HL IB Business Management

Your notes

3.4 Final Accounts

Contents

Statement of Profit or Loss

Your notes

An Introduction to Financial Accounts

- Financial accounts detail the **financial performance** of a business over a trading period

- The two main financial accounts are
  - The **Statement of Profit or Loss**
  - The **Statement of Financial Position**

- Public Limited Companies (PLCs) have to produce financial reports annually
  - Annual reports must comply with International Financial Reporting Standards (IFRS) allowing straightforward comparisons of performance **over time** and **between companies**

Examiner Tip

The two main financial accounts sometimes go by different titles

- The **Statement of Profit or Loss** is also widely known as the **Profit and Loss Account** or an **Income Statement**
- The **Statement of Financial Position** is often referred to as the **Balance Sheet.**

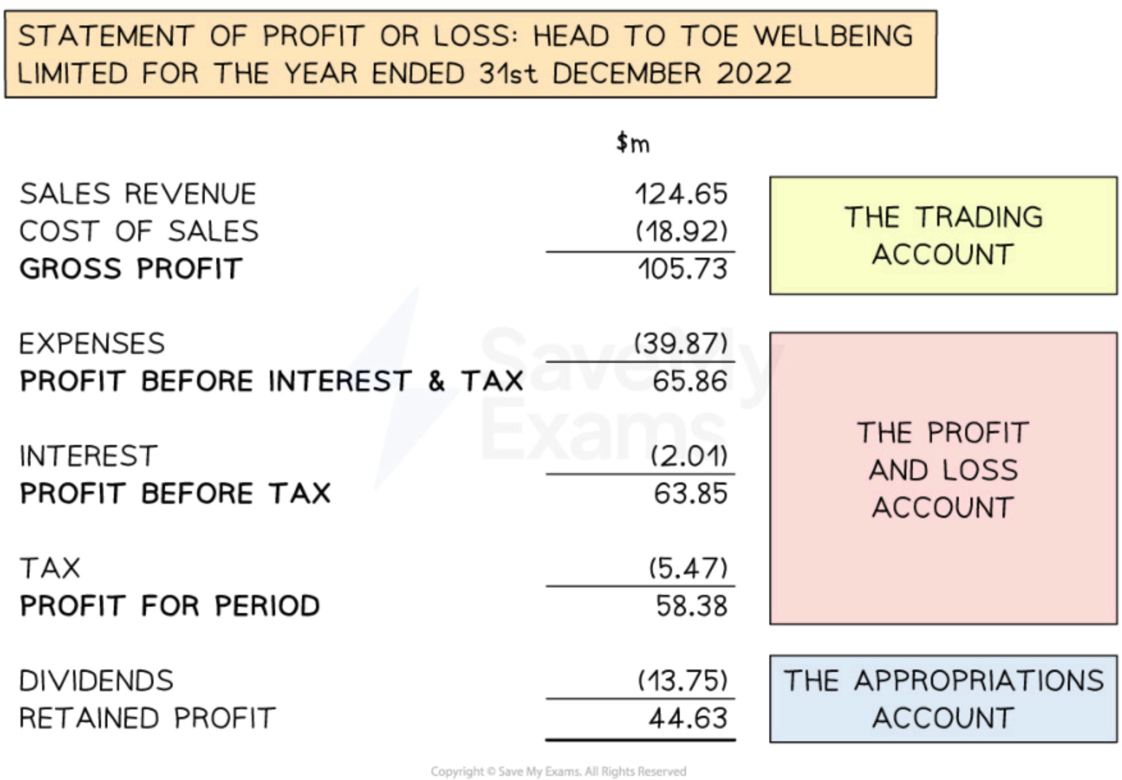
The Statement of Profit or Loss

Your notes

- The **Statement of Profit or Loss** shows the **income** and **expenditure** of a business over a period of time - usually a year - and calculates the amount of **profit** made

- It is divided into three parts
  - The **trading account**
  - The **profit and loss account**
  - The **appropriation account**

