

Accounting Fundamentals

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Question 1:

Requirement a.i: Profit and Loss Statement

Kedison Plc.

Profit and Loss Statement

For the year end 31st December 2020

	Amount	Amount	Amount
Sales Revenue		826,650.00	
(+) Unrecorded sales revenue		<u>980.00</u>	
			827,630.00
(-) Cost of sales			<u>578,650.00</u>
Gross profit			248,980.00
(-) Operating Expenses:			
Administrative expenses		30,000.00	
Interest paid	2,000.00		
(+) Interest payable (Workings-1)	<u>2,000.00</u>		
		4,000.00	
Director's remuneration		5,000.00	
Director's cost		28,000.00	
Ordinary dividend paid		20,000.00	
Preference dividend paid		30,000.00	
Commission payable		<u>3,000.00</u>	
Total operating cost			<u>120,000.00</u>
Profit before tax			128,980.00
(-) Corporate tax			<u>68,000.00</u>
Profit after tax			60,980.00
Retained profit b/f			<u>132,000.00</u>
Retained profit c/f			<u>192,980.00</u>

Workings-1:

Interest Payable = $(100,000 * 4\%) - 2,000 = £2,000$.

Requirement a.ii: Statement of Financial Position

Kedison Plc.

Statement of Financial Position

For 31st December 2020

	Amount	Amount	Amount
Current assets:			
Closing inventory		330,600.00	
Debtors	170,125.00		
(+) Unrecorded sales	<u>980.00</u>		
		171,105.00	
Cash at bank		<u>12,900.00</u>	
			514,605.00
Non-current assets:			
Plant Equipment		<u>632,730.00</u>	
			<u>632,730.00</u>
Total Assets			<u>1,147,335.00</u>
Equity:			
Ordinary Shares		310,000.00	
Preference Shares		300,000.00	
Retained profit c/f		<u>192,980.00</u>	
			802,980.00
Non-current liability:			
Debentures		<u>100,000.00</u>	
			100,000.00
Current liabilities:			
Creditors		171,355.00	
Corporate tax payable		68,000.00	
Interest payable		2,000.00	
Commission payable		<u>3,000.00</u>	
			<u>244,355.00</u>
Total Equity and Liability			<u>1,147,335.00</u>

Requirement b

The main reason of the balancing position of financial position is the double entry concept (Godfrey et al, 2015). Here, for a debit entry there will always be equivalent one or more credit entry. The debit and credit side will always be same. This double entry accounting system makes sure recording all transactions in at least two different accounts and this can also work as a check that all entries are consistent with each other.

In the double entry system, all transactions are recorded in the journal by separating each transaction at least into two accounts and book those two accounts: one at debit and another in credit (Warren et al, 2020). After that, all the accounts are posted into the ledger. In the ledger, there is one ledger for one account. After that, the balance of each account is transferred to the trial balance to check the accuracy and completeness of the entries. And when no deviation is found, financial statements are prepared. As the whole the process is a scientific method, so at the last of step, the financial position balances.

Question 2

1. ROCE

ROCE stands for Return on Capital Employed. It is a financial ratio that helps to determine a company's profitability and efficiency. Higher ROCE means that the capital has been used more efficiently.

$$\text{ROCE} = \frac{\text{Earnings before interest and tax}}{\text{Capital employed}} \text{ (Scott and O'Brien, 2018)}$$

Here,

	2020	2019
Profit before taxation	620.00	539.00
(+) Interest payable	<u>226.00</u>	<u>181.00</u>
Earnings before interest and tax	846.00	720.00
Capital employed		
Ordinary shares	300.00	300.00
Share premium	<u>1,071.00</u>	<u>1,071.00</u>
Capital employed	1,371.00	1,371.00
Return on capital employed:		
Earnings before interest and tax	846.00	720.00
Capital employed	<u>1,371.00</u>	<u>1,371.00</u>
Return on capital employed	<u>62%</u>	<u>53%</u>

2. ROE

ROE stands for Return on Equity. It is a financial ratio that helps to determine the profitability of the company calculating how much a shareholder will be earning for investing each of his dollar value.

$$\text{ROE} = \frac{\text{Net income}}{\text{Shareholder's equity}} \text{ (Warren et al, 2020)}$$

Here,

	2019	2020
Net income	431.00	366.00
Shareholder's Equity:		
Ordinary shares	300.00	300.00
Share premium	1,071.00	1,071.00
Retained profits	1,717.00	1,541.00
Shareholder's Equity	3,088.00	2,912.00
Return on Equity:		
Net income	431.00	366.00
Shareholder's Equity	<u>3,088.00</u>	<u>2,912.00</u>
Return on Equity	14%	13%

3. Earnings Per Share

Earnings per share is a profitability ratio that measures how much profit will be earned by a shareholder for investment in each share.

$$\text{EPS} = \frac{\text{Net Income}}{\text{Outstanding shares}} \text{ (Kieso et al, 2016)}$$

Here,

	2019	2020
Net income	431.00	366.00
Outstanding shares:		
Ordinary share	300.00	300.00
Per share price	0.50	0.50
Outstanding shares	600.00	600.00
Earnings per share:		
Net income	431.00	366.00
Outstanding shares	600.00	600.00
EPS	0.72	0.61

4. Net Profit Margin

Net profit margin is a profitability ratio that determines how much profit has been earned after considering all operating and financial cost from the sales revenue. It also indicates a company's efficiency.

