Profit and Loss Accounts And Balance Sheets of Limited Companies

Specification requirement— Profit and loss accounts and balance sheets of limited companies.

Profit And Loss Accounts and Balance Sheets of Limited Companies.

In the real world the structure of Profit and Loss Accounts and Balance Sheets can be a great deal more complex than those we have studied at AS Level. This complexity results from two factors, firstly the intricate nature of most large businesses, and secondly the requirements of presentation and format of accounts, as laid down by government and accounting bodies. In the notes below you will be shown the detail of a sample Profit and Loss Account and Balance Sheet. How to analyse accounts and comment on your findings are dealt with in the other notes within the 'Measures of performance :Financial' section of the NGFL Wales resource.

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For those students who wish to gain an in-depth understanding of accounts I strongly advise that you take some time to look at actual accounts produced by PLC's. These are readily available, and the reading of these will give you a great deal of insight and practical knowledge.

The Layout of Complex Profit and Loss Accounts

When looking at a Profit and Loss Account typical of those presented by a Limited Company or PLC, we see the same basic layout as was introduces at AS Level, but with added complexity. It is also normal for Limited Companies to show the previous years figures along side the current years figures, this adds information for comparison of performance, and also allows examiners to test your insight!

On the next page we have an example P&L Account. This example account covers many of the main expenditures, costs and incomes found in a typical P&L account of a large business. We see the added complexity, different types of profit, and the appearance of dividends. In the detailed, but straight forward examination of the Profit and Loss Account that follows, we will flesh out these bare bones.

Note. In this part of the notes on P&L account will not repeat explanations given in the AS notes. Instead we will focus on the parts that are new to us.

Costs and Operating Profit.

Costs have been subdivided into broad groups, such as marketing, distribution etc. Further details on how these totals have been arrived at are often provided in the notes to the accounts which are found towards the rear of published accounts.

Operating Profit is the profit the business has made from its normal business activities.

Profit on Disposal of Investments, and Profit before Interest and Taxation.

We often find in accounts an amount of money that has been made by the firm, but has not come from the normal trading activities of the firm. For example the business may have sold land that had previously been used for storage of redundant machinery. This land may have

	2012 £m	2011 £m
Turnover	621.3	611.0
Cost of Sales	(357.0)	(360.9)
Gross Profit	264.3	250.1
Marketing Costs	(17.9)	(14.9)
Distribution Costs	(54.8)	(53.6)
Administrative Expenses	(26.0)	(24.9)
Other operating charges	(5.9)	(5.1)
Operating Profit	159.7	151.6
Profit on disposal of investment	3.6	
Profit before Interest and Taxation	163.3	151.6
Net interest	(15.9)	(14.6)
Profit Before Taxation	147.4	137.0
Tax Paid	(43.6)	(39.8)
Profit after Taxation	103.8	97.2
Preference Dividends Paid	(6.8)	(6.8)
Ordinary Dividends	(57.9)	(41.6)
Retained Profit	39.1	48.8

been sold at a profit, but if the main activity of the business was the production of man made fabrics, then placing this extra, one-off income, as a separate category helps keep the accounts clear and easily interpretable. Distortions of profits will be minimised if this exceptional income is shown separately from normal trading income. This type of income , or expenditure is known as an 'Exceptional Item'. (For more on exception items, see chapter Window Dressing). By keeping this sort of item separate from the figures produced from normal business activities, we are able to make judgements on **'Profit Quality'**.

Profit Quality refers to the likelihood of a source of profit generating similar or improved returns in the future. To judge profit quality we therefore need to be able to strip out costs or revenue that distort the picture.

Once we have included these exceptional items in the account we are then able to calculate Profit before Interest and Taxation.

Profit before Interest and Taxation

Virtually all large businesses will have figure for Net Interest, the figure is a balance of Interest Paid on loans, and Interest Received on deposits held. This Profit before Interest and Taxation figure is important as it tells us the profits made by the trading activities of the firm.

The next profit figure, Profit before Taxation, takes Net Interest into account. It is worth noting at this point that different sets of published accounts will have some differences in how they categorise different types of profit. The best way of examining these differences is to look at published accounts.

More importantly, we must always examine carefully the types of profit given in examination questions. The reason for this is, that if they are there, they are shown for a reason. That reason is that some comment, analysis or evaluation of these profit figures will be required in your answer!

Profit After Taxation.
This simply allows for tax paid by the business. This tax is typically Corporation Tax. This Profit after Taxation is the profit that is available to the shareholders of the business, it may therefore be described as 'Profit Accruing to Shareholders' or a variation on this.

Preference Dividends Paid.
Preference shares are a type of share that pays a fixed dividend. This dividend is paid out of Profit after Taxation, and is paid before ordinary shareholders get their bite of the cherry. Because the preference dividend is fixed. Preference shares are regarded as less risky than ordinary shares, but it is not without risk. It is not unknown for preference dividends not to be paid, and they do not guarantee a return of capital.

Ordinary Dividends.
This is the amount of profit that is distributed to the owners of the company, the shareholders, in the form of a dividend payable on each share held. For example the company may declare a dividend of 2.895p per share, and if there are 20,000,000 shares in issue, the total dividend to Ordinary Shareholders would be £57.9m. Firms can and often do pay dividends, even if losses are made. These payments are made from reserves, and are made to protect share price, reward the owners and to help reduce the potential for takeover.