Diagram Showing the Statement of Profit or Loss Layout



STATEMENT OF PROFIT OR LOSS: HEAD TO TOE WELLBEING LIMITED FOR THE YEAR ENDED 31st DECEMBER 2022

	$m	
SALES REVENUE	124.65	THE TRADING ACCOUNT
COST OF SALES	(18.92)	
GROSS PROFIT	105.73	
EXPENSES	(39.87)	THE PROFIT AND LOSS ACCOUNT
PROFIT BEFORE INTEREST & TAX	65.86	
INTEREST	(2.01)	
PROFIT BEFORE TAX	63.85	
TAX	(5.47)	
PROFIT FOR PERIOD	58.38	
DIVIDENDS	(13.75)	THE APPROPRIATIONS ACCOUNT
RETAINED PROFIT	44.63	

Head to Toe Wellbeing Ltd made a profit of £44.63m in 2022

The Trading Account

- The **trading account** is where the cost of sales is deducted from sales revenue to calculate the **gross profit**
  - In 2022 Head to Toe Wellbeing Limited's sales revenue was $124.65m and its cost of sales were $18.92m
  - The **gross profit** for the period was therefore

$$\$124.65m - \$18.92m = \$105.73m$$

Your notes

The Profit & Loss Account

- The **profit and loss account** deducts a series of expenses to determine the **profit for the period**
  - In 2022 gross profit was $105.73m and expenses were $39.87m
  - The **profit before interest and tax** was therefore

$$\$105.73m - \$39.87m = \$65.86m$$

  - The business also paid $2.01m interest
  - The **profit before tax** was therefore

$$\$65.86m - \$2.01m = \$63.85m$$

  - The business also paid $5.47m tax
  - The **profit for the period** was therefore

$$\$63.85m - \$5.47m = \$58.38m$$

The Appropriations Account

- The **appropriations account** shows how profits are distributed for the period
  - In 2022 Head to Toe Wellbeing Limited distributed $13.75m to shareholders as dividends
  - $44.63m was therefore **retained as profit**

Examiner Tip

For **non-profit organisations** some amendments are made to the standard layout of the Statement of Profit or Loss

1. The word 'profit' is replaced by '**surplus**'
2. Non-profit organisations are usually **exempted from the payment of corporation tax** so this is not normally recorded or is recorded as a 0 value

How Stakeholders use the Profit & Loss Account

Your notes

- The Statement of Profit or Loss is a very useful source of information for stakeholders to **evaluate the performance of a business**

How Stakeholders use The Statement of Profit or Loss

Shareholders	Employees
▪ Interested in revenues, costs and profits earned, business growth and dividend payments ▪ Shareholders may use **ratio analysis** tools to identify profit margins and returns on investment	▪ Interested in profits earned and the **potential for wage increases** and job stability ▪ Employees may look at **notes to the accounts** that detail levels of executive pay
Managers & Directors	**Suppliers**

▪ Interested in key performance data **such as an improvement in sales revenue and net profit**
  ▪ This data can aid business decision making
  ▪ Financial data can provide evidence to support the payment of bonuses
	▪ Interested in the **continued success of the company** the are supplying and this information is also used by suppliers to determine the level of trade credit offered to businesses

Government	**Local Community**
▪ Used to determine how much **tax** is payable ▪ The Statement of Profit or Loss can provide an insight into whether the business will **continue to provide employment**, place orders with other businesses and supply goods and services to the public sector	▪ Interested in the **stability** of the business and what this may mean for jobs in the community ▪ Another interest is to see if the firm is generating enough profit to perhaps approach them for local sponsorship

Your notes

Statement of Financial Position (Balance Sheet)

The Statement of Financial Position

- The Statement of Financial Position shows the **financial structure** of a business at a specific point in time
- It records the business assets and liabilities and specifies the **capital** (equity) used to fund the business
- The Statement of Financial Position is also known as the **Balance Sheet**
  - It is called the balance sheet as the **net assets should equal the total equity**

