

ACCOUNTING FUNDAMENTALS

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Question 1

a) Profit and Loss statement and statement of financial position for year ended 31st December 2020 for Kedison PLC

Profit and Loss statement

Profit and loss statement is financial statement prepared for understanding profitability of loss of an organisation in a particular year. Profit and loss statement mainly signifies total revenue, gross profit and net profit of organisation (Profir, 2017). Profit and loss statement for Kedison Plc has been prepared by considering balances related to 31st December 2020.

Profit and Loss Statement		
For the year ended 31st December 2020		
Entity: Kedison PLC		
Details	Sum (£)	Sum (£)
Sales		826,650
(-) Cost of sales	578,650	
Profit (Gross)		248,000
(-) Administrative expenses	30,000	
(-) Distribution costs	28000	
Profit (Operating)		190,000
(-) Payment outstanding	980	
(-) Salesmen commission	3000	
Profit before interest		186,020
(-) Finance Costs		
Interest paid	2,000	
(+) Outstanding interest	2000	
Profit before tax		182,020
(-) Corporation tax	68,000	
Profit (Net)		114,020
Preference dividend paid	30,000	
Ordinary dividend paid	20,000	
Directors remuneration	5,000	
Net Gain		59,020

Profit and loss statement of Kedison Plc indicates total sales of £826650 and net profit has been calculated as £114020. Calculation of net profit has been made by deducting administrative expenses, distribution cost and finance cost. In the calculation, owed commission of salesmen £3000 were deducted from operating profit of Kedison Plc for determining profit before tax of the company. Besides, goods sent to customers amounting £980 were sent to customers on the last day of the year. However, its payment is going to be received on 28th February 2021. As per Maenuddina *et al.* (2020), the profit and loss

statement of an organisation includes present year's income and expenses. Thus, the goods valued £980 sent to customers were recorded in the profit and loss statement of 2020. Besides, preference shares' dividend, ordinary share dividend and directors remuneration has been deducted from net profit of Kedison Plc in order to determine net gain for the year. Feasible profitability of Kedison Plc has been assessed by help of profit and loss statement of 2020.

Financial Position Statement

Financial position statement or balance sheet is a tool of recording assets, liabilities and equities of an organisation. According to McLaney and Atrill (2016), a financial position statement is developed at the last date of a financial year. Financial position statement of Kedison Plc has been prepared by considering balances related to 31st December 2020.

Financial Position Statement		
As on 31st December 2020		
Entity: Kedison PLC		
Details	Sum (£)	Sum (£)
Assets		
Assets (Non-Current)		
Plant and equipment	632,730	
Assets (Non-Current) Total		632,730
Assets (Current)		
Trade Debtors	170,125	
Stock at 31st December 2020	330,600	
Cash and bank	12,900	
Assets (Current) (Total)		513,625
Assets (Total)		1,146,355
Liabilities & equities		
Liabilities		
Liabilities (Long-term)		
4% Debentures	100,000	
Liabilities (Long-term) (Total)		100,000
Liabilities (Short-term)		
Trade creditors	184,355	
Outstanding interest	2000	
Payment outstanding	980	
Salesmen commission due	3000	
Liabilities (Short-term) (Total)		190,335
Liabilities (Total)		290,335

Equities		
£1 ordinary shares	310,000	
(+) Retained profits at 1st January 2020	132,000	
(+) Profit (Net)	114,020	
(+) 10% £1 preference shares	300,000	
Equities (Total)		856,020
Liabilities & equities (Total)		1,146,355

Calculation of financial position statement has been made by help of non-current assets £632730, current assets £513625, long-term liabilities £100000 and short-term liabilities amounting £190335. Asset side of Kedison Plc's financial position statement includes plant & machinery amounting £632730, trade debtors £170125, stock £330600 and cash and bank amounting £12900. Besides, equity balance of Kedison Plc includes ordinary shares amounting £3100000, retained earnings £132000, net profit £114020 and 10% preference shares £300000. Thus, total equity balance of Kedison plc as on 31st December 2021 is £856020. Besides, interest of 4% December has been calculated as £4000 for the year but only £2000 were recorded in the books. Therefore £2000 were considered as interest outstanding and recorded in the short-term liability section of the financial position statement. Total balance of financial position statement for Kedison Plc is £1146355 as on 31st December 2021. Sound financial performance and net worth of Kedison plc can be analysed through the financial position statement of 2020.

b) Reason behind statement of financial position balance

Balance sheet or statement of financial position provides a snapshot of company's assets and liabilities. As per Jones (2013), financial position statements act as a crucial tool for understanding net worth of business at a single point of time. A crucial fact about balance sheets is that the asset and liability side of balance sheet is always equal. It means, a company needs to maintain same amount of assets and liabilities in business for maintaining a sound net worth. Key reason behind this is the use of the accounting principle of double entry. Accounting principle of double entry records every business transaction which has a minimum two accounts. So, it helps the business in balancing debit and credit side of the transaction. As opined by Ward and Thomas (2012), for every debit, there must be an equal and opposite credit balance in an accounting transaction. For instance, an organisation like Kedison Plc is required to record each and every business transaction with more than one account in a double entry bookkeeping system. Say for example, a loan of £50000 were taken

by Kedison Plc, it would be recorded by debiting assets by £50000 and crediting liabilities by £50000. Therefore, both the debt and credit side of the company have equal amounts. As per this accounting system, an organization is required to ensure that all the entries are recorded on a consistent basis. Presence of consistency in accounting transactions helps in preventing errors and material misstatements from records. Hence, the balance sheet of an organization is always balanced.

