

ACCOUNTING FUNDAMENTALS

LCBB4001

Accounting Fundamentals Assessment 1

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Introduction

It is the key target of every investors to invest in such companies which is financially healthy and stable. In order to find out the financial condition of any company, investors generally look into the financial statements and analyse those statements. Among the three financial statements, statement of financial position and income statement are the two basic financial statements from where investors can find out the financial performance and financial activity of the company (Kieso, 2020). In the statement of financial position, investors try to measure flexibility, financial resources, and value of the company (Bitesize, 2020). Through income statement, investors can easily find out the income of the company occurred during a time period (Chen, 2019). It helps the investors to create the financial model of that company which will help them to visualise the creditworthiness, value of investment and profitability of that company (Kieso, 2020). Ratio analysis can be a great tool for measuring company's financial health and this measurement also helps the investors to find out how the company is performing comparing with its competitors in the industry (Andrew Bloomenthal, 2020). Ratio analysis also helps to create the broad picture of the company's potential financial health (Andrew Bloomenthal, 2020).

Question 1:

(a) Preparation of financial statements for Eccles plc:

Financial statements define some written records that include balance sheet, income statement, cash flow statement (Fraser and Ormiston, 2016). The income statement basically focuses on the company's revenue, expenses of a certain period. From this data, by subtracting total expense from total earned revenue company's net income is calculated which is basically the profit of that company. So, the income statement of Eccles plc for the year of 2018 is calculated below –

Eccles plc Income Statement For the year ended 31st December 2018		
Particular	Amount (£)	Amount (£)
Sales	826,650	
Credit sales	980	
Net sales		827,630
Cost of sales		(578,650)
Gross profit		248,980
Operating expenses	Amount (£)	Amount (£)
Administrative expenses	(30,000)	
Directors remuneration	(5,000)	
Distribution costs	(28,000)	
Commission of Salesman	(3,000)	
Total Operating Expenses		(66,000)
Operating Income		182,980

Non-operating income or expenses	Amount (£)	Amount (£)
Interest expense	(2,000)	
Add: Interest due (W1)	(2,000)	(4,000)
Profit before tax		178,980
Income Taxes		(68,000)

Net profit	<u>110,980</u>
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Another key statement is the statement of financial position also known as balance sheet. This statement includes the assets, liabilities, and shareholder's equity of a company for a certain period (Fraser and Ormiston, 2016). Through this statement what a company owns and owes can be figured out. Also, the investment of the shareholders is also provided by this statement. The statement of financial position of Eccles plc for the year of 2018 is calculated below –

Eccles plc Statement of Financial Position As of the 31st December 2018		
Non-Current Asset		
Plant and equipment		632,730
Current Assets:		
Ending Stock	330,600	
Debtors (170,125 + 980)	171,105	
Cash and bank	12,900	
Total current Asset		514,605
Total Asset (A)		<u>1,147,335</u>

Current Liabilities:		
Trade creditors	(171,355)	
Commission Due	(3,000)	
Interest Due (W1)	(2,000)	
Provision for taxes	(68,000)	
Total Current Liabilities		(244,355)
Non-Current Liabilities		
4% Debentures		(100,000)
Total Liabilities (B)		(344,355)
Net Asset (A-B)		<u>802,980</u>

Equity:		
Ordinary shares	310,000	
Preference shares	300,000	
Retained Earnings (W2)	192,98	

Total Liabilities & Equity	<u>802,980</u>
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Workings:

W1: Calculation of Interest due		
Interest for the Period		4000
Less: Interest Paid		(2,000)
Interest Due		<u>2,000</u>
W2: Retained Earnings		
Beginning Retained Earnings		132,000
Add: Net Profit		110,980
Less: Ordinary dividend paid	(20,000)	
Preference dividend paid	(30,000)	
		(50,000)
Ending Retained Earnings		<u>192,980</u>

Thus, the statement of financial position of Eccles plc is calculated. Both sides of the statement are equal.