Diagram: Statement of Financial Position

STATEMENT OF FINANCIAL POSITION: PACKER SPORTS LIMITED AS AT 31st DECEMBER 2022

	$	$
NON-CURRENT ASSETS		
PROPERTY, PLANT & EQUIPMENT	22.700	
ACCUMULATED DEPRECIATION	1.550	
NON-CURRENT ASSETS		24.250
CURRENT ASSETS		
CASH	4.665	
DEBTORS	2.630	
STOCK	8.250	
CURRENT ASSETS		15.545
TOTAL ASSETS		39.795
CURRENT LIABILITIES		
BANK OVERDRAFT	540	
TRADE CREDITORS	3.960	
OTHER SHORT-TERM LOANS	560	
CURRENT LIABILITIES		5.060
NON-CURRENT LIABILITIES		
LONG-TERM BORROWING	20.000	
NON-CURRENT LIABILITIES		20.000
TOTAL LIABILITIES		25.060
NET ASSETS		14.735
EQUITY		
SHARE CAPITAL	1.500	
RETAINED EARNINGS	13.235	
TOTAL EQUITY		14.735

NON-CURRENT ASSETS ARE ITEMS THAT ARE OWNED BY THE BUSINESS IN THE LONG-TERM. EXAMPLES INCLUDE MACHINERY, BUILDINGS & VEHICLES

CURRENT ASSETS ARE ITEMS THAT ARE CONVERTED INTO CASH QUICKLY – USUALLY WITHIN 12 MONTHS. THE MAIN TYPES OF CURRENT ASSETS ARE CASH, DEBTORS & STOCK

TOTAL ASSETS = NON-CURRENT ASSETS + CURRENT ASSETS

CURRENT LIABILITIES ARE MONIES OWED BY A BUSINESS THAT WILL FALL DUE WITHIN 12 MONTHS. THE MAIN TYPES OF CURRENT LIABILITIES ARE BANK OVEDRAFTS & CREDITORS

NON-CURRENT LIABILITIES ARE MONIES OWED THAT DO NOT NEED TO BE PAID BACK FOR AT LEAST 12 MONTHS. EXAMPLES INCLUDE BANK LOANS & MORTGAGES

TOTAL LIABILITIES = CURRENT LIABILITIES + NON-CURRENT LIABILITIES

NET ASSETS = TOTAL ASSETS – TOTAL LIABILITIES

EQUITY SHOWS HOW THE NET ASSETS OF A BUSINESS ARE FUNDED. TOTAL EQUITY IS ALSO KNOWN AS **CAPITAL EMPLOYED**

The Statement of Financial Position for Packer Sports Ltd balances on $14,735

Your notes

Calculating the total assets

- On the stated date *Packer Sports Ltd* owned non-current assets worth $24,250
  - Property, plant and machinery is valued at $22,700
  - These assets have been depreciated by $1,550
- The value of its current assets (cash, debtors and stock) was $15,545
- Total assets were therefore

$$\$\,24{,}250 + \$\,15{,}545 = \$\,39{,}795$$

Calculating total liabilities

- On the stated date Packer Sports Ltd had current liabilities worth $5,060, comprised of a bank overdraft, trade creditors and other short-term loans
- The value of its long-term liabilities were $20,000
- Total liabilities were therefore

$$\$\,5{,}060 + \$\,20{,}000 = \$\,25{,}060$$

Calculating the net assets

- Packer Sports Limited's net assets were therefore

$$\$\,39{,}795 - \$\,25{,}060 = \$\,14{,}735$$

Calculating total equity

- Net assets of $14,735 were funded through **share capital** of $1,500 and **retained earnings** of $13,235

Your notes

Examiner Tip

In Paper 2 you may be asked to construct a balance sheet from given data.