Question 2

a) Calculating financial ratios for Chocco Plc for 2020 and 2019

Financial ratio can be analysed as relative magnitude of two selected numbers taken from financial statements and reports of an organisation. Financial ratios mainly shed light on profitability, efficiency, liquidity and solvency position of an organisation (Anwar, 2019). Calculation of financial ratio has been made for Chocco Plc which is a long-established chocolate and confectionery manufacturer of UK.

1- ROCE

ROCE		
Entity: Chocco plc		
Details	2020 (£m)	2019 (£m)
Earnings before interest & tax	805	699
(/) Capital employed	7,225	7,041
Total assets	9,736	10,087
(-) Liabilities (Current)	2,511	3,046
ROCE	11%	10%

Return on capital employed (ROCE) is profitability ratio that emphasises on profitability of company by the use of capital employed (Atidhira and Yustina, 2017). Formula of calculating ROCE is “earnings before interest and tax or operating profit/capital employed”. Capital employed is total assets minus current liabilities. In case of Chocco Plc, ROCE shows 1% in profitability. It means Chocco Plc was able to enhance use of capital employed for generating higher profit. Moreover, capital employed of Chocco plc has increased by £184m in 2020.

2- ROE

ROE		
Entity: Chocco plc		
Details	2020 (£m)	2019 (£m)
Income (Net)	431	366
(/) Capital (Equity)	3,088	2,912
ROE	14%	13%

Return on equity (ROE) is a financial ratio that emphasises on profitability of business. Generating higher return on equity indicates higher profitability of business (Nariswari and Nugraha, 2020). This ratio can be calculated by dividing net income with equity capital. Comparing return on equity of Chocco Plc for last two years, profitability of Chocco Plc is higher in 2020. It means, Chocco Plc is effectively using its equity capital for making sales of chocolate and confectionery all over the world.

3- Earnings per share

Earnings per share		
Entity: Chocco plc		
Details	2020 (£m)	2019 (£m)
Income (Net)	431	366
(-) Paid Dividend	255	242
(/) Weighted average share outstanding (50p shares)	600	600
Earnings per share	0.29	0.21

This ratio indicates monetary value of earnings generated by company by help of each outstanding common stock. Earnings per share are “net income-dividend paid/weighted average share outstanding”. Therefore, higher earnings per share indicate better business performance (Kurniawan, 2021). Chocco Plc has £0.21 EPS in 2019 and £0.29 EPS in 2020. Therefore, an improvement of £0.08 has been taken place in 2020. Along with consistency in weighted average share outstanding, increasing trend in net income and dividend paid indicates feasible performance of Chocco Plc.

4- Net profit margin

Net profit margin		
Entity: Chocco plc		
Details	2020 (£m)	2019 (£m)
Profit (Net)	431	366
(/) Revenue (Sales)	6,738	6,441
Net profit margin	6%	6%

It is a financial ratio that emphasises on sale revenue and net profit of an organisation. Net profit margin is calculated by dividing net profit by net sale. So, if an organization has a higher net profit margin, it has sound profitability (Nadarajan *et al.* 2018). In case of Chocco Plc, consistency in net profit margin has been found. In both 2020 and 2019, the company has made 6% profitability. However, due to slightly higher operating expenses, net profit margin of 2020 is similar to 2019.

5- Asset turnover

Asset turnover		
Entity: Chocco plc		
Details	2020 (£m)	2019 (£m)
Sales (Net)	6,738	6,441
(/) Total assets (Average)	9,736	10,087
Asset turnover	69%	64%

Asset turnover is a financial ratio that emphasises on efficiency of business to use its asset balance for generating revenue. As per Purwanti (2019), formula of this ratio is “net sales/average total assets”. Comparing asset turnover of the last two years, Chocco Plc has utilised its assets more efficiently in 2020 as compared to 2019. Asset turnover of the venture was 9% higher in 2020 along with £351m reduction in asset base.

6- Stock holding days

Stock holding days		
Entity: Chocco plc		
Details	2020 (£m)	2019 (£m)
Closing inventory	708	659
(*) 365 Days	258420	240535
(/) Cost of sales	3,235	3,096
Stock holding days	80	78

Stock holding days is equivalent to the average number of days taken by an organisation for converting stocks into sales. A company taking less time for making sales is more efficient (Ji, 2017). Formula of stock holding days is “closing inventories*365 days/cost of sales. Stock holding days of Chocco Plc is 80 days in 2020 and 78 days in 2019. Along with an increment in closing inventories, the company has taken 2 days extra for converting inventories in sales in 2020. Thus, Chocco Plc has sound efficiency in 2019 as compare to 2020.