Retained Profit
It is normal for businesses to keep at least part of the profit made each year within the business to assist with business growth. Firms that are attempting fast, self-funded growth, may retain all of profits made within the business. Shareholders are willing to accept this as this type of investment policy should bring higher future profits and therefore higher future dividends and share prices.

Depreciation.
Depreciation has not been shown on the example Profit and Loss Account, but it is a business expense. Loss of value of existing assets must be accounted for, and this is done by depreciating their value over time. For example, a van may be purchased for £15,000 and have an expected useful life of 8 years. At the end of this time it is predicted that the value of this van will be £2,000. Over the 8 year period the van will have depreciated by £13,000. This should be shown on the Profit and Loss Account as an annual depreciation of £1625 (£13,000 divided by 8 years). For more on depreciation, see chapter Understanding and Measuring Depreciation.

Why Prepare Accounts?

All businesses should prepare full sets of accounts.
There are a number of reasons why this should be done:

- Legal requirements – this applies to all limited companies. The form and timing of presentation of accounts, is laid down by statute and by the accounting bodies.
- Tax requirements – if a firm's turnover is more than £15,000 then a full set of accounts can be requested by the Inland Revenue.
- To accurately calculate profit, liabilities and assets.

- Accounts can be used in business planning
- Accounts will be required if the business is seeking investors or loans.
- Accounts are useful if credit is required.

Balance Sheets of Limited Companies.

The Balance Sheet on this page gives a typical layout, and typical content of the type of Balance Sheet found in published accounts.

The layout is similar to that seen at AS level, but added complexity arises with different types of Fixed Assets, liabilities and shareholding.

In the example we have a valuation for Brand, in this case £130m. It makes sense to have brands as a fixed asset, after all brands produce sales, allow higher prices to be charged, and are bought and sold, Brand values are often described as 'intangible assets'.

	£m	£m
Fixed Assets		
Land and Buildings	500.0	
Machinery	120.8	
Fixtures and Fittings	17.6	
Vehicles	29.7	
Brand Valuation	130.0	
Total Fixed Assets		796.3
Current Assets		
Stock	126.6	
Debtors	154.9	
Cash	9.3	
Total Current Assets	290.8	
Current Liabilities		
Creditors	145.4	
Overdraft	Nil	
Tax Payable	12.6	
Total Current Liabilities	158.0	
Net Current Assets		132.8
Total Assets		929.1
Balanced by		
Long Term Liabilities		
Mortgage	86.8	
Bank Loan	71.0	
Share Capital (Ordinary)	575.0	
Reserves	196.3	
Total		929.1

Share capital is often the major form of funding for Limited Companies. Shares are issued at flotation, and further issues can occur during the life of a company. Ordinary Share Capital is referred to as permanent capital, this means that it does not have to be repaid. Some types of share capital do require the payment of annual interest or dividend. The main types of share capital are:

Ordinary Shares. The holder of an ordinary share has a share in the ownership of a limited (or joint stock) company. Ordinary share holders will expect to receive an annual dividend (their share of the profits), but this is in no way guaranteed. Payment of dividend depends upon the performance of the company, and the dividend policy adopted by the company.

Preference Shares. These will pay a fixed annual amount to the holder, again known as a dividend. Preference share holders will receive their dividends from profits, or reserves, before the dividend to ordinary shareholders is paid. This means that preference shares are less of a risk that ordinary shares, but the payment of dividend and return of capital is not guaranteed.

Debentures. These are a form of loan stock. The holder has made a secured loan to the business, and these Debentures will have a fixed redemption date (the date the loan must be repaid). Debentures are more secure than ordinary shares or preference shares, but again if the business fails there is no guarantee of repayment of capital. Debenture holders do get their 'bite of the cherry' before ordinary and preference share holders. From the businesses point of view Debentures are an effective way of raising capital because the Debenture holders have no say in which the company is run, this means that is there is no dilution of control that can come with other types of shares.

Exam Question Guidance

In examinations you may be given figures for the current years trading and the previous year and asked to compare these sets of figures. Of course ratios (see later notes) should be used to do this, but be aware of factors such as inflation, growth of markets and success of competitors, which will influence your interpretation of ratios calculated.

For example you might calculate a growth of sales or net profit of 10%, this might look good, but what if inflation is 4%, this means that the real growth has only been 6%. Also you should add the proviso that comment is limited by lack of information. How well have competitors done? How much has the market grown by? A software company that has seen growth of 10% a year over the last 15 years may appear impressive, but most major software companies have seen increases of 20%+ over the same period.

It is normal within A Level type questions, for the examiner to require the candidate to demonstrate an ability to examine a P&L Account and Balance Sheet in some depth. This analysis is carried out using:

- the information provided in the question
- appropriate methods of analysis
- and at the same time the student is expected to build into the answer, evidence of a broader understanding of financial analysis

This may sound like a great deal, but steps one and two are based on a few easily learnt techniques which you have been introduced to in this chapter, and are covered fully in the ratio analysis chapters. Step three comes with developing awareness of the weaknesses of the methods used—the chapter on Ratio Limitations.

Notes