

Accounting Fundamentals

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Question One

Income statement for the year ended 31st December 2021 for Wales plc

Wales PLC			
Profit and Loss Statement for the year ended 31st December 2021			
PARTICULARS	Amount	PARTICULARS	Amount
Cost of Sales	£ 578,650	Sales (800,000 + 980)	£800,980
Interest paid	£ 2,000		
Distribution Cost	£ 28,000		
Administrative	£ 30,000		
Expenses	£ 3,000		
Sales commission	£ 5,000		
Directors	£ 30,000		
remuneration	£ 30,000		
Preference dividend			
paid	£ 20,000		
Ordinary dividend	£100,000		
paid			
	£ <u>4,330</u>		

Provision for corporate tax	£800,980		£800,980
Net profit			

Statement of financial position as at that date.

Wales PLC		
Statement of financial position as of 31st December 2021		
Equity and liabilities		
Shareholder's Fund		
£1 ordinary shares		£ 500,000
10% £1 preference shares		£ 200,000
Retained profits at 1st January 2021	£132,000	
<u>Add: Net profit</u>		
Long Term Liability	£ 4,330	£ 136,330
4% Debentures		
Current Liabilities		£ 100,000
Trade payable		
Outstanding sales commission		
Provision for corporate tax		£ 188,625
Total		£ 3,000

Assets		£ <u>100,000</u>
Non- Current assets		£ 1,227,955
Fixed Assets		
Plant and equipment		
Current assets		
Debtors (170,125 + 980)		£ 650,000
Stock		
Cash and bank		£ 171,105
Total		£ 330, 600
		£ <u>76,250</u>
		£ 1,227,955

b) Why does the statement of financial position balance?

The balance sheet, also known as the statement of financial position, will always balance. Like the accounting equation, the total worth of a company's assets will always equal its equity and liabilities, making it balanced. When analyzing how a business gets its resources, this makes perfect sense. If a firm purchases anything with cash or other assets, it must sacrifice the equivalent number of those assets in order to acquire the new item. It balances because of the double entry principle in the preparation of the accounts

Another alternative is for the company's owners to pay the purchase with cash, maybe by selling shares. The corporation can finally be able to get funding to purchase an asset. Under these

circumstances, the accounting equation is double entered; therefore, the statement of financial position will always balance. The company's assets will equal its liabilities plus any shareholders' equity

Question 2

Calculate the following ratios for Sweets plc for 2021 and 2020, showing the formulas and workings:

1. ROCE

ROCE = $\frac{\text{Earnings before interest and tax}}{\text{Total assets - current liabilities}}$

Total assets - current liabilities

Year	2020 (£ million)	2021 (£ million)
Earnings before interest and tax	720	846
Total assets	10,087	9,736
Current Liability	3,046	2,511
ROCE (%)	10.22	11.70

2. ROE

Formula

ROE = $\frac{\text{Net income}}{\text{shareholder equity}}$

Year	2020 (£ million)	2021 (£ million)
Net income	366	431
Shareholders' equity	2,912	3,088
ROE (%)	12.56	13.96

3. Earnings per share

Formula= $\frac{\text{Net income of the company}}{\text{Average outstanding shares of the company}}$

Average outstanding shares of the company

EPS = $\frac{\text{net income of the company} - \text{dividend to preferred to shareholders}}{\text{Average outstanding shares of the company}}$

Average outstanding shares of the company

Year	2020 (£ millions)	2021 (£ millions)
Net income	366	431
Dividend to preferred shareholders	242	255
Average outstanding shares of the company	1371	1371
	$\frac{366-242}{1371}$	$\frac{431-255}{1371}$
	0.09	0.128

4. Net profit margin

Net profit margin = Net profit / Revenue

Net profit margin (2020)

$$366 / 6,441 = 5.682$$

Net profit margin (2021)

$$431 / 6,738 = 6.397$$

5. Asset turnover

Formula = Net sales / average total assets

2020

$$6,441 / 10,087 = 0.63$$

2021

$$6,738 / \{(10,087 + 9,736) / 2\}$$

$$6,738 / 9,911.5 = 0.67$$

6. Stock holding days

Formula = COGS

Average value of inventory

Year	2020	2021
COGS	3,096	3,235
Average value of inventory	659	708
Stock holding days	4.7days	4.6days

