

Programme: Business Management

Module: Accounting Fundamentals

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Accounting Fundamentals

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Introduction

Accounting can be financial accounting and management accounting. Both accounting systems are required for the business operation. From the transactions to preparing the final statement for the business, accounting is followed. Accounting is a process by which a business organization records its transactions, follows principles and prepares the report for the organization. GAAP principles are mandatory for the organization and these principles make the business record easy. The report will show the income statement and balance sheet. The cause of the balancing of the balance sheet and different financial ratios will be included in this report.

Income statement

To know the profit and loss, an organization prepares an income statement. Wales Plc also prepared its income statement including necessary elements. The profit and loss statement is prepared below:

Wales Plc

Profit and Loss account

For the year-end

Particulars	amount (£)	amount (£)
Sales	800000	
Add: sales at credit	980	800980

Less: Cost of sales		(578650)
Revenue		222330
Administrative expense		30000
Interest paid	2000	
Add: due	6000	8000
Directors remuneration		5000
Distribution costs		28000
Salesman Commission		3000
Profit before tax		148330
Less: tax		100000
Profit after tax		48330

From the above profit and loss account it is found that the net profit after tax for Wales Plc is £48330. To calculate net profit from revenue, the operating and other expenses including tax are deducted.

Balance sheet

Following the $A = L + OE$ equation the balance sheet is prepared. A means assets of the business, L means the liabilities of the business, and OE means owners' equity of the business (Edmonds, & Olds, 2021). To know the financial position of the organization, the balance sheet is prepared. Wales Plc has also prepared a balance sheet for getting a financial position and this is given below:

Wales Plc

Financial Statement

For the year-end

Particulars	amount (£)	amount (£)
Current assets		
Trade receivable	170125	
Cash and bank	96000	
Receivable	980	
Stock at 31st December 2021	510850	

Total current assets		777955
Long term assets		
Plant and equipment		1250000
Total assets		2027955
Current liabilities		
Trade payable	188625	
payable	3000	
Interest	6000	
10% dividend on preference share	50000	
Corporation tax	100000	
Total current liabilities		347625
Non-current liabilities		
Debenture		200000
Total liabilities		547625
Shareholder's equity		
Ordinary share		900000
Preference share		500000
Retained profits on 1st January 2021	132000	
Profit after tax	48330	
		180330
Less: 10% dividend on preference share	(50000)	
Ordinary dividend paid	(20000)	
Preference dividend paid	(30000)	
		100000
Retained earnings at the year-end		80330
Liabilities and shareholder's equity		2027955

From the above balance sheet, it is found that total assets including long-term and current assets are £2027955. Total liabilities including current liabilities and non-current liabilities are £547625.

Total liabilities and shareholder's equity are £2027955. Based on the accounting equation, total assets are equal to total liabilities and owner's equity.

Balance of balance sheet

From the above balance sheet calculation, it is found that the total assets are equal to the total liabilities and owner's equity. The main cause of the balance sheet is the accounting formula $A = L + OE$. This equation demonstrates that the total assets of a company will be equal to the total liabilities and owner's equity (Flynn & Koornhof, 2015). The name balance sheet means that it is a document of the balance of the amount. In the accounting system, one of the most important principles double entry theory is followed. By following this principle, a transaction when occurs, is recorded based on a double entry system where one account is debited and another account is credited. Each of the transactions and its two accounts impacts the equation $A = L + OE$. Because each of the transactions has two accounts and these accounts either impact assets, liabilities or equity. This accounting formula and the double entry principle are the reasons for the balancing amount. From the transactions following the accounting formula, the accounts are recorded in journal books, then ledger books, then trial balances and then financial statements (Henderson, Peirson, & Howieson, 2015). All of these steps equal the amount of the balance which eventually makes the balance sheet to be balanced. In the balance sheet, the assets of the company are recorded as asset denominations and total liabilities and owner's equity are also recorded in each denomination. The amount of total assets is equal to the amount of total liabilities and owner's equity. So, from the above description, it can be said the amount of balance on both sides is equal or balanced due to the accounting principle and the accounting formula.

Ratio analysis and comment on the performance of the company

The ratio analysis is conducted based on two years so that the comparison of the company with the previous year can be easy and the recent performance can be understood (Hopwood, 2016). Like other business companies, Sweet Plc wanted to know its performance for the last two years. That's why to calculate the ratio analysis for the last year's income statement and balance sheet for the company are given below. Because without this information, the ratio analysis will be impossible.

