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Accounting for Management

Problem Solving Assessment

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Executive summary

The purpose of this report is to evaluate the financial performance of High Energy. The findings are that High energy did not perform well in 2015 and the beginning of 2016 based in the financial statements. However, when LNR is used as the benchmarking company to evaluate the performance of High energy, it seems that the performance of High Energy is much better than the average of industry. t has been recommended that impairment test should be made to test the PPE of High Energy and High Energy should prepare its financial statements on a accrued basis and in a more complete way.

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1. Introduction

This report is going to evaluate the performance of HIGH Energy Ltd, a resource company. There are nine questions that will be answered one by one in this report. First, the retained profit on 31January 2016 will be calculated. Secondly, the worksheet of several transactions happened in February and March will be dealt with. Thirdly, an income statement for the period 1 February to 31 March 2016 will be given. Fourthly, the balance sheet ended at 31/03/2016 will be given. Fifthly, a classified cash flow statement will be given. In the seventh sector, an analysis of financial position of High energy is made based on the financial statements. In the eighth sector, a benchmarking company will be chosen to evaluate the performance of High Energy. In the ninth sector, some additional concerns will be raised. In the tenth sector, issues related to environment protection will be discussed. In the end, conclusion and recommendations will be made.

2. Question 1: Retained Profit on 31 January 2016

This section will answer the first question. As it is known that equity is the residual value after assets deducted by liabilities. As for equity, it is composed of share capital, capital reserves, retained profit and other reserves. In this case, the retained profit can be calculated as follows.

accounts	
Total assets	$1,412,897,588
Total liability	$423,702,503
Total equity (residual value)	$989,195,085

Therefore the retained profit is $73,645,085 (Total equity less share capital).

3. Question 2: a worksheet outlining the transactions of HIGH Energy Ltd in February and March 2016

This section will give a worksheet that outline the transactions in February and March 2016. The accounts on March 31 is showed as follows. There are 11 workings after the worksheet.

Worksheet For High Energy LTD.

Accounts	on January 31	Total movements	on March 31
Cash and cash equivalents	$72,300,000	$55,866,905	$128,166,905
Accounts Receivable	$88,057,588	($32,655,525)	$55,402,063
Inventories	$191,000,000	($460,800)	$190,539,200
Prepayments	$86,490,000	$1,717,500	$88,207,500
Property, Plant and Equipment	$975,050,000	$7,785,200	$982,835,200
Total ssset			$1,445,150,868
Accounts Payable	$66,902,503	$7,227,580	$74,130,083
Bank Loan	$356,800,000	$0	$356,800,000

Total liabilities			$430,930,083
Share Capital	$915,550,000	$18,375,500	$933,925,500
Retained Profit	$73,645,085	$6,650,200	$80,295,285
Total equity			$1,014,220,785

Workings

Working 1: There is an insurance payment of $960,000. As the payment covers the whole year from 1 February 2016 to January 31 2017. $800,000 should be recognised as prepayments.

Working 2: High energy raised share capital of $18,375,500 cash, so the amount should be added to share capital and cash.

Working 3: $260,600 should be added to Cash and cash equivalents in February. The balance of $760,600 should be added to Cash and cash equivalents in March.

Working 4: $42,510,325 payment from customers should has been recognised as Accounts Receivable. Therefore, the payment should be accounted as:

Dr: Cash and cash equivalents:	$42,510,325	
Cr: Accounts Receivable:		$42,510,325

Working 5: Half of the salary $877,500 in March should be recognised as prepayments as that part is not accrued yet.

Working 6: $789,620 for inventories should be recognised as:

Dr: Accounts payable:	$789,620	
Cr: Cash and cash equivalents:		$789,620

Working 7: The $330,000 bill should be recognised as payable in February if it has not been recognised before. When the bill is paid in March, $330,000 should be deducted from Cash and cash equivalents.

Working 8: Depreciation of PPE of February and March was $202,000. New operation equipment of $8,017,200 should be recognised as payable. As the useful life is 20 years and the residual value is $817,200. Depreciation for a month should be $30,000 (Whittred, 2005).

Working 9: $509,200 of sales should be recognised as accounts receivable as follows:

Dr: Accounts receivable:	$509,200	
Cr: Inventories:		$460,800
Cr: Retained profits		$48,400

Working 10: There is a possible grant of $800,000 from the government. As the result and the probability is unknown, the grant cannot be recognised. If the probability is higher than 50%, the grant should be disclosed. $9,345,600 should be added to receivable.

Working 11: Paid interest of $450,500 should be deducted from both cash and cash equivalent and retained profits.

4. Question 3: An income statement for the period from 1 February to 31 March 2016

Revenue	$10,876,000
Cost of sales	$692,800

Gross profit	$10,415,200
Expenses:	
Insurance expenses	($120,000)
Salary	($2,632,500)
Marketing and sales expenses	($330,000)
Interest	($450,500)
Net profit	$6,650,200

5. Question 4: a *classified* balance sheet as at 31 March 2016

According to the workings in Question 2, the balance sheet at 31 March 2016 is shown as follows. According to notes on March 31, current loans is $105,500,000, the rest should be classified as non-current liabilities.

