finance costs	x
Profit before tax	xx
- Tax expense	x
Profit for the year	xx

Other comprehensive income	
Gain on revaluation	x
Total comprehensive income	xx
Earnings per share for profit attributable to equity holders	xx

2.2.2 Components

- **Revenue:** In accounting, **revenue** is the total amount of income generated by the sale of goods and services related to the primary operations of the business.
- **Cost of sales:** Cost of sales reflects the raw material, components, wages and salaries expended in producing the goods sold. Changes in inventory levels (both finished goods and raw materials) will need to be included, as will the charges for depreciation



Cost of sales = beginning inventory + purchases - ending inventory.

- **Distribution costs and administrative expenses:** Distribution costs include costs associated with sales, distribution and advertising. Administrative expenses include associated wages and salaries and directors' remuneration.
- **Finance income :** Financial Income is the revenue generated by the temporary surplus cash invested in short-term investments and Marketable securities

2.2.2 Components

- **Finance costs:** Financing cost (FC), also known as the cost of finances (COF), is the cost, interest, and other charges involved in the borrowing of money to build or purchase assets.
- **Tax expense:** The tax charge in the income statement arises because companies pay corporation tax on their adjusted profit figures. The adjustments to profit may be disputed by the tax authorities and may be revised after the publication of the accounting statements. The estimate for corporation tax forms the core of the charge in the statement of profit or loss, although there are usually additional charges.
- **Categories of profit:**
 1. Gross profit is the difference between the selling price of the goods and services which provide the basis for the company's main trading activities and the cost of sales.
 2. Operating profit is usually defined as profit earned after all expenses except finance costs (interest).
 3. Profit before tax is the operating profit adjusted for financing (interest) costs and income. Profit for the year is this profit after deduction of tax.

The difference between cost and selling prices represents the contribution toward the non-trading expenses and profit.

2.2.2 Components

- **Earnings per share:** Companies are obliged to calculate the earnings per share (EPS) figure and disclose it on the face of their statements of profit or loss. EPS is equal to the earnings attributable to the ordinary shareholders (usually, profit for the year) divided by the number of ordinary shares in issue.
- **Realized capital gains (and losses):** Capital gains are profits on an investment. When you sell investments at a higher price than what you paid for them, the capital gains are "realized" and you'll owe taxes on the amount of the profit.
- **Other comprehensive income:** Other Comprehensive Income refers to items of income and expenses that are not recognized as a part of the profit and loss account. In simple words it is gain or loss that has not been realized.

2.3 Cash flow statement



The cash flow statement reports the cash paid during the accounting period for non-current assets, raw materials, wages, etc (rather than matching the consumption of those resources to the sales generated) and the cash received from customers (rather than the sales made). It also includes cash received from owners and lenders.

The net cash inflow or outflow for the year is broken down into categories such as:

- cash received from customers and paid to suppliers (operating)
- cash applied by purchasing property, plant and equipment and raised from its disposal (investing)
- cash raised from borrowing and issuing shares and applied to repayments and repurchases (financing).



Net (decrease)/increase in cash:

Cash flows from operating activities + Cash flows from investing activities + Cash flows from financing activities

2.3.1 Why is the cash flow statement needed?

1. To show cash movements:

- The statement of profit or loss and statement of financial position do not provide a sufficient insight into movements in cash balances. This is unfortunate because even profitable companies will collapse if they are not sufficiently liquid.
- The bank balance is, of course, disclosed in the statement of financial position. It is, however, difficult to identify the major causes of such changes. Shareholders and other readers require a more structured description of the cash flows.

2. Cash is important

- Very few businesses could survive a prolonged cash outflow
- Cash flows are important, but only because the entity needs cash to survive. The main reason for being in business is to earn a profit.
- Cash flows should be monitored to ensure, for example, that expansion of the business does not force it into a cash deficit, but a strong cash inflow is not always the aim. If a business has too much cash then it may be desirable to put that money to some good use by investing in productive assets or even by repaying loans. If there are no such opportunities then it may even make sense to make a sizeable payment to the shareholders as a dividend or the repurchase of shares.

