

ACCOUNTING FUNDAMENTALS



STUDENT NUMBER: 1913408

MODULE TITLE:

**Accounting Fundamentals
(LCBB4001)**

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Introduction

Accounting is a process that provides information to its users through the financial statement. Again, ratio analysis finds out the facts from the financial statements of a business. Thus, this report solves a practical case of preparation of financial statements and also calculate ratios from financial statements to understand the true performance and position of a business.

The Solution to Question No 1

The Income Statement of Wales PLC

The Income Statement of the Statement of Comprehensive Income is the statement that shows the financial performance of a company or business over a period of time (Hoffman, Pacsy and Flashner, 2013). The Income statement of Wales PLC is given below to determine the financial performance, i.e. net profit or a net loss of the company:

Wales PLC			
Income Statement			
<i>For the year Ended on December 31, 2019</i>			
Particulars	Amt ('000)	Amt ('000)	Amt ('000)
Sales			£ 30,300.00
Less: Cost of Goods Sold			
Cost of Sales		£ 16,220.00	
Depreciation of Plants	(25,600*10%)	£ 2,560.00	-£ 18,780.00
Gross Profit			£ 11,520.00
Less: Operating Expenses			
Administrative Expenses		£ 2,920.00	
Depreciation of Buildings	(16,000*2%)	£ 320.00	
Bad Debt:			
Irrecoverable	£ 240.00		
Bad Debt Allowance	£ 160.00	£ 400.00	
Outstanding Insurance Fees		£ 500.00	
		£ 4,140.00	
Distribution Expense		£ 2,160.00	-£ 6,300.00
Operating Profit			£ 5,220.00
Less: Non-Operating Expenses:			
Debenture Interest		£ 240.00	
Add: Due Interest		£ 240.00	-£ 480.00
Net Income Before Tax			£ 4,740.00
Less: Income Tax			-£ 1,600.00
Net Profit			£ 3,140.00

Figure 1: Income Statement of Wales PLC | Source: Learner Self-Created

As it can be seen from the above income statement, Wales PLC earned gross profit amounting to 11,520 thousand pounds, and net profit after taxes amounting to 3,140 thousand pounds in 2019.

The Statement of Changes in Equity of Wales PLC

The Statement of Changes in Equity shows the changes in the owner's equity over a period of time (Kieso et al., 2017). Before preparing the Statement of Financial Position for Wales PLC, it is essential to prepare the Statement of Changes in Equity first. The Statement of Changes in Equity of Wales PLC is as follows:

Wales PLC			
Statement of Changes in Equity			
For the year Ended on December 31, 2019			
Particulars	Amt ('000)	Amt ('000)	Amt ('000)
Ordinary Shares		£ 29,000.00	
Share Premium		£ 5,000.00	
Retained Profits		£ 8,380.00	
Revaluation Surplus		£ 5,000.00	
Net Income after Tax		£ 3,140.00	£ 50,520.00
Less: Dividends Paid			-£ 560.00
Total Owners Equity			£ 49,960.00

Figure 02: Statement of Changes in Equity of Wales PLC | Source: Learner Self-Created

As can be seen from the above statement, Wales PLC had a Total Owner's Equity as of December 31, 2019, amounting to 49,960 thousand pounds.

The Statement of Financial Position of Wales PLC

The Statement of Financial Position is prepared to show the financial position, i.e. total assets, liabilities, and equity of a firm for a specific point of time (Thomas, Tietz and Harrison, 2015). Now, the Statement of Financial Position for Wales PLC is given below:

Wales PLC			
Statement of Financial Position			
For the year Ended on December 31, 2019			
Particulars	Amt ('000)	Amt ('000)	Amt ('000)
Assets			
<i>Current Asset:</i>			
Bank		£ 320.00	
Trade Receivable	8240		
Less: Bad Debt Irrecoverable	-£ 240.00		
Less: Bad Debt Allowance	-£ 160.00	£ 7,840.00	
Closing Inventory		£ 3,120.00	£ 11,280.00
<i>Non-Current Asset:</i>			
Land:			
At Cost	£ 15,000.00		
Add: Revaluation Surplus	£ 5,000.00	£ 20,000.00	
Building At Cost	£ 16,000.00		
Less: Accumulated Depreciation	-£ 4,580.00	£ 11,420.00	
Plant at Cost	£ 25,600.00		
Less: Accumulated Depreciation	-£ 7,520.00	£ 18,080.00	£ 49,500.00
Total Asset			£ 60,780.00
Liabilities and Owner's Equity			
<i>Liabilities:</i>			
<i>Current Liabilities:</i>			
Trade Payable		£ 4,480.00	
Due Interest		£ 240.00	
Income Tax Payable		£ 1,600.00	
Due Insurance Fees		£ 500.00	£ 6,820.00
<i>Non-Current Liabilities:</i>			
12% Debenture			£ 4,000.00
Total Liabilities			£ 10,820.00
Total Owners Equity			£ 49,960.00
Total Liabilities and Owners Equity			£ 60,780.00