Accounts	On March 31

Current assets

Cash and cash equivalents	$128,166,905
Accounts Receivable	$55,402,063
Inventories	$190,539,200
Prepayments	$88,167,500
Total current assets	$462,275,668
Non-current aasts	
Property, Plant and Equipment	$982,835,200
Total assets	$1,445,110,868

Liabilities and equities

Current liabilitues	
Accounts Payable	$74,130,083
Bank Loan	$105,500,000
Total current liabilities	$179,630,083
Non current liabilities	
Bank Loan	$251,300,000
Total liabilities	$430,930,083
Equity	
Share Capital	$933,925,500
Retained Profit	$80,295,285
Total equity	$1,014,220,785

6. Question 5: a *classified* cash flow statement for the period from 1 February to 31 March 2016

According to the workings in Question 2, cash flow statement for the period from 1 February to 31 March 2016 is shown as follows.

cash flow from operating activities	
cash received from customers	$43,531,525
cash paid to suppliers and empolyees	($4,629,620)
cash paid for insurance	($960,000)
cash generated from operations	
interest paid	($450,500)
net cash from operating activeties	
net cash from investment activities	$0

net cash from financing activities	$18,375,500
cash and cash equivalents at the beginning	$72,300,000
cash and cash equivalents on March 31 2016	$128,166,905

7. Question 6: financial position and performance of HIGH Energy Ltd

From the financial statements, the financial position and performance will be analysed from four aspects.

Firstly, there is a large amount of prepayments. It may be related to special project, however, the $88,167,500 occupied as prepayments should be delayed if the payments can be made when the goods or services are completed. Besides, both the amount of accounts receivable and payable is relatively low. As we can see from the transactions of February and March, there is only on transaction that lowers inventory, so High Energy may have trouble selling its inventories.

Secondly, the gearing ratio (debt/assets) is 25.25% on January 31. $105,500,000 of bank loan would be due in three months. This amount can be covered by the cash or equivalents on 31/03/2016. As we know, debt is an important way of financing and the cost of debt is always cheaper than equity. The gearing ratio of High energy is relative low. It means that share capital is the main method for financing for High energy. It can be explained in two ways: the company hates risks or it has few good investments to make. If the latter is the case, investors should be careful because the growth potential of High energy could be low.

Thirdly, the liquidity of High energy is at the safe level. The current ratio is the ratio between current assets and current liabilities which measures the company's ability to meet the repayments of loans. In this case, it is nearly 3.55 ($374,108,168/$105,500,000) on 31/03/2016. Although there is no standard current ratio because of industry differences, a ratio greater that 2 is supposed to be safe. So High energy is able to pay its short-term loans. As for long-term loans, it is highly possible it can repay them as long as there is no large amount of new loans raised.

Fourthly, the Return on assets in February and March is 0.465% ($6,650,200/$1,429,004,228). Assuming the profits is generated evenly in each month, the annual profits is 2.79%. In common case, the ratio should be compared with industry average. In the case, it is obviously that the return on assets in too low, which means High energy does not make efficient use of the assets. High energy can hardly meet the required return of shareholders. If that is the case, High energy should find ways to make use of the assets by improving sales or lower the expenses.

In conclusion, the financial position of High energy is not bad and its growth potential is not optimistic. If high energy cannot find a way to improve the performance, it will be hard to attract investors.

8. Question 7: benchmarking company for further analysis

The benchmarking company chosen is LNR--- LONESTAR RESOURCES LIMITED. LNR is also an energy company which engages in oil&gas exploration and production. After checking the annual reports of several energy companies with the first letter of "L". I believe that in 2015, many of the resources companies suffer loss (Ji, 2015).

From the 2015 annual report of LNR, it can be calculated that the net return on assets is negative. The return on assets of LNR is 6.52% in 2014, which can be used as a number for normal years. In 2015 the return on assets of High energy is 5.21%. As many other resources companies made losses, High energy is undoubtedly more profitable. A large part of the revenues of LNR in 2015 was generated from hedge gains, which is not related to the main business. Although hedge is a very useful tool to avoid risks. It is hardly possible to use hedge to generate significant amounts of revenues. Without the hedge gains, LNR would make a greater loss in 2015. So High energy generated healthier profits than LNR.

