

Accounting Fundamentals

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Assessment 1

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Question 1

A):

Profit and loss account

Profit and Loss Account for the year ending 31 December 2020 of Kedison Plc		
Particulars		Amount in £
Sales		826,650
Add: accrued sales		980
Net sales		827,630
Less: cost of sales		578,650
Gross profit		248,980
Less: Operating expenses		
Outstanding commission	3,000	
Administrative expenses	30,000	
Distributions costs	28,000	
Directors remuneration	5,000	66,000
Earnings before interest and tax		182,980
Less: Interest paid		2,000
Earnings after tax		180,980
Less: tax		68,000
Net profit after tax		112,980
Less: ordinary dividend paid	20,000	
Less: preference dividend paid	30,000	50,000
Retained earnings		62,980

Balance sheet

Statement of Financial Position (Balance Sheet) as on 31 December 2020 of Kedison Plc			
Liabilities	Amount in £	Assets	Amount in £
Current liabilities		Current assets	
Creditors	171,355	Cash and bank	12,900
Outstanding commission	3,000	Inventory	330,600
Tax	68,000	Accrued income	980
		Debtors	170,125
Total current liabilities	242,355	Total current assets	514,605
Non current liabilities		Non current assets	
Debentures	100,000	Plant and equipment	632,730
Equity stock	610,000		
Retained Earnings	194,980		
Total non current liabilities	904,980	Total non current assets	632,730
Total liabilities	1,147,335	Total assets	1,147,335

Footnotes

- In the income statement accrued sales are added to the sales which was given in the additional information and accrued sales are valued at pound 980.
- According to the information given, in this balance sheet the financial manager included preference shares into ordinary shares.

As per the income statement of Kedison Plc the net profit for the year ending 2020 was £ 112,980. The retained earnings of the Kedison Plc valued as on 31st was £ 194,980. If the financial manager or any investor of the Kedison Plc compared their assets and liabilities in the statement of financial position then current assets are greater than current liabilities and noncurrent assets are lesser than non current liabilities. Total share capital of the Kedison Plc was £ 610,000 and total debt £ 100,000. Total dividend paid by Kedison Plc to its shareholders was £ 50,000. If investors or other stakeholders want to make investment in this company, then it will be considered beneficial for them (Haralayya, 2021).

B):

Balance sheet comprises three elements that is equity, assets and liabilities. It shows the financial position at point in time (Thomas and Anne Marie Ward, 2012).

The main reason behind the matching amount of balance sheet at all times is because it follows the financial accounting principle that is the double entry system of bookkeeping. It means that every transaction or activity is recorded at least two times in different ledger or accounts. However, it also makes sure that entries made by the financial manager are accurate and reliable. That's the reason the balance of the balance sheet is matched every time.

For example if businesses come to a decision that they want to sell fixed assets for value £ 100,000. In this state of affairs assets account of business would be declined by £ 100,000 on the contrary business cash account increased by £ 100,000, as a result the balance sheet would be balanced.

Balance includes three elements.

An asset includes current assets and noncurrent assets. Current assets are those assets which are to be turned into cash and cash equivalents within 1 year or 1 operating cycle either is superior. Current assets reprised accounts receivables, stock, cash and prepaid expenses. Non current assets are those assets which can be converted into cash more than a year and they are considered the long term assets of the business (Bragg, 2021). Non current assets are also known as investment activity. It considered plant and machinery, business equipment, copyrights and building.

A liability includes current liabilities and non current liabilities. Current liabilities are those that are due within 1 year or within a normal operating cycle. Current liabilities take trade payables, salary outstanding and short term loans. Non current liabilities are those liabilities which are to be paid in more than a year or they are considered long term liabilities of the business.

Non-current liabilities are also known as financing activities. It considered debentures, shares and buyback of shares.

Shareholders' capital considers the preference shares and equity shares and mutually they refer to share capital of the business. Share capital is the capital which is provided by the holders of the business. Retained earnings which refers to the portion of the net income that is not allocated to shareholders as a dividend in its place would be used by business for reinvestment.

Shareholders' capital defines the net worth of the business and helps the business to calculate approximately or assess the financial strength of the business.

Question 2

A): Calculation of ratios

	Ratio Calculations for Chocco PLC		
1	Return on capital employed		
		2020	2019
	Operating profit	805	699
	Capital employed		
	Total assets	9736	10087
	Current liabilities	2511	3046
	Capital employed	7225	7041
	ROCE		
	Operating profit X100%		
	Capital employed	11.14%	9.93%
2	Return on Equity		
	Net profit	431	366
	Equity	3088	2912
	Net profit X100%		
	Equity	13.96%	12.57%
3	Earning per share		
	Net profit after tax	431	366
	Total shareholders	600	600
	Profit/ total shareholders	0.7183333	0.61

