

Critically analyse financial statements

Finance



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Features of financial statements I. Introduction: of the financial statements To better understand the distinctive features of financial statements, it would be necessary to define the functions of a certain type of financial statement in a business organization.

a. Income Statement - income statement summarizes the company's operating performance over a specified period of time. It shows the total revenues of the business enterprise and the cost or expense of operating the business. Income statement's determines whether a company is making a profit or losing money (Temte, 2005).

b. Balance Sheet - balance sheets provides a summary of the value of a business enterprise's assets, liabilities and equity at a specific point in time. It provides " the value of everything that a company owns less all the claims against the business (liability and equity)" (Temte, 2005).

c. Cash Flow - cash flows provides the business' operating, investing, and financing cash flows over a specified period. It reconciles the changes on the cash on hand at end of a period with the beginning balance by including the income derive from non-cash revenue and expenses " by adjusting net income for non-cash revenues and expenses" (Tempte, 2005).

d. Statement of Changes in Owners' Equity - the change in owner's equity happens when a business profits, its asset value changes and when its owners adds more capital or made withdrawals against the business (McGrann, 1998).

II. Features of financial statements

1. Sole traders

Sole trader or single proprietorship is a business owned solely by an entrepreneur where owner assumes all responsibilities pertaining to the

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business and do not distinguish between the owner and the business. In effect, he or she also carries the whole burden of the business's liability. In the event that loss occurs, the liability will affect and extend to the owner's finances.

With regard to its income statement, a sole trader has to pay tax on the business net profit and in the event that the net profit is over a certain threshold, the owner has to pay the Value Added Tax (VAT) of 17.5%. This VAT rate however has been decreased to 15% in consideration of the recent financial crisis.

With regard to insurance expense, the owner also has to pay their own class 2 National Insurance Contributions (NIC) which is pegged at £2.40 if the net profit is within the standard margin of £5,715. If net profit exceeds that figure, the owner has to pay the additional class 4 NIC.

With regard to reporting for taxation purposes, a complete income statement and balance sheet should be submitted to HMRC. The owner is responsible for keeping all the expenses for a certain tax year.

The duration of the business is also dependent on the life of the owner. If the owner dies, the business will also cease to exist.

The financial statement of a sole trader is straightforward where accounts are simpler compared to limited companies where entries vary due to the complexity of the business. It involves deduction of expenses from sales to arrive at the taxable net profit or loss (which of course not taxable anymore because it is a loss).

Figure 1. Example of a sole trader financial statement

Figure 2. Example of a sole trader financial statement

(Osbornebooks nd)

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2. Limited Companies-

Limited companies are also called as Joint stock companies or partnership where owners or shareholders pool their resources together to form a corporation. The shareholders share the profit and losses depending on the proportion of their contribution to the company. In simpler terms, Limited Companies are what we call now as corporations.

During the formation or incorporation of a limited company, the incorporators are required to submit certain documents to the Registry of Companies for them to benefit from limited liability. Every year, they are required to submit certain financial information to all its shareholders and register certain information with the Register of Companies (Brendley et al 2004).

Unlike the sole trader where the business liability extends to the owner's account, liabilities of a limited company is limited only to the business and therefore, the owners assets are separated and not affected by the company's liabilities in the event that the business is experiencing financial difficulty.

Limited companies also have separate personality from the owner and assume a personality as an "artificial being". Shares of stocks are also transferable. In the event of death, bankruptcy or incapacity of an owner, his or her shares can be sold or transferred to another person unlike in sole trader where the business dies with the owner. In preparing the financial statements of a limited company however, such financial statement has to adhere to International Financial Reporting Standards (IFRS) and Generally Accepted Accounting Principle (GAAP) unlike in sole trader business where it is not necessary because the financial statements are primarily for use by

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the owner and need not be compared and harmonised with other organizations (Bouwman 1995).

In the attached financial statement of Young & Co. Brewery, P. L. C. Annual Report, it can be seen that the form of ownership of capital is expressed in owner's equity indicating that ownership came from several people and that the business is a separate entity from its owners (Figure 3). The liability also includes borrowings from other sources and not only accounts payable indicating that the liability is incurred by the company as an entity separate and apart from its owners (Figure 2). It is also important to note that Limited Companies use their properties and equipments for profit and dispose them at salvage value to still extract economic value even at the equipment and property's end of life (Figure 3).