It has been stated that 2015 is a special year for the resources companies. LNR has leasehold which exceeds 30,000 net acres, yet it made loss in 2015. The revenues is much lower in 2015 than 2014. Part of the reason of the losses derived from the impairment of 74.9 million dollars. The impairment may be common in the industry because the market made the recoverable amount of the properties lower and it is possible that the impairment can be covered once the market becomes better (Lodhia, 2011). As for High energy, it also seems to have trouble selling inventories. Besides, its PPE may also suffer impairment and impairment tests should be done to determine whether the PPE's recoverable amount exceeds its carrying amount. If impairment happens, it should be recognised directly. So both LNR and High energy fail to make efficient use of their assets because LNR has a negative return on assets and High energy has a very low return on assets in 2015.

The current liabilities of LNR is $30,344,000 while the current assets is $44,892,000. The current ratio is 1.48. If this ratio is used as industry average, then High energy is much more capable of meeting its short-term liabilities. The total liabilities of LNR is $345,271,000 while the total assets is $498,477,000. The gearing ratio of LNR of year 2015 is 0.69. If this ratio is used as industry average, then High energy has a much lower gearing ratio than the industry average. The interest and other financial expenses of LNR is $24,577,000, which is almost 6 times of cash and cash equivalents. LNR is probable unable to pay the interests. As for High energy, it has a much higher interest cover, which means it is more than able to pay the interests. Therefore, it can be concluded that High energy can meet short term and long term debts while LNR cannot.

In conclusion, if LNR is used as the benchmarking companies, then High energy outperforms than the industry average in profitability, efficiency, liquidity and repayment abilities in year 2015.

9. Question 8: additional issues of concern

As it has been stated before, year 2015 may be an unusual year for resources companies. The impairment loss of LNR is larger than its loss in 2015. Therefore, impairment loss may be the main reason for the losses in 2015 (Shaari, 2013). As there is no impairment loss for High energy, it is possible that High energy did not do the impairment test to make the financial statements better because PPE accounts for a very large portion of assets (Shaari, 2013).

LNR closed a new $500 million senior secured credit facility in 2015. The new facility got LNR an extended borrowing base in Citibank. LNR extended its borrowing base although it made loss in 2015. It may be assumed that the prospect of LNR is good. As for High energy, it is possible that the reason for the low gearing ratio is because it is unable to extend its borrowing base or get loans at a low interest rate and has to keep financing from shareholders.

Because of lower WTI, which the prices of crude oil are based on, in some places the price per BOE in 2015 is almost half of the price in 2014 (Baumeister, 2016). So it is understandable that the revenues of LNR is much lower in 2015 than 2014 although the production increased. As for High Energy, it did not make efficient use of the assets in 2015 and at the beginning in 2016. Because of the bad market situation, it is very hard to make profits from sales. In 2015, selling each BOEPD means loss. Therefore, it is possible that High Energy is holding its sales to lower the losses. That is to say, High Energy could make more sales but it avoids that.

In conclusion, impairment losses is a more source of loss while High Energy may fail to do the impairment tests. Besides, the low gearing rate of High Energy may be due to its inability to get cheaper loans. And because the market is slumping in 2015, High energy may hold down its sales while LNR did not do that and suffered a big amount of losses.

10. Question 9: information about environmental issues

As a matter of fact, almost all the conventional energy companies have to deal with the environmental issues. LNR states that it uses unconventional ways to acquire oil and gas reserves. It also can be seen that almost half of the impairment losses is because of the impairment of an unconventional properties. It may be assumed that LNR is trying to be environmental friendly.

High energy should do the same to abandon conventional ways and use high-tech equipment to lower the emission of harmful gases such as carbon dioxide. Because only in that way can High energy be able to develop in a sustainable way. Nowadays, the society cares more about whether the companies are behaving in an ethical way, especially the companies which are not environment friendly fundamentally.

Matthew Rice suggests to report on HIGH Energy's environmental protection activities. It is fine as long as the information will not mislead the stakeholders. As the protection activities are disclosed, the fact should also be disclosed that High Energy is emitting large amount of carbon gases which will influence the environment adversely.

In conclusion, High energy should adopt unconventional ways to acquire the resources for its long-term developments. And if it has to report environmental protection activities, all the information related to environment should be disclosed to give stakeholders a more complete view of the companies' activities that relate to environment (Hargreaves, 2013).

11. Conclusion

This report mainly evaluates the financial performance of HIGH Energy Ltd. Three financial statements have been prepared and certain financial analysis is given based on the calculations. Besides, a benchmarking company is chosen for further analysis of the financial position of High Energy. Based on the analysis, it can be concluded that the performance of High Energy is not very good. Although it is capable of meeting long-term and short-term loans, it does not make good use of debts, but keeps its gearing ratio in a relatively low level. Besides, it does not prepare its financial statements in a complete way. However, if there are no significant omissions, the performance of High Energy is better than the industry average which is represented by LNR.

12. Recommendations

This report is based on both on practical and case data. The analysis shows that although High Energy does not prepare its financial statements in a complete way on accrued basis, its performance is not bad. It is recommended that High Energy should try its best to prepare the financial statements in accordance with the standards, such as doing impairment test when the market prices of the assets have declined obviously.

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