7- Debtors collection period

Debtors collection period		
Entity: Chocco plc		
Details	2020 (£m)	2019 (£m)
Trade receivables	1,249	1,287
(*) 365 Days	455885	469755
(/) Sales revenue	6,738	6,441
Debtors collection period	68	73

Debtor collection period is equivalent to the average number of days taken by an organisation for collecting dues from customers. A company taking higher time for collecting dues from customers is more efficient (Purwanti, 2019). Formula of debtor collection period is “trade receivables*365 days/sales revenue. Debtor collection period of Chocco Plc is 68 days in 2020 and 73 days in 2019. Along with reduction in trade debtors, the company has made higher sales in 2020 as compared to 2019. Thus, Chocco Plc has sound efficiency in 2020 as compare to 2019.

8- Current ratio

Current ratio		
Entity: Chocco plc		
Details	2020 (£m)	2019 (£m)
Assets (Current)	2,303	2,355
(/)Liabilities (Current)	2,511	3,046
Current ratio	0.92	0.77

It is a liquidity ratio mainly emphasised on current assets and current liabilities. According to Kurniawan (2021), current ratio is current asset divided by current liabilities. Chocco Plc has 0.92 times current ratio in 2020 and 0.77 times current ratio in 2019. However, current assets of Chocco Plc have declined by £52m and current liabilities have declined by £535m in 2020.

It indicates the sound working capital of Chocco plc has a proportion of current assets higher than current liabilities in 2020.

9- Gearing ratio

Gearing ratio		
Entity: Chocco plc		
Details	2020 (£m)	2019 (£m)
Debt capital	6648	7175
(/) Equity capital	3,088	2,912
Gearing ratio	2.15	2.46

Gearing ratio is a financial ratio that compares debt capital of an organisation with equity capital. Gearing ratio is “debt capital/equity capital”. If a firm has higher debt capital, it is highly leveraged (Sinurat *et al.* 2021). In Chocco Plc, proportion of debt capital has declined to 2.16 times from 3.86 times. Reducing debt capital is efficient for Chocco Plc as presence of higher debt capital may create pressure on ongoing operations. Besides, equity capital is increased to £3088m from £2912m in 2020.

10- Interest cover

Interest cover		
Entity: Chocco plc		
Details	2020 (£m)	2019 (£m)
Earnings before interest & tax	805	699
(/) Interest paid	226	181
Interest cover	3.56	3.86

This ratio determines how easily a firm pays interest on its outstanding debts. It can be calculated by dividing earnings before interest and tax from interest paid (Ji, 2017). Chocco Plc has paid £226m interest in 2020 and £181m interest in 2019. Therefore, an increasing trend of interest payment has been found. Besides, earnings before interest and tax have been increased to £805m in 2020. Therefore, Chocco Plc has a sound ability to honour its debt payments.

b) Commenting in financial performance and position of Chocco plc

An organisation having sufficient profitability, liquidity, efficiency and solvency position has a sound organisational performance. Performance of a company can be determined by help of financial position statements and ratio analysis. In the case of Chocco Plc, revenue has been increased to £6738m from 6441m in 2019. The company was able to generate 1% higher profitability in 2020 as equity capital was increased to £3088. The company has made £139m higher cost of sales in 2020 in order to expand sales of chocolate and confectionery in all over the world. In 2020, Chocco Plc has made total expenses of £2924m in 2020 which was £2834m in 2019. So, a light increment in total operating expenditure of Chocco Plc has been found in 2020. As per statement of financial position, Chocco Plc has £9736m total assets in 2020 and £10087m total assets in 2019. It signifies reduction in assets balance by £351m in 2019. Non-current liabilities of Chocco Plc were £4137m in 2020 and £4129m in 2019. Therefore, Chocco Plc has introduced more non-current liabilities in 2020 for financing its operations. As the company maintains lower non-current liabilities, exposure to lever risk is lower for the company.

As per ratio analysis, improvement in performance of Chocco Plc has been found as per ROCE, ROE and EPS. Moreover, net income of Chocco Plc has increased to £431m in and dividend paid has been increased by £13m in 2020. Net profit margin of the company shows consistency in performance and asset turnover indicates efficient use of assets for generating revenue. Stock holding period indicates reduction in performance by 2 days and debtor collection period shows efficiency in collecting due from customers. Considering the current ratio of the last two years, Chocco plc is in a sound liquidity position. Comparing net profit of last two year, profit in 2020 was higher than 2019. As per generating ratio and interest cover ratio, Chocco Plc has had sound performance in the last two years. As per ratio analysis, Chocco Plc has a sound profitability, liquidity and efficiency position. According to information in financial statements and financial ratios, Chocco Plc has sound financial performance and position.

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