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Accounting Fundamentals LCBB4001

Profit and Loss Account for the year ended 31 December 2020

	£
Sales	827630
Less: Cost of sales	578650
Gross Profit	248980
Operating expenses	
Administration expenses	30000
Director's remuneration	5000
Distribution expenses	31000
Total operating expenses	66000
Profit before interest & tax	182980
Less: Interest	2000
Profit before tax	180980
Tax	68000
Profit after tax	112980

Kedison PLC

Statement of financial position as at 31 December 2020

Assets	£
Current Assets	
Cash and bank	12900
Debtors	171105
Stock	330600
Total current assets	514605
Non current assets	
Plant & Equipment	632730
Total Assets	1147335
Liabilities and Equity	
Current Liabilities	
Trade Creditors	171355
Accrued expenses	3000
Corporation Tax Payable	68000
Total Current Liabilities	242355
Non Current Liabilities	

4% Debentures	100000
Total Liabilities	342355
Equity	
£1 Ordinary Shares	310000
10% £1 Preference Shares	300000
Retained Profits	194980
Total Equity	804980
Total Liabilities & Equity	1147335
Retained Profits	
As at 1 January 2020	132000
Add: Profits of the year	112980
	244980
Less: Preference dividend paid	30000
Less: Ordinary Dividend paid	20000
Balance on 31 December 2020	194980

Q.1 (a) Financial statements of Kedison PLC

Kedison PLC	
Profit and Loss Account for the year ended 31 December 2020	
	£
Sales	827630
Less: Cost of sales	578650
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10% £1 Preference Shares	300000
Retained Profits	194980
Total Equity	804980
 Total Liabilities & Equity	 1147335
 Retained Profits	
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Add: Profits of the year	112980
	244980
Less: Preference dividend paid	30000
Less: Ordinary Dividend paid	20000
Balance on 31 December 2020	194980

Q.1 (b) Why does the statement of financial position balance

Due to double entry accounting system statement of financial position will always balance, which means that the total assets will always be equal to total liabilities plus shareholders equity.

If there is an increase in assets there will be a corresponding increase in liabilities or there will be a decrease in another asset. For example if goods are sold on credit then Accounts receivable will increase and there will be corresponding increase in equity. If customer makes payment on due date then Accounts Receivable will decrease and cash balance will increase.

Likewise if there is an increase in liabilities then there will be a corresponding increase in assets or decrease in another liability. For example if a company buys goods on credit then Inventory and Accounts payable will both increase. When payment is made on due date cash balance and accounts payable will both decrease.

If a cash expense is incurred then cash balance will decrease and equity will also decrease.

All income and gains will be reflected in retained earnings on the credit side and all expenses will be reflected on the debit side of retained earnings.

The aforesaid double entry system of accounting will ensure that total assets will be equal to total liabilities and equity.

Q.2 Ratio Analysis of Choco Plc

Ratios of Choco Plc of 2020 and 2019		2020	2019
ROCE	%	11.71	10.23
(EBIT/(Total Assets - Current Liabilities) * 100)			
EBIT		846	720
Total Assets - Current liabilities		7225	7041
ROE	%	13.96	12.57
(Net Income / Total Equity * 100)			
Earnings per share	p	0.72	0.61
(Net Income / Number of ordinary shares)			
Net Profit Margin	%	6.40	5.68
(Net Profit / Revenue * 100)			
Asset Turnover ratio	times	0.69	0.64
(Revenue / Total Assets)			
Stock holding	days	80	78
(365/Inventory turnover ratio)			
Inventory turnover ratio	times	4.57	4.70
(Cost of sales / inventory)			
Debtors collection period	days	68	73
(365/Debtors turnover ratio)			
Debtors Turnover Ratio	times	5.39	5.00
(Sales/Debtors)			
Current Ratio	times	0.92	0.77
Current Assets / Current Liabilities)			
Gearing Ratio	times	2.15	2.46
(Total Debt / Total Equity)			
Total debt	£million	6648	7175
Interest Cover	times	3.74	3.98
(EBIT / Interest expense)			

Some of these ratios should have been calculated with reference to average inventory, average debtors, average total assets and average total equity. Since the figures of 2018 are not available the average figures of 2019 cannot be calculated. Therefore only the year- end figures have been considered. To maintain homogeneity ratios of 2020 have also been calculated with reference to year- end figures.

Q.2 (b) Comments on the financial performance and financial position of Choco Plc

The ratios of a particular year should be compared with the ratios of previous years and also with that of competitors and the industry for arriving at a proper conclusion.

ROCE: This ratio has significantly improved by 1.48% in 2020. Generally a ratio of more than 10% over a long-term period is considered as good. (moneyweek, 2018) The company has exceeded this ratio in both the years. It is also showing an increasing trend. Therefore Choco Plc is earning adequate returns on its capital employed.

ROE: Long term average of S&P 500 of ROE is 14%. Therefore 14% ROE may be considered as acceptable but a ratio of less than 10% is considered to be poor. (Fernando, 2021) ROE of the company is more than 10% but less than 14% and hence may be considered as reasonably good. ROE of the company in 2020 has also increased by 1.39% in 2020.

EPS: It has increased by 0.11p in 2020 (17.76% increase). But this ratio should also be compared with competitors, industry and with the expectations of analysts.

Net Profit Margin: According to NYU report, the average net profit margins of US companies are 7.71%. As a thumb rule up to 5% margin is considered to be low and between 5 to 10% the margins are considered to healthy. (Brex, 2020) NP margin of Choco Plc was more than 5% in both the years. Hence the margins may be considered as reasonable good and is also showing an increasing trend.

Asset turnover ratio: If this ratio is less than 1 then it means that the company is not generating enough revenue by using its assets. (Mukhopadhyay, 2021) This ratio is well below 1 in both the years which indicates that the company has not been efficiently using all its assets.

Stock holding ratio: Inventory turnover ratio between 4 and 6 is considered as good. (sortly.com, 2021) In terms of number of days it should be in the range of 60 to 90 days. The average holding period of the company was 78 days in 2019 which increased to 80 days in 2020. Therefore the holding period is on the higher side.

Debtors collection period: An ideal debt collection period is 30 days. (Kenton, 2021) The debt collection period in 2019 was 73 days which decreased to 68 days in 2020. Therefore the collection period is very high. This is one of the reasons for low asset turnover ratio.

Current Ratio: An ideal current ratio is 2 but it also depends on the type of industry. (Edupristine, 2014) In any case ratio of less than 1 in both years is considered to be poor.

Gearing Ratio: A gearing ratio in the range of 0.25% to 0.50% is considered to be optimal. (Boyte-White, 2021) This ratio of the company was more than 2 years in both the years. Therefore it may be concluded that the company is carrying too much debts in its books.

Interest Cover: An interest coverage ratio of 2 is considered to be good. (Maverick, 2021) Therefore the interest coverage of both the years is satisfactory though it declined marginally in 2020.

Conclusion: The company has registered good growth in profits. However it has poor liquidity and debt to equity ratios. The company is relying on external debt for financing its growth.

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