Sweet Plc Income statement

	2021	2020
Revenue	6738	6441
Cost of sales	3235	3096
Gross profit	3503	3345
Distribution costs	437	422
Marketing and selling costs	1324	1274
Administrative expenses	927	950
Operating profit	805	699
Profit/loss on sale of fixed assets	19	-5
Investment Income	22	26
Interest payable	226	181
Profit before tax	620	539
tax	189	173
Profit for the year	431	366

Sweet Plc Balance sheet

	2021	2020
Non-current assets		
Intangible assets	5485	5809
Property plant and equipment	1613	1605
Investments	335	318
Current assets		
inventory	708	659
Trade receivable	1249	1287
Investments	145	232
Cash	201	177
Total assets	9736	10087
Current Liabilities		
Trade payable	583	655

other creditors	1928	2391
Noncurrent liabilities		
Loans and other borrowings	4137	4129
Net assets		
Equity	3088	2912
Ordinary share capital	300	300
Share premium	1071	1071
Retained profits	1717	2912

ROCE

ROCE		2021 (£m)	2020 (£m)
	Total Assets	9736	10087
	Current liabilities	2511	3046
	Capital employed	7225	7041
	Earnings before tax	620	539
	ROCE	8.58%	7.66%

Capital efficiency is an important element of an organization. If an organization has sufficient capital efficiency, the organization will have a higher ROCE (Libby, Short, & Libby, 2014). Using capital efficiency, the profitability of the organization can be determined. To get the ROCE the capital employed for the period should be determined. Capital employed can be determined by deducting current liabilities from total assets. Then the earnings before tax should be divided by capital employed and the ROCE should be determined. From the above calculation, it is found that Sweet Plc has 7.66% and 8.58% ROCE for the years 2020 and 2021 respectively. In both of the years, it has less than 10% ROCE which means the company has less capital employed. The company needs to increase its assets and decrease current liabilities to increase capital employed.

ROE

ROE		2021(£m)	2020(£m)
	Net Income	431	366
	Shareholder's equity	3088	2912
	ROE	13.96%	12.57%

Return on Equity or ROE is an important performance measurement of a company. ROE provides an idea about the financial performance of the company. From ROE, how much net income can be achieved by using a company's shareholder's equity? If the net income is higher, the ratio will be higher. If the net income is lower, the ratio will be lower. ROE is a standard performance measurement of a company and this can be determined by dividing net income by the company's shareholder equity (Turtle & Wang, 2017). ROE gives an idea about the financial efficiency of the company and the company can know how much net profit can be generated by equity. From the above calculation, it is found that in 2020 Sweet Plc has 12.57% ROE and in 2021, it has 13.96% ROE. Sweet Plc has less net income and it generated less ROE. So, Sweet Plc needs to increase its net income.

EPS

EPS		2021 (£m)	2020 (£m)
	Profit	431	366
	Number of shares	600	600
	EPS	71.83%	61.00%

Earnings per share or EPS is an important performance measurement which is used to determine the profit of the company by using the number of shares (Warren, Jonick, & Schneider, 2020). By EPS profitability of the company can be measured. EPS will provide an idea about the profit of the company compared to the number of shares. Higher EPS will provide an advantage to the company and it will also attract the investors for the investment. From the above calculation, it is found that Sweet Plc has higher EPS in both of the years. In 2020 it has 61% and in 2021 it has 71.55% EPS. This means that the company has a handsome profit compared to its number of shares. Sweet Plc can get investment opportunities from investors.

Net profit margin

Net profit margin		2021 (£m)	2020 (£m)
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	Net profit	431	366
	Revenue	6738	6441
	Net Profit margin	6.40%	5.68%

To measure the profitability of the company, the net profit margin is a good index. The net profit margin will give an idea about the profitability of the company. By using the revenue of the company the net profit is evaluated. If the net profit is less compared to revenue, the net profit margin will be lower. If the net profit is higher, the net profit margin will be high. A higher net profit margin indicates that the company has good profitability. To get the net profit margin, net profit is divided by the revenue of the company and then multiplied by 100 (Weil, Schipper, & Francis, 2017). A higher than 10% net profit margin indicates that the company is in a good position. But less than 10% net profit margin indicates that the company is not good at generating profit. from the above calculation, it is found that Sweet plc has less than a 10% net profit margin in both of the years. In 2020, it had a 5.68% net profit margin, in 2021, it has a 6.40% net profit margin. It explains that the profitability of the company is not well and should be increased.