Net profit margin = Net Profit/Sales Revenue (Horngren et al, 2020)

Here,

	2019	2020
Net income	431.00	366.00
Sales Revenue	6,738.00	6,441.00
Net Profit Margin	6%	6%

5. Asset Turnover

This is ratio of efficiency that determines how effectively companies are using its assets to generate the sales revenue. It is calculated dividing net sales or revenue by the average total assets.

Asset Turnover = Sales Revenue/Total assets (Warren et al, 2020)

Here,

	2019	2020
Sales Revenue	6,738.00	6,441.00
Total Assets	9,736.00	10,087.00
Asset Turnover	69%	64%

6. Stock Holding days

Stock holding days provides a figure that determines the number of days that a business holds its inventory. If the days are lower than this is indicating a company's efficiency that they have been able to produce finished goods or sold them efficiently.

Stock Holding Days = (Inventory/Cost of goods sold) * 365 (Godfrey et al, 2015)

Here,

	2019	2020
Inventory	708.00	659.00
Cost of goods sold	3,235.00	3,096.00
Days in a year	365.00	365.00
Stock holding days	79.88	77.69

7. Debtors Collection Period

Debtors collection period helps a company to determine the number of days that they can collect from their customers (Hornngren et al, 2020). It also helps to determine its liquidity because if the customers will take more time, the company will fall in liquid shortage more. So, the lower the days, the better for the company.

Debtors Collection Period = (Debtors/Net sales) * 365

Here,

	2019	2020
Debtors	1,249.00	1,287.00
Sales Revenue	6,738.00	6,441.00
Days in a year	365.00	365.00
Debtors collection period	67.66	72.93

8. Current Ratio

Current ratio is a liquidity ratio which determines how much dollar value is available to cover 1 dollar of the current liability.

Current Ratio = Current assets: Current liabilities (Scott and O'Brien, 2018)

Here,

	2019	2020
Current Assets	2,303.00	2,355.00
Current Liabilities	2,511.00	3,046.00
Current ratio	1 : 1.09	1 : 1.29

9. Gearing ratio

It determines how much of the capital has been financed through using the debt financing sources.

Gearing Ratio = Total Liabilities/Shareholder's Equity

Here,

	2019	2020
Shareholder's Equity:		
Ordinary shares	300.00	300.00
Share premium	1,071.00	1,071.00
Retained profits	<u>1,717.00</u>	<u>1,541.00</u>
Shareholder's Equity	3,088.00	2,912.00
Total Liabilities:		
Long term liabilities	4,137.00	4,129.00
Short-term liabilities	<u>2,511.00</u>	<u>3,046.00</u>
Total Liabilities	6,648.00	7,175.00
Gearing Ratio:		
Total Liabilities	6,648.00	7,175.00
Shareholder's Equity & Liabilities	9,736.00	10,087.00
Gearing Ratio	68%	71%

10. Interest Coverage

Interest coverage ratio is basically a debt and profitability ratio that determines how easily company can cover its interest on the outstanding debts of the company.

Interest coverage = Earnings before interest and tax/Interest expense (Warren et al, 2020)

Here,

	2019	2020
Profit before taxation	620.00	539.00
(+) Interest payable	<u>226.00</u>	<u>181.00</u>
Earnings before interest and tax	<u>846.00</u>	<u>720.00</u>
Interest payable	<u>226.00</u>	<u>181.00</u>
Interest Coverage ratio:		
Earnings before interest and tax	846.00	720.00
Interest payable	226.00	181.00
Interest Coverage ratio	3.74	3.98

Requirement b

	2020	2019
Return on capital employed	62%	53%
Return on Equity	14%	13%
EPS	0.72	0.61
Net Profit Margin	6.40%	5.68%
Asset Turnover	69%	64%
Stock holding days	80	78
Debtors collection period	68	73
Current ratio	1 : 1.09	1 : 1.29
Gearing Ratio	68%	71%
Interest Coverage ratio	3.74	3.98

From the above calculation we can observe the following things:

- The company has become efficient in its using the capital as we can see that the company's ROCE has been increased by 9% in the year 2020.
- Return on equity is a profitability ratio the ratio has also been increased by 1% in the year 2020 and this is also indicating that the company's profitability has been increased.
- Earning per share is also increased and it may lead the company to see increasing market price of the share.
- As we can see that due to increase in net profit, company's net profit margin has also been increased. The reason behind increasing net profit is increasing sales revenue, decreasing cost of sales. But we can see that the operating cost has been increased in the year 2020 due to administrative cost but as the sales and cost of sales were higher so that increasing amount has been offset by the increasing gross profit.
- Another noticeable ratio is current ratio. We can see that the company is in liquidity crisis as its current assets are lower than the current liabilities and this may cause of hampering their reputation in the market.
- We can also see that interest coverage ratio has also been decreased and it is a clear indication that if the management of the company will not address this issue, in the near future they may have liquidity crisis.

- The reason of liquidity crisis can be said because of decreasing in gearing as we can see that gearing has been decreased in the year 2020.

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