		Pence	Pence
4	Net profit margin ratio		
	Net profit	431	366
	Revenues	6738	6441
	Net profit X100%		
	Revenues	6.40%	5.68%
5	Asset turnover Ratio		
	Net sales	6738	6441
	Average total assets	9736	10087
	Net sales/ Average total assets	0.69	0.64
		Times	Times
6	Stock holding days		
	Inventory	708	659
	Cost of goods sold	3235	3096
	Inventory/ Cost of goods sold X365	79,882513	77.692148
		days	days
7	Debtors collection period		
	Average accounts receivables	1249	1287
	Total credit sales	6738	6441
	Receivables / credit sales X365	67.658801	72.931998
		Days	Days
8	Current ratio		
	Current assets	2303	2355
	Current liabilities	2511	3046
	Current assets/ current liabilities	0.92	0.77
9	Gearing ratio		
	Debt	4137	4129
	Equity	<u>3088</u>	<u>2912</u>
		7225	7041
	Debt X 100%	57.26%	58.64%
	(Debt + Equity)		
10	Inventory cover		
	Cost of goods sold	3235	3096
	Average inventory	708	659
	COGS/ Average inventory	4.57	4.70
		Times	Times

B): Comment of financial performance using the financial ratios

- **Return on capital employed-** The ratio helps to find the return available over the capital employed of the company. Capital employed consists of funds raised from equity and long term capital sources (Dyson, 2010). It can be seen in the Chocco PLC that the return was **9.93% in the year 2019** which increased to **11.14% in the year 2020**.
- **Return on equity-** The return equity tells how much returns have been generated for the equity shareholders of the company. The return for the year **2019 was 12.57%** which marginally increased to **13.96%** during the year. It is favourable for the company as a higher return suggests there are chances of interim dividends and other schemes for the equity holders, such as the issue of bonus shares. Even if the funds are reinvested, it will only contribute to the maximisation of shareholders' wealth (Carlson, 2020).
- **Earnings per share-** The share value of the company's share are 50 pence and the overall capital is 300. It means there are 600 m shares in total. The net profit of the company will be divided by the number of shareholders for the purpose of calculation of earnings per share. It can be seen that during the **year 2019 the EPS was 0.61 pence, which increased to 0.72 pence in the year 2020**. A higher EPS suggests that the profits for the company have increased which is favourable for its business (Fernando, 2021).
- **Net profit margin-** The net profit margin indicates the profits available for the company expressed in % terms against the sales figure of the company. Here the sales figure is treated as the base and profits are expressed as a percentage of that figure. The net profit ratio for the **year 2019 was 5.68% which increased to 6.40% in 2020**. It could be more because the company has generated more sales as well as its operating expenses have reduced.
- **Asset turnover-** The ratio suggests the amount of sales made as against the level of assets in the company. It is expressed a number of times. The ratio suggests the productivity of the assets of the company. In case the ratio is more for a year it means the company has used its fixed assets more effectively in the business. **The ratio will be 0.64 times in the year 2019,**

which becomes 0.69 times in 2020. It can be said that over the period of time the company managed to improve the productivity of the assets (Thompson, 2018).

- **Stock holding days-** It represents the number of days for which a company holds its stock or inventories in the business. A lower figure of stock holding days means the processes of the company are more efficient. It can be seen that in the year **2019 the stock holding days were 77 days which increased to 79 days in the year 2020.** It suggests that the company could not manage to improve this ratio and now it takes almost 79 days, which is the time for which the goods remain in business until those are delivered. The ratio needs to be improved for Chocco PLC.
- **Debtors' collection period-** The ratio tells the number of days within which a company manages to collect funds from its receivables. **In 2019 the receivables days were 72 days which have decreased to 67 days in the year 2020.** It indicates that the debtors are now swift to make payments to the company which might be the result of its promptness in collection of dues in time (Ullah, 2021).
- **Gearing ratio-** The gearing ratio tells the distribution or apportionment of funds to raise capital. It tells the variety of sources through which capital has been raised. It puts debt capital on one side and tells how much of long term capital requirements are fulfilled by issuing debts in the business. A high proportion of debt into the financial structure of a firm indicates a high capital gearing for the company. Since debts are more, naturally then the interest obligations will also be more for the company. **The gearing ratio has been 58.64% for the year 2019 and it declined to 57.26% in the year 2020.** It indicates a favourable position as lower existence of debts in the capital structure means, the interest obligations are going to be low for the year and more profits can be provided to the shareholders.
- **Current ratio-** The ratio tells the proportion of current assets in comparison to the current liabilities of the business. **The working capital ratio for the year 2019 was 0.77 times which accretion to 0.92 for the year 2020.** The company has more liquidity in the year 2020 which is favourable. A current ratio of about 1.5 is considered ideal for the businesses as it means the company has more liquid sources and can make quick payments to the creditors.
- **Inventory cover-** It is a ratio which tells the efficiency of business with respect to management of the inventories. It is a fraction of the cost of goods sold and average

inventory present in the business. A higher ratio here indicates that the inventory management system is more effective in the company and inventory is replaced in fewer periods of time. **The ratio has been 4.70 times in 2019 which decreased to 4.57 times in 2020.** It can be said that the ratio is required to be improved for the business (Woodruff, 2018).

Financial performance of the business would be evaluated through income statement account and balance sheet ratios giving business the mixed results. If ratios go up it's the affirmative sign but if ratios go down it's the negative or warning sign for the business. Businesses have to decide some necessary steps or actions to diminish the impact of liquidity and solvency issues related to operations of the business. Therefore management of the business has to consider the advantages and disadvantages of the sources of finance.

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