(b) Reasons for Statement of Financial Position being balanced

The statement of financial position calculated above has two sides and two sides are perfectly balanced. The balance sheet is made using the basic equation of accounting which is $\text{Asset} = \text{Owner's equity} + \text{Liability}$. The reasons why the two sides are perfectly balanced is briefly described below –

The basic reason of this balanced statement is the principle rule of accounting which is ***double-entry accounting method***. In this method the overall transaction is recorded in at least two different accounts. This process automatically acts as a checker to check that the entries are correctly entered. For this method, the two sides of the statement are perfectly balanced.

Another reason for the balance is ***accrual accounting method***. In this method, company's performance and economic events are measured when the transaction of cash is occurred. This method strictly follows matching principle which is recognizing revenues and expenses at the same period. The ***nature of cash inflows and cash outflows*** is another major reason of balanced statement. Cash inflows and outflows always effects both sides of the balance sheet. When any cash inflow occurs it either increases the assets and decreases the liabilities or

decreases the assets and increases the liabilities. Same goes for cash outflows. Thus, the statement is balanced perfectly. Moreover, ***funding assets*** can be another reason for balanced statement. Like, if a company starts its business by issuing 50,000\$ from a bank and then again issues 10,000\$. So, total liability and equity is 60,000\$. But this is also the available cash for the company. Which is the asset. So, in this way the balance is maintained.

By the description above, we can come to conclusion that if the transaction amount of any company is recorded properly then both sides of the statement of financial position will be perfectly balanced. In this way anyone can easily check whether the balance sheet is correct or not.

Question 2

According to Andrew Bloomenthal, ratio analysis is a method of studying company's financial statements to find out the organisation's efficient value, profitability, and liquidity. It is a quantitative approach which is expressed in fractional ratio or percentage (Andrew Bloomenthal, 2020).

(a) A Schedule of Ratios for Chocco plc for 2019 and 2018

A schedule of ratios for Chocco plc was prepared in order to analyse the financial statements of the company.

Profitability Ratios

Profitability ratios are referring to that type of analysing metrics that are used to find the income of a company with relative to assets, operating cost, revenue etc. (Kenton, 2019). Profitability ratios can define how an organisation can generate value for shareholders efficiently (Kenton, 2019).

Gross Profit Ratio

Formula:

$$(Gross\ Profit)/(Net\ Sales) \times 100$$

Gross Profit Ratio for 2018

$$= 3,345/6,441$$

$$= 51.93\%$$

Gross Profit Ratio for 2019

$$= 3,503/6,738$$

$$= 51.99\%$$

Operating Cost Ratio

Formula:

$$(Operating\ Cost)/(Net\ Sales) \times 100$$

$$Operating\ Cost = Distribution\ costs + Marketing\ and\ selling\ costs + Administrative\ expenses$$

Operating Cost Ratio for 2018

$$= ((422 + 1,274 + 950)) / 6,441 \times 100$$

$$= (2,646) / 6,441 \times 100$$

$$= 41.09\%$$

Operating Cost Ratio for 2019

$$= ((437 + 1,324 + 937)) / 6,738 \times 100$$

$$= (2,698) / 6,738 \times 100$$

$$= 40.04\%$$

Operating Profit ratio

Formula:

$$(Operating Profit) / (Net Sales) \times 100$$

Operating Profit ratio for 2018

$$= 699 / 6,441 \times 100$$

$$= 10.85\%$$

Operating Profit ratio for 2019

$$= 805 / 6,738$$

$$= 11.95\%$$

Net Profit Ratio

Formula:

$$(Net Profit) / (Net Sales) \times 100$$

Net Profit Ratio for 2018

$$= 366 / 6,441$$

$$= 5.68\%$$

Net Profit Ratio for 2019

$$= 431/6,738$$

$$= \mathbf{6.40\%}$$

Net Profit Ratio

Formula:

$$(Net\ Profit)/(Net\ Sales) \times 100$$

Net Profit Ratio for 2018

$$= 366/6,441$$

$$= \mathbf{5.68\%}$$

Net Profit Ratio for 2019

$$= 431/6,738$$

$$= \mathbf{6.40\%}$$

Return on Capital Employed

Formula:

$$(Net\ Profit\ After\ Interest\ and\ Taxes)/(Capital\ Employed) \times 100$$

Return on Capital Employed for 2018

$$= 366/(2,912 + 4,129)$$

$$= \mathbf{5.20\%}$$

Return on Capital Employed for 2019

$$= 431/(3,088 + 4,137)$$

$$= \mathbf{5.97\%}$$

Earnings Per Share

Formula:

$$(Net\ Profit\ After\ Tax + Preference\ Dividend)/(No\ of\ Equity\ Shares)$$

Earnings Per Share for 2018

$$= (366 + 0) / 600$$

$$= 0.61$$

Earnings Per Share for 2019

$$= (431 + 0) / 600$$

$$= 0.72$$

Dividend Pay Out Ratio

Formula:

$$(Dividend Per Equity Share) / (Earning Per Equity Share) \times 100$$

Dividend Pay Out Ratio for 2018

$$= 0.40 / 0.61$$

$$= 65.57\%$$

Dividend Pay Out Ratio for 2019

$$= 0.425 / 0.72$$

$$= 59.03\%$$

Dividend Yield Ratio

Formula:

$$(Dividend Per Share) / (Market Value Per Share) \times 100$$

Dividend Yield Ratio for 2018

$$= 0.40 / 4.00$$

$$= 10\%$$

Dividend Yield Ratio for 2019

$$= 0.425 / 5.12$$

$$= 8.30\%$$

Price Earnings Ratio

Formula:

(Market Price Per Share Equity Share)/(Earning Per Share)

Price Earnings Ratio for 2018

$= 4.00/0.61$

$= 6.56$

Price Earnings Ratio for 2019

$= 5.12/0.72$

$= 7.11$

Liquidity Ratios

Liquidity Ratios refers to that type of financial ratio which indicates whether a company's current assets are enough to debt obligations without collecting any extra capital (Hayes, 2019).

Current Ratio

Formula:

(Current Assets)/(Current Liabilities)

Current Ratio for 2018

$= 2,355/3,046$

$= 0.77: 1$

Current Ratio for 2019

$= 2,303/2,511$

$= 0.92: 1$

Quick Ratio

Formula

(Liquid Assets)/(Current Liabilities)

Liquid Assets: Cash + Short-term investment + Trade receivables

Quick Ratio for 2018

$$= (177 + 232 + 1,287) / 3,046$$

$$= 1,696 / 3,046$$

$$= 0.56 : 1$$

Quick Ratio for 2019

$$= (201 + 145 + 1,249) / 2,511$$

$$= 1,595 / 2,511$$

$$= 0.64 : 1$$

Working Capital Ratios

Working Capital Ratios are one of the vital ratios for the investors because this ratio expresses the liquidity of company (Course, 2019). This ratio measures the ability of a firm to pay off its debts.

Inventory Turnover Ratio

Formula

$$(Cost\ of\ Sales) / (Inventory)$$

Inventory Turnover Ratio for 2018

$$= 3,096 / 659$$

$$= 4.70\ times$$

Inventory Turnover Ratio for 2019

$$= 3,235 / 708$$

$$= 4.57\ times$$

Debtors Turnover Ratio

Formula

$$(Total\ Sales) / (Account\ Receivables)$$

Debtors Turnover Ratio for 2018

$$= 6,441/1,287$$

$$= 5 \text{ times}$$

Debtors Turnover Ratio for 2019

$$= 6,738/1,249$$

$$= 5.39 \text{ times}$$

Debt Collection Ratio

Formula

$$(Months \text{ or } days \text{ in a year}) / (Debtors \text{ Turnover Ratio})$$

Debt Collection Ratio for 2018

$$= 365/5$$

$$= 73 \text{ days}$$

Debt Collection Ratio for 2019

$$= 365/5.39$$

$$= 67.72 \text{ or } 68 \text{ days}$$

Creditors Turnover Ratio

Formula

$$(\text{Cost of sales}) / (\text{Accounts Payable})$$

Creditors Turnover Ratio for 2018

$$= 3,096/655$$

$$= 4.73 \text{ times}$$

Creditors Turnover Ratio for 2019

$$= 3,235/583$$

$$= 5.55 \text{ times}$$

Average Payment Period

Formula

(Months or days in a year)/(Creditors Turnover Ratio)