2.3.1 Why is the cash flow statement needed?

3. Profit is not the same as cash

- The profit figure for the year is unlikely to bear any resemblance to the increase or decrease in the company's bank balance or total for working capital (current assets less current liabilities) over that period. Several entries in the statement of profit or loss, such as depreciation, do not involve a payment or receipt of cash. Furthermore, the statement of profit or loss recognizes credit sales and purchases before any cash changes hands. Conversely, many receipts and payments, such as the proceeds of share issues and loan repayments, have no immediate impact on profit.
- It is possible for a company to trade profitably and still run into liquidity problems.

2.3.2 Format

Cash flows from operating activities	Amount
Cash generated from operations	x
- Interest paid	x
- Tax paid	x
Net cash generated from operating activities	xx
Cash flows from investing activities	
- Purchases of property, plant	x
Proceeds from sale of property, plant	x
- Purchases of intangible assets	x
- Loans granted to related parties	x
Net cash used in investing activities	xx

Cash flows from financing activities	Amount
Proceeds from issuance of ordinary shares	x
Proceeds from borrowings	x
- Repayments of borrowings	x
- Dividends paid to company's shareholders	x
Net cash used in financing activities	xx
Net increase/ decrease in cash, cash equivalents	xx
Cash ,cash equivalents at beginning of year	xx
Cash, cash equivalents at the end of year	xx

2.3.3 Components

1. Cash from Operating Activities

The operating activities on the CFS include any sources and uses of cash from business activities. In other words, it reflects how much cash is generated from a company's products or services.

These operating activities might include:

- Receipts from sales of goods and services
- Interest payments
- Income tax payments
- Payments made to suppliers of goods and services used in production
- Salary and wage payments to employees
- Rent payments
- Any other type of operating expenses

In the case of a trading portfolio or an investment company, receipts from the sale of loans, debt, or equity instruments are also included because it is a business activity.

2.3.3 Components

2. Cash from Investing Activities

Investing activities include any sources and uses of cash from a company's investments.

These can include the following:

- purchase and sale of non-current assets, property, plant and equipment plus intangible assets, like patents
- receipts of interest and dividends from investments
- transactions involving 'liquid' assets other than cash, such as short-term investments in securities.

2.3.3 Components

3. Cash from Financing Activities

Cash from financing activities includes the sources of cash from investors and banks, as well as the way cash is paid to shareholders.

These can include the following:

- payment of dividends to the company's shareholders
- Cash flows arising from the repayment of loans and from fresh borrowing and the issue of shares.

2.4 Statement of Changes in Equity



This summarizes the changes in the capital and reserves attributable to equity holders of the company over the accounting period, and so reconciles the amounts shown in the statement of financial position at the start and end of the period.

2.4.1 Components

- For each class of contributed equity, the accumulated balance of 'other comprehensive income', and 'retained earnings'.
- In terms of non-cash assets, the increase or decrease in the carrying amount which is distributed to the owners as a result of changes in the fair value of such assets.
- Changes in the equity share capital and other equity during the accounting period of:
 1. Changes in accounting policy
 2. Prior period errors
 3. Total comprehensive income
 4. Dividends
 5. Transfers to retained earnings (it is the accumulated earnings from the beginning of the operations net of dividends paid or any restatement adjustments)
 6. Any other changes

2.4.1 Components

- With respect to changes in other equity, the following are to be disclosed:
 1. Share application money – pending allotment
 2. Compound financial instrument's equity component
 3. Reserves and surplus such as capital reserve, securities premium reserve, etc.
 4. Revaluation surplus
 5. Cash flow hedges gain/loss
 6. When a financial statement of a foreign operation is translated, the related exchange difference
 7. Debt and equity instruments through other comprehensive income etc.
- Changes in other reserves including:
 1. Capital redemption reserve
 2. Debenture redemption reserve
 3. Others – with descriptive information of nature and purpose of each reserve
- Changes due to the re-measurement of defined benefit plans etc.

2.5 Notes to the accounts

- UK legislation requires companies to produce accounts which include detailed disclosures – appropriate explanatory notes and additional information. These are normally presented as a series of notes to the accounts.
- The notes will cover details of the:
 1. accounting policies used in preparation of the financial statements
 2. analysis of totals shown in the statement of financial position
 3. analysis of items in the statement of profit or loss
 4. significant events after the end of the accounting year .
- In addition, companies will normally disclose, voluntarily, additional information designed to help the readers of the accounts to gain a true and fair view of the position of the company.

