

Accounting Fundamentals
Module Code: LCBB4001

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Introduction

Financial accounting helps its users by providing them with information regarding the performance of the company. The main purpose of financial accounting is to serve the external users for being able to compare between various companies and make their investment decisions (Horngren and Philbrick , 2017). Financial accounting keeps a hold of all financial transaction that takes place in an organization and finally put the outputs in some major financial statements. Income statement and financial statements are two of the major financial report; income statement shows the profit loss position of the organization and the financial statement demonstrates the asset liability position of the organization. By using available information from these statements, interested parties can calculate various ratios to determine the efficiency and profitability of a company.

The first part of the report deals with preparing financial statements and the second part deals with calculating and interpreting various ratios which are widely used for measuring the performance of an organization.

Question 1

Income Statement

Wales plc

As on 31st December 2019

Particulars	Amount £'000	Amount £'000	Amount £'000
Sales			£30 300 000
<u>Less: Operating Expenses</u>			
Distribution Cost		£2 160 000	
<u>Selling cost:</u>			
Cost of sales		£16 220 000	
Depreciation on Plant		£2 560 000	
<u>Administration Cost:</u>			
Administration expense		£2 920 000	
Depreciation on Building		£320 000	
Bad Debt written off		£240 000	
Allowance for receivables		£160 000	
Insurance Expense		£500 000	<u>(£25 080 000)</u>
Operating Profit			£5 220 000
<u>Less: Non-operating Expense</u>			
Interest on Debenture paid	£240 000		
Interest on Debenture Payable	£240 000	<u>£480 000</u>	<u>(£480 000)</u>
Net Profit before tax			£4 740 000
<u>Less: Income Tax</u>			<u>(£1 600 000)</u>
Net Profit after tax			<u>£3 140 000</u>

Note: Depreciation on building (£16 000 000*2%)= £320 000; depreciation on plant (£25 600 000*10%)=£ 2 560 000.

Financial Satetment

Wales plc

As at 31st December 2019

Particulars	Amount £'000	Amount £'000	Amount £'000
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<u>Fixed Assets</u>			
Building at cost	£16 000 000		
Less: Accumulated Depreciation (4260+320)	<u>(£4 580 000)</u>	£11 420 000	
	£25 600 000		
Plant at cost	<u>(£6 820 000)</u>	£18 780 000	
(-) Accumulated Depreciation	£15 000 000		
Land at cost	<u>£5 000 000</u>	£20 000 000	
Add: Revaluation Surplus			
<u>Current Assets</u>	£8 240 000		
Trade receivables	<u>(£240 000)</u>		
Less: Bad Debt	£8 000 000		
	<u>(£160 000)</u>	£7 840 000	
Less: Allowance for bad debt		£3 120 000	
Closing Inventory		<u>£320 000</u>	
Bank Account			<u>£61 480 000</u>
<u>Total Assets</u>			
<u>Owner's Equity</u>	£5 000 000		
Revaluation Surplus	£29 000 000		
£1 Ordinary Share	£5 000 000		
Share Premium	£8 340 000		
Retained Profits	<u>(£560 000)</u>		
Less: Dividend paid	<u>£3 140 000</u>		
Net Profit		£49 920 000	
<u>Net Owner's Equity</u>			
<u>Liabilities</u>	£240 000		
Interest on debenture payable	£500 000		
Insurance payable	£1 600 000		
Income Tax Payable	£4 480 000		
Trade Payable			
<u>Secured loan:</u>	£4 000 000		
Debenture			
	<u>£740 000</u>	<u>£11 560 000</u>	
Suspense Account			<u>£61 480 000</u>
<u>Total owner's equity + liabilities</u>			

Note: a suspense account of £740 has been created to balance the financial statement.

Question 2

Ratio analysis enables someone to get a more in depth view of a company by applying ranges of ratios. By using the available information from the income statement and financial statement, one can bring out more information to better understand the profitability and efficiency of a company.

Ratio Analysis of Jerry plc Supplies

1) Return on Capital Employed

Year	Formula	Rate
2019	$\text{ROC} = \frac{\text{Operating Profit}}{(\text{Total Assets} - \text{Total Liabilities})}$ $= \frac{£23\,000\,000}{(£286\,100\,000 - £151\,000\,000)}$ $= \frac{£23\,000\,000}{£135\,100\,000}$	0.17
2018	$\text{ROC} = \frac{\text{Operating Profit}}{(\text{Total Assets} - \text{Total Liabilities})}$ $= \frac{£29\,700\,000}{(£293\,800\,000 - £148\,400\,000)}$ $= \frac{£29\,700\,000}{£145\,400\,000}$	0.20

2) Return on Equity

Year	Formula	Rate
2019	$\text{ROE} = \frac{\text{Net Income}}{\text{Equity}}$ $= \frac{£12\,900\,000}{£93\,200\,000}$	0.1384
2018	$\text{ROE} = \frac{\text{Net Income}}{\text{Equity}}$ $= \frac{£18\,300\,000}{£80\,300\,000}$	0.2279

3) EPS - Earnings Per Share

Year	Formula	Rate
2019	Total Earnings/ Outstanding Shares = £12 900 000/ £17 800 000	0.7247
2018	Total Earnings/ Outstanding Shares =£18 300 000/£17 800 000	1.028

4) Gross Profit Margin

Year	Formula	Rate
2019	Gross profit margin= Gross profit/ Revenue =£ 191 800 000/ £501 300 000	0.3826
2018	Gross profit margin= Gross profit/ Revenue = £186 900 000/£486 800 000	0.3839