Average Payment Period for 2018

$$= 365/4.73$$

$$= 77.16 \text{ or } 77 \text{ days}$$

Average Payment Period for 2019

$$= 365/5.55$$

$$= 65.77 \text{ or } 66 \text{ days}$$

Working Capital Turnover Ratio

Formula

(Net Sales)/(Working Capital)

Working capital = Current Assets – Current liabilities

Working Capital Turnover Ratio for 2018

$$= 6,441/(2,355 - 3,046)$$

$$= -9.32$$

Working Capital Turnover Ratio for 2019

$$= 6,738/(2,303 - 2,511)$$

$$= -32.39$$

It is found that both of them are meaningless in comparison.

Fixed Assets Turnover Ratio

Formula

(Net sales)/(Total Fixed Assets)

Fixed Assets Turnover Ratio for 2018

$$= 6,441/7,732$$

$$= \mathbf{0.83}$$

Fixed Assets Turnover Ratio for 2019

$$= 6,738/7,433$$

$$= \mathbf{0.91}$$

Capital Turnover Ratio

Formula

$$(Cost\ of\ Sales)/(Shareholders\ equity)$$

Capital Turnover Ratio for 2018

$$= 3,096/2,912$$

$$= \mathbf{1.06}$$

Capital Turnover Ratio for 2019

$$= 3,235/3,088$$

$$= \mathbf{1.05}$$

Capital Structure Ratios

Capital Structure Ratios are also crucial for any investors to find out the amount of debt and equity of the company so that the investors can have a proper idea of the company's mixed capital structure (Loth, 2020).

Debt Equity Ratio

Formula

$$(Total\ liabilities)/(Shareholders\ equity)$$

Debt Equity Ratio for 2018

$$= (7,175)/2,912$$

$$= \mathbf{2.46 : 1}$$

Debt Equity Ratio for 2019

$$= 6,648/3,088$$

$$= 2.15 : 1$$

Proprietary Ratio

Formula

$$(Shareholders\ equity)/(Total\ Assets)$$

Proprietary Ratio for 2018

$$= 2,912/10,087$$

$$= 0.29$$

Proprietary Ratio 2019

$$= 3,088/9,736$$

$$= 0.32$$

Capital Gearing ratio

Formula

$$(Equity\ Share\ Capital)/(Fixed\ Interest\ Bearing\ Funds)$$

Capital Gearing ratio for 2018

$$= 2,912/4,129$$

$$= 0.71$$

Capital Gearing ratio for 2019

$$= 3,088/4,137$$

$$= 0.75$$

Debt Service Ratio

Formula

$$(Net\ profit\ Before\ Interest\ \&\ Taxes)/(Fixed\ Interest\ Charges)$$

Debt Service Ratio for 2018

$$= 720/181$$

$$= 3.98$$

Debt Service Ratio for 2019

$$= 846/226$$

$$= 3.74$$

(b) Analysing financial performance and position of Chocco plc

In order to analyse the financial performance and financial position of Chocco plc, both financial statements analysis and ratio analysis were done which are crucial tools for any investors now a days (Kieso, 2020).

Income statement

From income statement, investors can easily find out whether Chocco plc is running on profit or loss. It is also a great indicator of the financial performance of Chocco plc. From the income statements of Chocco plc of both 2018 & 2019, it is found that they made profit in both years. In 2019, the sales revenue increased by 4.61% more than sales revenue in 2018. Operating profit also increased by 15.16% which was also better than the previous year. Besides, the administrative costs were decreased by 1.37% comparing with the year 2018. Overall, Chocco plc did good performance in their income statement.