Figure 03: Statement of Financial Position of Wales PLC | Source: Learner Self-Created

As can be seen from the above Statement of Financial Position of Wales PLC, the company had a total asset amounting to 60,780 thousand pounds. Contrarily, the company had total liabilities amounting to 10,820 thousand pounds and total owner's equity dragged down from the statement of changes in equity amounting to 49,960 thousand pounds.

The Solution to Question No 2

2 (a) Calculation of Ratios

Financial ratios are used by the stakeholders of a business that are calculated from the numerical values of the financial statements of a company to understand the numerical information in a useful way (Weygandt, Kieso, and Kimmel, 2014). The required ratios for Jerry PLC are calculated below:

1. Return on Capital Employed

Return on Capital Employed			
<i>Particulars</i>	<i>2019 ('000)</i>	<i>2018 ('000)</i>	<i>Change</i>
Net Income	£ 12.90	£ 18.30	-£ 5.40
Divided By Capital Employed (Debt + Equity)	£ 135.10	£ 145.40	-£ 10.30
Return on Capital Employed	10%	13%	-3%

Figure 04: Return on Capital Employed of Jerry PLC | Source: Learner Self-Created

2. Return on Equity

Return on Equity			
<i>Particulars</i>	<i>2019 ('000)</i>	<i>2018 ('000)</i>	<i>Change</i>
Net Income	£ 12.90	£ 18.30	-£ 5.40
Divided By Equity	£ 93.20	£ 80.30	£ 12.90
Return on Equity	14%	23%	-9%

Figure 05: Return on Equity of Jerry PLC | Source: Learner Self-Created

3. Earnings Per Share

EPS			
<i>Particulars</i>	<i>2019 ('000)</i>	<i>2018 ('000)</i>	<i>Change</i>
Net Income - Preferred Dividends	£ 12.90	£ 18.30	-£ 5.40
Divided By Shares Outstanding	£ 17.80	£ 17.80	£ -
EPS	0.72	1.03	-0.30

Figure 06: EPS of Jerry PLC | Source: Learner Self-Created

4. Gross Profit Margin

Gross Profit Margin			
<i>Particulars</i>	<i>2019 ('000)</i>	<i>2018 ('000)</i>	<i>Change</i>
Gross Profit	£ 191.80	£ 186.90	£ 4.90
Divided By Revenue	£ 501.30	£ 486.80	£ 14.50
Gross Profit Margin	38%	38%	0%

Figure 07: Gross Profit Margin of Jerry PLC | Source: Learner Self-Created

5. Asset Turnover

Asset Turnover Ratio			
<i>Particulars</i>	<i>2019 ('000)</i>	<i>2018 ('000)</i>	<i>Change</i>
Net Sales	£ 501.30	£ 486.80	£ 14.50
Divided By Average Total Assets	£ 289.95	£ 293.80	-£ 3.85
Asset Turnover Ratio	173%	166%	7%

Figure 08: Asset Turnover of Jerry PLC | Source: Learner Self-Created

6. Stock Holding Period

Stock Holding Period			
<i>Particulars</i>	<i>2019 ('000)</i>	<i>2018 ('000)</i>	<i>Change</i>
Stock * 365 Days	£ 14,162.00	£ 15,001.50	-£ 839.50
Divided By Cost of Sales	£ 309.50	£ 299.90	£ 9.60
Stock Holding Period	46	50	-4