5) Asset Turnover

Year	Formula	Rate
2019	Asset Turnover= Net sales/ Total assets = £501 300 000/£286 100 000	1.752
2018	Asset Turnover= Net sales/ Total assets = £486 800 000/£293 800 000	1.657

6) Stock Holding Period

Year	Formula	Rate
2019	$\text{(Inventory/ Cost of sales)} * 365 \text{ days}$ $= (£38\,800\,000/£309\,500\,000) * 365 \text{ days}$	45.76 days
2018	$\text{(Inventory/ Cost of sales)} * 365 \text{ days}$ $= (£41\,100\,000/ £299\,900\,000) * 365 \text{ days}$	50.021 days

7) Debtor Collection Period

Year	Formula	Rate
2019	$\text{Debtor Collection Period} = (\text{Trade debtors/ Revenue}) * 365 \text{ days}$ $= (£114\,900\,000/£501\,300\,000) * 365 \text{ days}$	83.66 days
2018	$\text{Debtor Collection Period} = (\text{Trade debtors/ Revenue}) * 365 \text{ days}$ $= (£114\,700\,000/£486\,800\,000) * 365 \text{ days}$	86 days

8) Current Ratio

Year	Formula	Rate
2019	$\text{Current Ratio} = \text{Current Assets/ Current Liabilities}$ $= £153\,900\,000/£151\,000\,000$	1.0192

2018	Current Ratio= Current Assets/ Current Liabilities = £156 500 000/£148 400 000	1.054
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9) Gearing

Year	Formula	Rate
2019	Gearing= Total debt/ Total equity = £41 9000 000/£93 200 000	0.4496
2018	Gearing= Total debt/ Total equity = £65 100 000/£80 300 000	0.81

10) Interest Cover

Year	Formula	Rate
2019	Interest Cover= Earnings before interest and tax/ interest expense = £23 000 000/0.2%	£11 500 000
2018	Interest Cover= Earnings before interest and tax/ interest expense = £29 700 000/3.5%	£8 485 714

b) The return on capital employed ratio determines profitability of a company on its employed capital. The ratio measures how efficiently a company use its capital to generate profit (Lammie, 2018). Jerry plc supplies enjoyed 20% return on its capital in the year 2018; but the rate has fallen down to 17% in 2019. The reduction of the net profit of the company in 2019 caused this reduction in the ROI.

Return on equity measures the efficiency of a company to use the capital of the shareholders. A higher return on equity demonstrates efficiency in using the equity finance in generating profit (Arditti, 2017). The return on equity of jerry plc supplies was 22.79% in 2018 but got reduced to 13.84% in 2019. Significant reduction in net income and increment in equity financing caused this deterioration.

EPS is the amount on which the shareholders of a company have claim (Kumar, 2017). The ratio is used for understanding, measuring and comparing the performance of company. EPS of Jerry plc supplies was 1.028 in the year 2018; it went down to 0.7247 in the year 2019. The reason behind this fall was the reduction of the net profit of the company.

Gross profit margin enables managers and investors to determine the profitability of a company from deducting the sales cost or cost of goods sold from the sales revenue. It calculates the percentage of sales which exceeds the cost of goods sold (Pavesic, 2013). Jerry plc supplies have enjoyed a gross profit margin of 38.39% in 2018 and 38.26% in 2019. So there was no major deviation in the gross profits of both years.

Asset turnover ratio demonstrates a company's ability to generate profit by using its assets. This ratio calculates sales against its total assets and brings out a result in percentage (Fairfield, 2011). Jerry plc supplies enjoyed an asset turnover ratio of 1.657 on 2018 which increased to 1.752 n 2019. Growth in sales caused this growth in asset turnover ratio.

Stock holding period determines the amount of days on average a business holds its inventory. Since holding inventory results in extra costs, a higher stock holding period is not desirable. Jerry plc supplies had a stock holding period of 50.21 days in 2018 which reduced to 45.76 days in 2019. This means that the business is re-ordering its required inventory more efficiently.

Debtor collection period is the amount of day a business takes to collect its trade receivables on average (Elliott and Fourer, 2018). A less debtor collection period indicates a higher efficiency of the management to collect its trade receivables. Jerry plc supplies had an average debtor collection period of 86 days in 2018 which improved to 83.66 days in 2019. Hence, it shows higher efficiency of the company to collect its trade receivables.

Current ratio is another widely used ratio which is calculated by managers or interested parties to measure the liquidity of a company to meet its short term obligations (Bagchi, 2014). The ability to meet the short term obligation of Jerry plc supplies was 1.05 in 2018 and 1.02 in 2019. Though this reduction is not significant, it shows the reduction of the company's capacity to meet its current liabilities.

The gearing ratio of determines the debt-equity ratio of a company. The gearing ratio of Jerry plc supplies was 0.81 in 2018 and 0.45 in 2019. This reduction demonstrates tremendous abandonment of debt equity in the capital mix of the business.

Interest cover measures a company's ability to meet its debt payment. The higher the interest cover ratio, the better the ability of the company to meet its debt payment. The interest cover of Jerry plc supplies enjoyed an interest cover ratio of 8.48 in 2018 which turned into 115 in 2019. Repayment of debt causes less interest payment which eventually increased the ability of the company to pay its debt expense.

Finally, though the company has experienced a reduction in the net profit, it has significantly reduced its liability in the year 2019.

Conclusion

A better understanding of financial statement and income statement helps a user to develop some general ideas about a company's performance. But for a more in dept understanding one can use various ratios to understand the performance of a company in various segments. Hence, a sound understanding of these ratios can enable a user to make his investment decisions more wisely and based on more valuable information. Ranging from a manager to a

general investor, all the concerned parties can enjoy superior understanding of a company with the basic knowledge of financial accounting.

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