3 Limitations of historical cost accounting

Historical cost accounting tends to distort profits during times of inflation.

1. Valuation of inventories
2. Depreciation
3. Interest payments
4. Consistency over time



Question

As an account officer, you have been requested to assist ABC Ltd., a company, to prepare its annual accounts. The following information has been provided from the company's Book-keeping records:

Balances as on 31 March 2019

Administrative staff wages: 3,000

Cost of Marketing: 55,000

Bank overdraft: 18,000

Buildings – depreciation: 40,000

Buildings – valuation: 400,000

Cost of inventory consumed: 350,000

Delivery vehicle running costs: 60,000

Delivery vehicles – cost: 325,000

Delivery vehicles – depreciation: 170,000

Dividend paid: 45,000

Factory running costs: 100,000

Interest: 10,000

Inventory at 31 March 2019: 30,000

Land – valuation: 600,000

Loan (repayable 2024): 145,000

Machinery – cost: 150,000

Machinery – depreciation: 80,000

Manufacturing wages: 175,000

Retained earnings: 250,000



Question

Revaluation reserve: 180,000

Revenue: 1,500,000

Sales salaries: 120,000

Share capital 200,000

Trade payables: 50,000

Trade receivables: 210,000

In addition to figures shown above, below information is provided:

1. A revaluation exercise was conducted on 1 April 2018. Land was revalued at 800,000 and buildings at 700,000
2. Depreciation has still to be charged as follows:
 - Buildings – 1% of cost or valuation
 - Delivery vehicles – 20% reducing balance
 - Machinery – 10% of cost

Prepare: i) An income statement for the year ended 31 March 2019
ii) A statement of changes in equity, and
iii) A statement of financial position as on 31 March 2019

Solution

i) ABC Ltd. Income statement for the year ended 31st March 2019

Revenue	1,500,000
Cost of Sales	(647,000)
Gross Profit	853,000
Administrative Staff wages	(3,000)
Distribution Cost	(266,000)
	584,000
Interest	(10,000)
Profit for the year	574,000

Solution

ii) ABC Ltd. Statement of changes in equity for the year ended 31st March 2019

	Share Capital	Revaluation Reserve	Retained Earnings	Total
Opening Balance	200,000	180,000	250,000	630,000
Revaluation		540,000		540,000
Profit for the year			574,000	574,000
Dividend Paid			(45,000)	(45,000)
Closing Balance	200,000	720,000	779,000	1,699,00

Solution

iii) ABC Ltd. Statement of financial position as at 31st March 2019

Non-current Assets	
Property, Plant and Equipment	1,672,000
Current Assets	
Inventory	30,000
Trade Receivables	210,000
	240,000
Total Assets	1,912,000
Equity and Liabilities	
Equity	
Share Capital	200,000
Revaluation Reserve	720,000
Retained Earnings	779,000
	1,699,000
Non-current Liability	
Loan	145,000
Current Liability	
Trade Payables	50,000
Bank	18,000
	68,000
Total Equity and Liabilities	1,912,000

Solution

Notes:

1) Property, Plant and Equipment

Cost or Valuation	Land	Building	Machinery	Vehicles	Total
Opening Balance	600,000	400,000	150,000	325,000	1,475,000
Revaluation	200,000	300,000			500,000
Closing Balance	800,000	700,000	150,000	325,000	1,975,000

2) Depreciation

Cost or Valuation	Land	Building	Machinery	Vehicles	Total
Opening Balance		40,000	80,000	170,000	290,000
Revaluation		(40,000)			(40,000)
Closing Balance		7,000	15,000	31,000	53,000
		7,000	95,000	201,000	303,000
Net book value	800,000	693,000	55,000	124,000	1,672,000

Solution

3) Cost of Sales

Cost of Inventory Consumed	350,000
Factory running costs	100,000
Manufacturing wages	175,000
Depreciation of buildings	7,000
Depreciation of Machinery	15,000
	647,000

4) Cost of Distribution

Advertising Cost	55,000
Delivery Vehicle running costs	60,000
Sales Salaries	120,000
Depreciation of Vehicles	31,000
	266,000