To achieve full marks you must **follow the format illustrated above** and you should check that you have

1. **Included all of the relevant headings in the correct order**
   - Non-current assets
   - Current assets
   - Total assets
   - Current liabilities
   - Non-current liabilities
   - Total liabilities
   - Net assets
   - Equity
2. **Correctly classified items under each heading**
   - For example, you need to ensure that you have correctly allocated cash, stock and debtors as current assets, and creditors and bank overdrafts as current liabilities
3. **Omitted irrelevant figures that belong to the profit and loss account**
   - For example, costs and revenues are not included in the balance sheet

How Stakeholders use the Statement of Financial Position

- Stakeholders will use the Statement of Financial Position **alongside the Statement of Profit or Loss** to perform **ratio analysis** and **compare performance over time or with other businesses**

How Stakeholders use the Statement of Financial Position

Stakeholder	Interest in the Balance Sheet
Shareholders	▪ Used to identify the **asset structure** of the business and how their investment has been put to use ▪ Used to calculate the working capital of the business and determine its solvency ▪ Used to determine the rough **value of a business** which helps a judgement on **whether their investment is growing**
Managers & Directors	▪ Used to identify the **financial position** of the business at a given point in time ▪ Useful to assess the **working capital** position of the business and determine if there are **enough** liquid **current assets to pay its bills** ▪ Provides information on the **capital structure** of the business which helps guide decisions on whether to raise further funds through **borrowing or via other means** (e.g. share issue)
Suppliers & Creditors	▪ Used to judge the solvency of the business to **determine the risk** when offering firms trade credit ▪ Businesses with **low levels of working capital** may find it difficult to pay short-term debts and so suppliers **may offer trade credit, but with stricter terms**

Employees	▪ Used to answer questions such as:
	  ▪ Is the business financially stable or are jobs at risk?
	  ▪ Has the businesses performance improved or worsened?
	  ▪ What is the business spending its money on?
	  ▪ How much are senior executives paid?
	  ▪ How much tax is the business paying?

Your notes

Examiner Tip

If you are answering a question about sources of finance you might be able to use the capital structure of the business to recommend whether a business should borrow or look at an alternative source. If a business already relies heavily on borrowing, it may be more sensible to recommend seeking to raise more share capital.