Figure 09: Stock Holding Period of Jerry PLC | Source: Learner Self-Created

7. Debtor Collection Period

Debtor Collection Period			
<i>Particulars</i>	<i>2019 ('000)</i>	<i>2018 ('000)</i>	<i>Change</i>
Average Accounts Receivable	£ 114.80	£ 114.70	£ 0.10
Divided By Net Credit Sales	£ 501.30	£ 486.80	£ 14.50
Debtor Collection Period	84	86	-2

Figure 10: Debtor Collection Period of Jerry PLC | Source: Learner Self-Created

8. Current Ratio

Current Ratio			
<i>Particulars</i>	<i>2019 ('000)</i>	<i>2018 ('000)</i>	<i>Change</i>
Current Assets	£ 153.90	£ 156.50	-£ 2.60
Divided By Current Liabilities	£ 151.00	£ 148.40	£ 2.60
Current Ratio	1.02	1.05	-0.04

Figure 11: Current Ratio of Jerry PLC | Source: Learner Self-Created

9. Gearing Ratio

Gearing Ratio			
<i>Particulars</i>	<i>2019 ('000)</i>	<i>2018 ('000)</i>	<i>Change</i>
Debt	£ 41.90	£ 65.10	-£ 23.20
Divided By Debt + Equity	£ 135.10	£ 145.40	-£ 10.30
Gearing Ratio	31%	45%	-14%

Figure 12: Gearing Ratio of Jerry PLC | Source: Learner Self-Created

10. Interest Cover

Interest Cover			
<i>Particulars</i>	<i>2019 ('000)</i>	<i>2018 ('000)</i>	<i>Change</i>
EBIT	£ 23.00	£ 29.70	-£ 6.70
Divided By Interest Expense	£ 0.20	£ 3.50	-£ 3.30
Interest Cover	115.00	8.49	106.51

Figure 13: Interest Cover of Jerry PLC | Source: Learner Self-Created

2 (b) Interpretation of Ratios

1. Return on Capital Employed

The return on capital employed by Jerry PLC has been decreased by 3% from 2018 to 2019. This means, in 2019, the company has been managing its employed capital less efficient compared to the previous year in respect to earning profits.

2. Return on Equity

The return on equity of Jerry PLC has been decreased by 9% from 2018 to 2019. This means, in 2019, the company has been managing its shareholder's invested capital less efficient compared to the previous year in respect to earning profits.

3. Earnings Per Share

The EPS i.e. the profitability of Jerry PLC have been decreased by 0.30 from 2018 to 2019. This means, in 2019, the shareholders of the company are earning 0.30 pounds less for every share they have invested in compared to the previous year.

4. Gross Profit Margin

The gross profit margin of Jerry PLC has been remained unchanged from 2018 to 2019. As the rate is 38%, it can be considered that the company is generating gross profit in 2018 and 2019 effectively.

5. Asset Turnover

The asset turnover ratio of Jerry PLC has been increased by 7% from 2018 to 2019. This means, in 2019, the company has been able to utilize its asset 7% more efficiently in respect to generating revenue compared to the previous year.

6. Stock Holding Period

The stock or inventory holding period of Jerry PLC has been decreased by 4 days from 2018 to 2019. This means, as the ratio is low in 2019, the company has been able to hold its inventory more efficiently compared to the previous year by lowering the inventory carrying cost of the business.

7. Debtor Collection Period

The debtor collection period of Jerry PLC has been decreased by 2 days from 2018 to 2019. This means, as the ratio is low in 2019, the company has been able to collect its owing money from the debtor more fast compared to the previous year. But the ratio is still high and the company should adopt a more aggressive approach in collecting money from debtors.

8. Current Ratio

The current ratio of Jerry PLC has been decreased by 0.04 times from 2018 to 2019. As the ratio is more than 1 times in both the years, it can be concluded that the company has enough current assets against its current liabilities. But the company should try to increase the ratio to 2 times.

9. Gearing Ratio

The gearing ratio of Jerry PLC has been decreased by 14% and yet remains optimal from 2018 to 2019. As the ratio has been decreased in 2019, the company has a relatively low degree of financial leverage that is covered by debt finance.

10. Interest Cover

The interest coverage ratio of Jerry PLC has been increased by 106.51 times which is a great improvement from 2018 to 2019. As the ratio assesses the ability to pay the interest expense, the company has done great in 2019 by increasing the ratio. In 2018, the company had 8.49 pounds of EBIT against 1 pound of interest expense which increased to 115 pounds of EBIT against 1 pound of interest expense in 2019.