Asset turnover

Asset turnover		2021 (£m)	2020 (£m)
	Net sales	6738	6441
	Average total assets	9911.5	9911.5
	Asset Turnover ratio	67.98%	64.99%

Assets are used in the company for longer benefits because assets are resources from which a company get benefits in future. The company's assets are valuable for creating profit for the business. The asset turnover ratio is calculated to know how much effective the business' assets are to generate profit (Warren, Jonick, & Schneider, 2020). The asset turnover ratio is calculated by dividing net sales by the average total assets of the company. From the above calculation it is found that in 2020 Sweet Plc has 64.99% asset turnover and in 2021, it has 67.98%. In 2021, it has a higher asset turnover than that of 2020. For the future period, it needs to increase its net sales compared to its assets.

Stock holding day

Stock holding days		2021 (£m)	2020 (£m)
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	Closing stock	708	659
	cost of goods sold	3235	3096
	Stock holding days	79.882535	77.692183

A company's stock holding days need to be calculated because by calculating stock holding days a company can get an idea about its inventory stock at the end of the period. Higher holding stock depicts that the company has a higher inventory in stock without selling and the company will generate less profit. From the above calculation, it is found that in 2020 Sweet Plc has 78 days and in 2021 it has 80 days holding days.

Debtor collection period

Debtors collection period		2021 (£m)	2020 (£m)
	Accounting receivables	1249	1287
	Credit sales	6738	6441
	Debtors collection period	67.658801	72.931998

Debtor collection needs to be calculated for a business because it will provide the business with how many days it takes to collect the money from the debtors. If the debtor collection is higher, the company will face a lack of cash and the business operation will be difficult due to insufficient cash (Weil, Schipper, & Francis, 2017). From the above calculation, it is found that in 2020 Sweet Plc has 73 days and in 2021 it has 68 days' collection period. That means Sweet plc has a higher collection period and the company needs to decrease this period.

Current ratio

Current ratio		2021 (£m)	2020 (£m)
	Current assets	2303	2355
	Current liabilities	2511	3046
	Current ratio	0.92	0.77

The current ratio is calculated to know the company's ability to pay its current liabilities using its current assets. Greater than 1 means that the company has higher current assets to meet its current obligation. On the other than, less than 1 means the company has insufficient current assets to pay its current liabilities. From the above calculation, it is found that in 2020 Sweet Plc has 0.77 and

in 2021 it has a 0.92 current ratio. This means that Sweet Plc has less than 1 current ratio and the company needs to increase its current assets to meet its current obligations.

Gearing ratio

Gearing ratio		2021 (£m)	2020 (£m)
	Creditors	1928	2391
	Loans and other borrowings	4137	4129
	Total debt	6065	6520
	Equity	3088	2912
	Gearing ratio	1.96	2.24

From the above calculation, it is found that in 2020 Sweet Plc has 2.24 and in 2021 it has a 2021 gearing ratio. As the ratio is higher than 1 that means the company has higher funding from debt. The company has less equity and Sweet Plc needs to increase its equity funding and decrease its debt funding.

Interest coverage ratio

Interest cover ratio		2021 (£m)	2020 (£m)
	Earnings before tax	620	539
	Interest expense	226	181
	Interest coverage ratio	2.74	2.98

From the above calculation, it can be said that in 2020 Sweet Plc has 2.98 and in 2021 it has a 2.74 interest coverage ratio. In both years, the company has a higher than 1 coverage ratio which means the company has enough profit before tax to pay its interest.

Conclusion

An income statement is a statement which records operating expenses and operating income to get net profit for the business. The profit and loss account is an important statement which explains the profitability of the business. The balance sheet is known as a financial statement which records all the assets and liabilities along with equity of the business. From the balance sheet, the total asset amount and total liabilities of the business can be determined. The equity of the business can also be known from the balance sheet. Ratio analysis is an analysis which describes the

performance of the business. From the ratio analysis, a business company know its profitability performance, financial performance and other related performance.

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