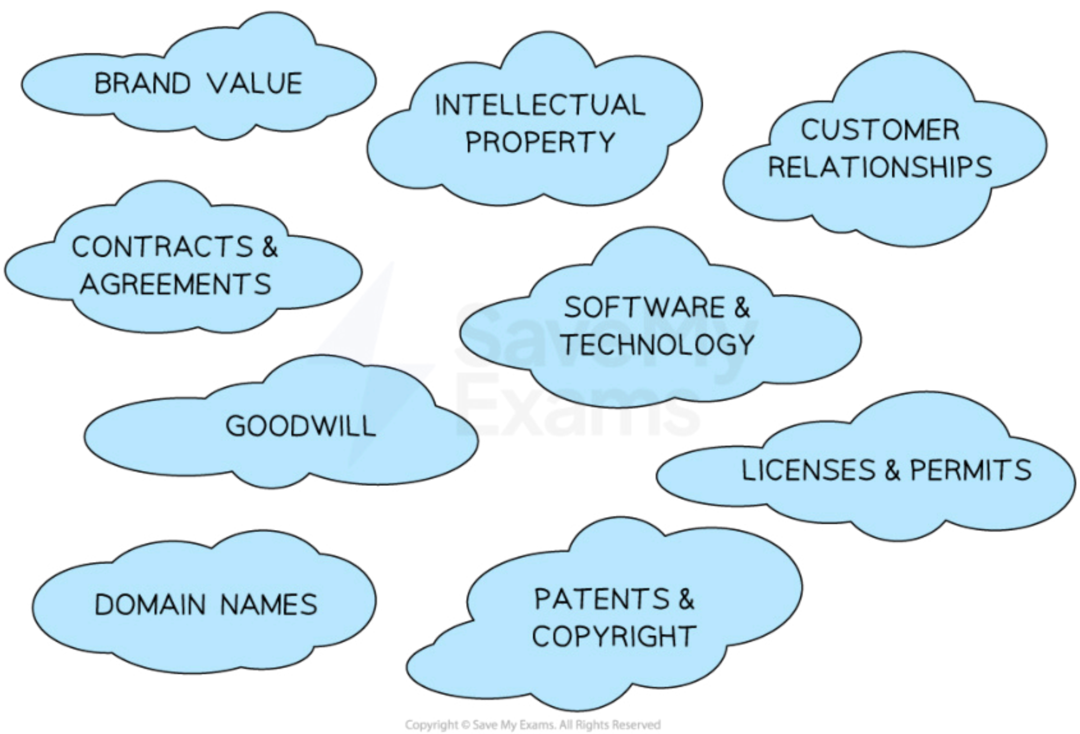
Your notes

Your notes

Different types of Intangible Assets

- Intangible assets are **non-physical and cannot** be held
- Businesses need to **account for intangible assets** in their annual reports as it adds to the value of the business

Diagram Showing Different Types of Non-physical Assets



Intangible assets include assets such as intellectual property and domain names

Intellectual property

- This includes patents, trademarks, patents and copyrights which protect unique ideas, inventions, artistic works, and brand names

Brand value

- The reputation and recognition associated with a brand has a value
  - It includes the **brand name, logo, slogans, and customer loyalty to the brand**

Customer relationships

- Long-term relationships with customers including customer lists, contracts, and customer loyalty programs
  - These relationships can provide **recurring revenue and a competitive advantage**

Your notes

Software and technology

- **Proprietary software**, computer programs and technology systems that are crucial to a business's operations or provide a competitive advantage

Contracts and agreements

- Long-term contracts, lease agreements, licensing agreements and franchise agreements that have value and **contribute to future cash flows**
- **Agreements with employees or business partners** that restrict them from competing with the company for a specific period which protect the company's interests and market position (non compete contract)

Goodwill

- The value of a **company's reputation**, customer base and brand
- Goodwill often represents the premium paid when one business takes over or merges with another business

Domain names and other online assets

- Valuable domain names, websites, social media accounts and online platforms **that drive customer engagement**, traffic, and online presence

Licenses and permits

- Licenses, permits, and regulatory approvals that **grant exclusive rights or access to certain markets** or resources, often issued by governments

Depreciation Methods

Your notes

Understanding Depreciation

- Depreciation is an **accounting technique** which recognises that **the value of fixed (non-current) assets falls** over time
  - It reflects wear and tear, the reduction in an asset's value **as it ages** or obsolescence
- Two common methods of calculating depreciation include
  - **Straight line depreciation**
  - **Units of production depreciation**
- Whichever method a business selects, the goal is to **allocate the** historic cost **of the asset** in a way that **reflects its reduction in value over time**

Reasons for Calculating Depreciation

Accurately calculate the businesses value	Plan effectively for the replacement of assets	Realistically reflect the performance of assets in financial statements
▪ As assets depreciate their **current value is recorded in the balance sheet** ▪ Historic cost is an inaccurate measure as time goes by ▪ Provides an accurate representation of **capital employed**	▪ Understanding the depreciation rate of assets helps a business to **budget for future replacements** ▪ Avoid sudden financial strain ▪ Schedule replacements to avoid disruption to production	▪ Depreciation is an **expense recorded in the income statement** ▪ Reduces reported operating **profit** ▪ Provides an accurate representation of a businesses financial performance

Straight Line Method

Your notes

- The straight line method reduces the value of an asset by the **same value each year of its useful life**

- Three key **variables** are required to calculate the **annual rate of depreciation** of an asset
  - **Life expectancy**
    - The number of years it is expected to be used before it will need to be replaced
  - **Residual value**
    - The scrap value of the asset at the end of its useful life
  - **Historic cost**
    - The initial cost of purchasing the asset

- The **annual rate of depreciation** is calculated using the following formula

$$\text{Annual depreciation} = \frac{\text{Historic cost} - \text{Residual Value}}{\text{Life Expectancy}}$$