Figure 3

(RLNI 2012)

3. Not-for-Profit Organisation

Non-profit organization as the nature of the organization suggests, are organization that are not intended for profit but rather for charitable purpose and for the welfare of society. Thus, its operations are not business for profit in nature but rather for philanthropic purposes. It goes without saying then that the organization does not manufacture goods, nor sell them and neither do they render profit oriented services.

The funds raised by not for profit organization did not come from owners or shareholders. Such, it is reflected in the organization as contributions, donations and support from the general public. It does not have sales nor revenues but rather, their major sources of their income usually come from the donations, subscriptions from their members, grants-in-aid, income from <https://assignbuster.com/critically-analyse-financial-statement/>

investments, etc.

The characteristic and features of a non-profit organization's operation reflecting in its annual report and financial statement can be best described in the annual report of Royal National Lifeboat Institution (RLNI). RLNI is a non profit organization which was founded in 1824 that provide non-profit services around the coast of the United Kingdom and Republic of Ireland lifeguard and has over 4, 600 volunteer lifeboat crew and 3, 000 volunteer shore crew for the delivery of its lifesaving service (RLNI 2012). This is important to note in describing the features of a non-profit organization's financial statement because these operational assets (lifeboat crew volunteers) are not owned by RLNI as we can see in its assets of only £319. 7 M (Figure 4). Had RLNI needed to purchase those 4, 300 boats (each costing millions of pounds) for the organization to use in its operation, it would have amounted to billions of pounds. Instead, it was used for its operation not through acquisition nor lease but rather by volunteering the equipment to the organization by its owners. In simpler language, it was borrowed to RLNI for free. Note also that goodwill has economic value in a non-profit organization in recognition of its economic contribution in raising funds for the organization of which RLNI and every non-profit organization is dependent on.

Figure 4

(RLNI 2012)

This shows how non-profit organizations acquire their assets such as RNL who is almost entirely reliant upon voluntary contributions for its funding where its legacies remain its largest single source of income (RLNI 2012). Since it is dependent on the goodwill of the public in raising its funds just like <https://assignbuster.com/critically-analyse-financial-statement/>

any other non-profit organizations, RNLI is associated with the Fundraising Standards Board and maintains a formal complaints procedure and is subjected to the Reputation Institute's Annual Charity Survey (RNLI 2012) which is a mechanism of check and balance that informs the public on how non-profit organizations operate.

They typical type of not for profit organizations are;

a. Company limited by guarantee and others

This is a non-profit organization that is established as a company, trust or unincorporated association, and their constitutions often share many characteristic with charities. Not for profit organizations typically have documents that prevent them to use their assets other than the purpose of charitable acts that prohibits them from engaging in commercial activities.

b. Community interest company (CIC)

Community interest companies are non-profit organizations that have assets and/or objects that are supposed to be used for the benefit of the community. It typically has governing documents that prevent the organization from using its asset to any commercial activity or distribution to its members other than the philanthropic and charitable intent of the organization. It is an established companies limited by guarantee that it will not operate other than for charitable purpose. Community Interest company however may pay some returns to investors while retaining most of its asset for reinvest to keep itself a going concern under the regulation of the government (Registrar of Societies).

III. Conclusion

The three types of financial statements differ in their features because of the nature of their operations and the consideration of the different audience

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which these financial statements serve. In the sole trader, financial statements only serves the sole owner and thus needs not to be complex nor adhere to IFRS standards because its audience is only its owner in addition to the regulating agency. Limited Companies are complex because the financial statement serves a multitude of audience which includes the various shareholders, the Register of Companies and the general public. It also needs to be prepared in accordance to IFRS and GAAP. Non-profit organisations othe other hand is dependent on the goodwill of the public for its funding and thus prepares it financial statements to satisfy audience such as the Fundraising Standards Board and Registrar of Societies.

The formats and presentation of these financial statements may differ depending on the nature of the organization that use them but regardless of this differences, they all need to prepare it with accuracy, timeliness, objectivity and integrity.

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