Statement of Financial Position

The statement of financial position of Chocco plc is another important statement for the investors to analyse Chocco plc's capital structure so that they can easily find out the comparative analysis of financial position of Chocco plc. In the statement of financial position of Chocco plc, overall net asset was increased by 6.04% which was possible even though the company's total asset was decreased by 3.48% in one year comparing with the total asset of 2018. Chocco plc increased the net asset by decreasing its liabilities by 17.56% which was a very positive sign for Chocco plc to complete the obligations from the debtors. The equity of Chocco plc was increased by from £2,912m to £3,088m which is an increase of more than 6% comparing with 2018. It was possible due to the increase in net profit in 2019. At the end, even though Chocco plc lost some of its asset, it maintained a good balance in its

financial statement by decreasing its liabilities and increasing its equity by enhancing its net profit.

Ratio analysis

Ratio analysis of the financial statements of Chocco plc is done in order to measure, determine and present the relationship of different items of the financial statement so that the investors can evaluate the efficiency of financial performance of Chocco plc (Andrew Bloomenthal, 2020). Liquidity ratios, profitability ratios, working capital ratios and capital structure ratios are being used in order to conduct ratio analysis for Chocco plc.

Liquidity ratios

Liquidity ratios indicates the ability of paying the short-term debt of the company in this case which is Chocco plc. Current ratio and acid test ratio are the key contributors to measure liquidity ratio of a company. The **current ratio** of Chocco plc has increased from 0.77 to 0.92 in 2019 which is a good improvement but not good enough since it is less than 1. There was an increase in **quick ratio** (0.56 to 0.64) too in 2019 but since current ratio was not in a satisfactory condition, quick ratio is not in favourable situation too. Overall, the short-term financial position of Chocco plc is not strong enough.

Profitability ratio

Profitability ratio of Chocco plc refers to the capability of its generating profit and operating efficiency of the management of Chocco plc. The **gross profit margin** of Chocco plc has increased from 51.93% to 52% in 2019, which is a good percentage of any company to convert its revenue into profit. Even though gross profit margin was quite satisfactory, it was observed that **net profit margin ratio** is not that much comparing with gross profit margin. Even though net profit margin ratio increased from 5.68% to 6.40% in 2019, it is indicating that Chocco plc' operating and non-operating costs are too high. **Return on Capital Employed** of Chocco plc has increased from 5.20% to 5.97% in 2019 but it is referring that for every 100 pound investment, investors are going to get almost 6 pound of profit which is not lucrative and satisfactory for the investors. Overall, in spite of having a good gross profit margin ratio, the other two ratios are not satisfactory from the investors point of view and showed poor performance of Chocco plc.

Working Capital Ratios

Working capital ratios also measure the financial health of Chocco plc which is used by the investors to measure the short-term funds of Chocco plc. Creditor turnover ratio, Debtor turnover ratio, Inventory turnover ratio etc. are measured to find out the working capital ratios of any company (Course, 2019). In the working capital ratio of Chocco plc, the **debtor turnover ratio** got increased from 5 times to 5.39 times with the decrease in collection period from 73 days to 68 days in 2019. But the benchmark is 11.76 times with the collection period of 31 days, and it is obvious that the performance of Chocco plc is not satisfactory. In the **credit turnover ratio**, it got increased from 4.73 times to 5.55 times with a decrease in collection period from 77 days to 66 days. It is an attractive performance for any investor. Even though the **inventory turnover ratio** of Chocco plc was decreased from 4.70 to 4.57, it is comparatively good performance for Chocco plc.

Capital structure ratios

Capital structure ratios are the description of how the company is using its mixed capital structure (debt & equity) to ensure efficiency (Loth, 2020). In the **debt-equity ratio** of Chocco plc, the ratio was 2.46 in 2018 and in 2019, it became 2.15 which can be attract both creditors and investors. The **capital gearing ratio** of Chocco plc got increased from 0.71 to 0.75 in 2019. Since it is still under 1, the ratio is describing that is highly geared which can be attractive for the investors.

Conclusion

In order to expand the business, it is vital for any company to gain new investment. In order to attract the investors, every company has to prove itself that it is capable enough for financial investment by showing its solvency, liquidity, profitability, stability etc. It can be proved via proper financial analysis of the financial statements of that company. Which is why, it is crucial for financial analyst to prepare the financial statement more carefully so that the investors can invest their capital in the right company which will be beneficial for both parties and do not have to face any loss in the future.

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