Worked example

Luftig Tours sells hot air balloon flights in the Salzburg area of Austria. The company recently paid €280,000 for a new balloon. Its life expectancy is anticipated to be 7 years. Its residual value is forecast to be €52,500

Calculate the annual rate of depreciation of the new hot air balloon

(2 marks)

Step 1: Deduct the residual value from the historic cost

$$€\,280{,}000 - €\,52{,}500 = €\,227{,}500 \quad \textbf{(1)}$$

Step 2: Divide the result by the life expectancy

$$\frac{€\,227{,}500}{7 \text{ years}} = €\,32{,}500 \quad \textbf{(1)}$$

- Once the annual rate of depreciation has been calculated, **until the end of its life expectancy**
  - It is recorded each year as an **expense** in the **income statement**
  - The **value of the asset is reduced each year** by this amount in the balance sheet and is recorded as its book value

Your notes

Worked example

Luftig Tours sells hot air balloon flights in the Salzburg area of Austria. The company recently paid €280,000 for a new balloon. Its life expectancy is anticipated to be 7 years. Its residual value is forecast to be €52,500

(a) Calculate the book value to be recorded in the balance sheet for each of the hot air balloon's years of useful life

(4 marks)

(b) Calculate the accumulated depreciation for each year of the the hot air balloon's useful life

(2 marks)

Step 1: Create a table with the following headers

Year	Depreciation	Book Value	Accumulated Depreciation
0			
1			
2			
3			
4			
5			
6			
7			

Step 2: Complete Year 0 with the historic cost

Year	Depreciation	Book Value	Accumulated Depreciation
0	0	€280,000	

Step 3: Calculate Year 1 by deducting the annual rate of depreciation

$$\text{Year } 1 = €\,280{,}000 - €\,32{,}500 = €\,247{,}500 \quad \textbf{(2)}$$

Step 4: Record these values in the table

Year	Depreciation	Book Value	Accumulated Depreciation
0	0	€280,000	
1	€32,500	€247,500	

Your notes

Step 5: **Calculate Years 2 to 7 in the same way**

Year	Depreciation	Book Value	Accumulated Depreciation
0	0	€280,000	
1	€32,500	€247,500	
2	€32,500	€215,000	
3	€32,500	€182,500	
4	€32,500	€150,000	
5	€32,500	€117,500	
6	€32,500	€85,000	
7	€32,500	€52,500	

(2)

Step 6: Calculate accumulated depreciation by adding the annual rate of depreciation each year

Year	Depreciation	Book Value	Accumulated Depreciation
0	0	€280,000	0
1	€32,500	€247,500	€32,500
2	€32,500	€215,000	+ €32,500 = €65,000
3	€32,500	€182,500	+ €32,500 = €97,500
4	€32,500	€150,000	+ €32,500 = €130,000
5	€32,500	€117,500	+ €32,500 = €162,500
6	€32,500	€85,000	+ €32,500 = €195,000
7	€32,500	€52,500	+ €32,500 = €227,500

(2)

Strengths and Weaknesses of the Straight Line Method

- The main benefit of the straight line depreciation over other methods is that it is **simple to calculate**
- In many countries it is **preferred for tax purposes** as it allows for a consistent deduction of depreciation expenses over the asset's useful life

The Main Strengths and Weaknesses of Using Straight Line Depreciation

Strengths	Weaknesses

▪ **Simplicity** ▪ Straightforward calculations make it a **practical method** for small businesses or assets with a **predictable** decline in value	▪ **Doesn't Reflect Actual Usage** ▪ If an asset is heavily used in the early years and experiences less use later on this method may not accurately represent its true value
▪ **Equal Allocation** ▪ Suitable when the asset's usefulness is expected to decline **steadily** over time	▪ **Market Value Ignored** ▪ Some assets - such as vehicles - depreciate rapidly in the early years and more slowly/not at all in later years
▪ **Stability** ▪ Predictability can be helpful for **budgeting** and **financial planning**	▪ **Mismatch with Reality** ▪ May not match the **actual wear and tear** of an asset leading to an inaccurate representation of its value