The Solution to Question No 3

3 (a) Three Different User Groups

The user groups of company accounts are broadly divided into two main groups, i.e. external and internal users (Brigham and Houston, 2016).

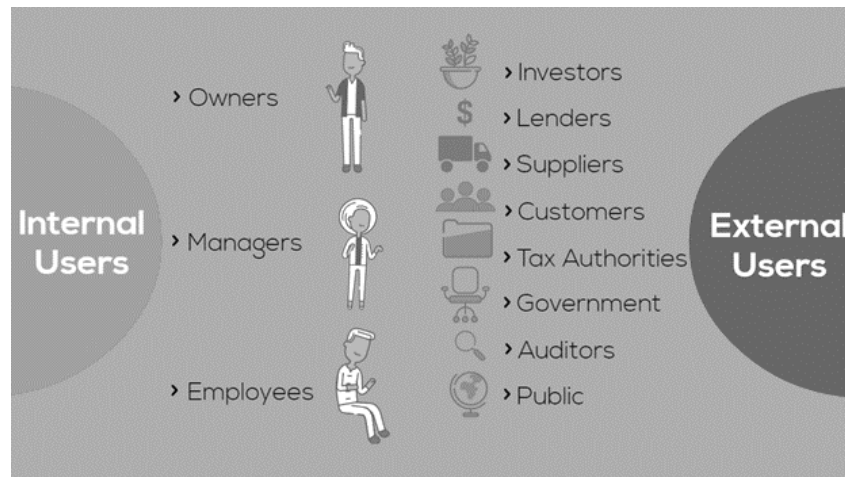


Figure 14: Users of Company Accounts | Source: (Accounting-simplified.com, 2020)

However, three different user groups are selected to discuss in this section are the owners (internal), investors (external), and tax authorities (external).

1. *Owners:* Owners are the internal users of company accounts who want to find out if their company is performing well or not, if the business is being risky or not, or if the business is in a stable position or not. To find it out, they look in the financial statements to know the cash flows, financial performance, and financial position of the company.
2. *Investors:* Investors are the external users of the company's accounts who want to find out if their investment is performing well or not. They assess the profitability and risk from the financial statement of a company to create a profitable portfolio of their investments.
3. *Tax Authorities:* Tax authorities are the external users of the company's accounts who want to know if the business has reported the correct amount of tax in the tax return of the company or not. Tax authorities sometimes conduct audits related to tax returns that are filed by the firm as well.

3 (b) Advantages and Disadvantages of Highly Regulated Regime

Regimes that have a high regulation financial reporting standard have some advantages and disadvantages (Filip, Labelle and Rousseau, 2014). Some of them are as follows:

Advantages

1. The quality of financial reporting increases in a regime where the reporting standards are highly regulated.
2. The users get more relevant, and reliable information which is easily verifiable and comparable within the business and with other businesses in a highly regulated regime (Weygandt, Kieso and Kimmel, 2014).

Disadvantages

1. Higher regulation over financial reporting causes higher costs in preparing and auditing financial statements for the companies. This decreases the profit of the company.
2. Higher regulations sometimes require some disclosures which might be sensitive and confidential for the companies (Ross, Westerfield and Jaffe, 2018). Revealing this information sometimes decreases the competitive ability of the company in the market.

3 (c) Limitations of Financial Statements

Users should not rely on the financial statements to an excessive extent as it has some significant limitations (Kieso et al., 2017). Those are discussed below:

1. *Historical Cost Dependency*: The items reported on the financial statements are reported at their costs. But, the values of assets and liabilities can be changed over time. Thus, the balance sheet can mislead in respect of assets and liabilities reported on it.
2. *Inflationary Effects*: Where the inflation rate is very high, the amounts that are reported on the balance sheet can show a lower amount and thus can show a different picture of the financial position of a business that it is.
3. *Intangible Assets are Ignored*: Many intangible assets are recorded as expenses instead of recording as assets. Thus, this can drastically show the business as undervalued.

Thus, there are some limitations to financial statements that a user should be aware of.

Conclusion

Understanding the financial statements properly is very important for a user of company information to use them most successfully. The financial statements can be properly interpreted by using different ratios. There are some regimes where financial reporting is highly regulated. This helps the users but can create problems for companies in preparing the financial statements.

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