7. Debtor's collection period

Formula:

Accounts receivable balance * 365

Total net sales

Year	2020	2021
Receivable amount	1,287	1,249
Total net sales	6,441	6,738
Days	365	365
Debtors' collection period	72.93 days	67.66 days

8. Current ratio

Current ratio = Current Assets

Current liabilities

Year	2020	2021
Current asset	2,355	2,303
Current liabilities	3,046	2,511
Current ratio	0.773	0.917

9. Gearing ratio**Formula:**

Gearing ratio = EBIT / total interest

Gearing ratio = Total debt / total equity

Gearing ratio = total debt / total assets

2020

Gearing ratio = total debt / total assets

$$(4,129) / 10,087 = 0.4093$$

2021

Gearing ratio = total debt / total assets

$$(4,137) / 9,736 = 0.4249$$

10. Interest cover

EBIT /interest expense

2020

$$720 / 181 = 3.978$$

2021

$$846 / 226 = 3.743$$

Comment on the financial performance and position of Sweets plc using ratios

The ROCE measures the efficiency with the employed capital and the company profitability. In 2020 the company had a ROCE of 10.22, while in 2021, it had 11.70. This means that the company improved efficiency in the capital employed, bettering its ROCE in 2021.

The second ratio, ROE, measures the company's proficiency in generating from the investment by the shareholders. In 2020 the company had an ROE of 12.52, and its performance in terms of proficiency to generate from the investment by the shareholders increased to 13.96 % in 2021. Both are still not good ROE as a return between 15%-20% is considered a good ROE (Suveera, 2017).

The third ratio of earnings per share is used to assess the performance and profitability before investing. In 2021 the company will be more profitable as it has higher earnings per share (0.128) compared to the previous year, which had 0.09.

Net profit margin measures how much the percentage of income is generated from the revenues received (Ogneva *et al.*, 2020). The company has lower margins in both 2020 and 2021; its profit

margins are below 10 which is considered the average. It, however, shows performance improvement as in 2021, it has a 6.397 higher net profit margin s compared to 2020(5.682)

Asset turnover indicates the company's efficiency in deploying assets to produce revenues. In 2021 the company deployed more assets efficiently to produce revenue (asset turnover of 0.67 as compared to 2020, which was 0.63. However, all shows that the company does not do good as a good turnover ratio should be 2.5 and above.

The stock holding days indicate how efficiently the firm is managing the inventory or whether the firm's stock is difficult to sell. The company has good inventory management, and its stock sells easily and quickly in 2020 and 2021; the stock holding days are 4.6 days and 4.7 days, respectively. This shows the company is doing excellently in inventory management and selling.

Debtor's collection period indicates the average time that the company takes to collect debts (Linares-Mustarós et al., 2018). The company collection for debts or payments is slower as it should take an average of 45 days. The reduced debtor's collection period from 72.93 days (2020) to 67.66 days (2021) indicates increasing efficiency.

The current ratio measures the efficiency or ability of the company to pay short-term obligations. Therefore, the company is straining to pay debts with a current ratio below 1.5 in both years. In 2020 it had a current ratio of 0.773, while in 2021, it had a current ratio of 0.913. While this is an improvement, the company does not have enough assets to pay for short-term obligations such as loans, creditors, and current liabilities.

Gearing ratio shows the company's financial risks with having many debts, which can lead to financial distress (Rashid, 2018). The company has average – financial risk. The gearing ratio is

below 50%, which is 0.4093 in 2020 and 0.4249 in 2021; this is considered normal if this company is well established. However, a gearing ratio below 25 % would be a low risk.

The last ratio, the interest cover ratio, shows how easily the company can pay interest on the company's outstanding debts. The company has interest coverage of 3.978 and 3.743 in 2020 and 2021 respectively, this shows a better interest coverage. Interest coverage of three is better (Laitinen, 2018). The company can, therefore, quickly pay the interest on the outstanding loans or debts.

References

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