Your notes

Units of Production Method

Your notes

- The **units of production method** depreciates an asset **based on its usage** or **production output** during an accounting period (usually a year)
  - It is commonly used for **assets that wear out** based on the **number of units produced** or **hours of operation** rather than the passage of time
  - **Vehicles** commonly lose value as their mileage increases
  - **Machinery** wears out as it is used in production

- The units of production calculation involves two steps
  - **Step 1: Calculate the depreciation per unit**

$$\text{Depreciation per unit} = \frac{\text{Historic cost} - \text{Residual value}}{\text{Expected units over asset's lifetime}}$$

  - **Step 2: Calculate the depreciation per time period (year)**

$$\text{Depreciation per time period} = \text{Depreciation per unit} \times \text{Number of units produced}$$

Your notes

Worked example

Emilio's Pizzeria purchased a new pizza oven for $22,600

It expects the pizza oven to last for 12,000 hours before it needs to be replaced

It will be sold for scrap for $4,000 after 4 years

(a) Calculate the depreciation expense if Emilio's Pizzeria uses the pizza oven for 2,900 hours in the first year

(3 marks)

Step 1: Calculate the depreciation per unit

$$\frac{\text{Historic cost} - \text{Residual value}}{\text{Expected units over pizza oven's lifetime}}$$

$$= \frac{\$22,600 - \$4,000}{12,000 \text{ hours}}$$ **(2)**

$$= \$1.55$$

Step 2: Calculate the depreciation for the time period

$$\text{Depreciation per unit} \times \text{Number of units}$$

$$= \$1.55 \times 2,900 \text{ hours}$$ **(1)**

$$= \$4,495$$

- Once the depreciation total has been calculated
  - It is recorded as an **expense** in the **income statement**
  - The **value of the asset is reduced** by this amount in the **balance sheet** and is recorded as its book value

Strengths and Weaknesses of the Units of Production Method

- This method is more **complicated to calculate** than the straight line method
- It is more likely to **reflect the true running costs** of non-current assets such as machinery

The Main Strengths and Weaknesses of Units of Production Depreciation

Strengths	Weaknesses
▪ **Depreciation expenses match actual usage of the asset** ▪ Particularly useful when an asset's wear and tear are directly related to its level of production	▪ **Calculation can be complex** ▪ Especially when measuring actual usage is difficult or when production levels fluctuate
▪ **Reflects the asset's actual value** ▪ Machinery in manufacturing experiences more depreciation when used more intensively	▪ **Financial statements less predictable** ▪ Inconsistent depreciation expenses each accounting period as it is directly tied to production levels

Your notes

Your notes

When to use each Depreciation Method

- The method chosen to depreciate a fixed asset depends on a range of factors, such as
  - Whether the asset is likely to become obsolete
  - Whether the asset is directly used in production
  - Whether its value is closely linked to the amount it is used

Appropriate Situations for each Depreciation Method

Straight Line Method	Units of Production Method
▪ Most appropriate when ▪ The asset's value is unlikely to change due to **obsolescence** ▪ A **small** business is valuing assets ▪ Assess are of relatively **low value** ▪ Assets have a **predictable lifespan**	▪ Most appropriate when ▪ The asset's value is linked to its **amount of use** ▪ Assets are **valuable** and need to be **valued with precision** ▪ A **manufacturing business** is valuing assets

Examiner Tip

Some assets **appreciate** over time

Increasing **land** and **property values** should also be recorded in the final accounts

- Usually recorded as **extraordinary income** in the profit & loss account
- Higher non-current (long term) asset value is recorded in the balance sheet
- Businesses should take a **cautious approach** in appreciating the value of these assets
- It may be deemed **fraudulent to misrepresent their value** in final accounts - especially if this value is used as leverage to obtain finance