

LCBB4001 Accounting Fundamentals

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Accounting Fundamentals Assessment 1

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“In submitting this work, I affirm that my work adheres to the scholarly and intellectual standards of honesty and integrity. I affirm that this work is my work only and that in the preparation of this work I have not consulted any person. I affirm that I have not plagiarised or misrepresented the ideas or language of someone else as my own and that I have fully and accurately attributed any ideas or text of others to the sources and documented each source”.

QUESTION 1

- a. Prepare an income statement for the year ended 31st December 2019 for Eccles plc and a statement of financial position as at that date.

Income statement for the year ended as at 31st December 2019

Particulars	Amount (£)	Amount (£)
Sales		827,630
Cost of sales		(578,650)
Gross Profit		248,980
Administration expenses	30,000	
Outstanding commission	3,000.00	
Directors remuneration	5,000.00	
Distribution expenses	28,000	
Total expenses		(66,000)
Operating profit		182,980
Interest		(2,000)
Net income		180,980
Corporation Tax		(68,000)
Net profit for the year		112,980

In the books of Ecles plc

SOFP as at 31st December 2019

ASSETS

£

Plant and equipment	632,730
	632,730

Stocks	330,600
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Debtors	170,125
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Bank and cash	10,880
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511,605

Accruals	0
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Corporation tax	-68,000
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Long term contracts	-100,000
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Trade creditors	-171,355
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-339,355

Total Assets

804,980

LIABILITIES AND EQUITY

£

Ordinary shares	310,000
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Preference shares	300,000
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610,000

Profit and loss account	194,980
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Net profit	0
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194,980

Total liabilities and equity

804,980

b. Explain why the statement of financial position balances.

The basic law for a balance sheet says that the total assets of an entity should be equal to the sum of liabilities and equity.

Assets = Total Equity + Total Liabilities

Assets represent all the economical resources that an entity, company, corporation, federation or even country owns and keeps under its management with the purpose to obtain in future an exclusive profit or benefit. The assets of an entity may be financed from internal stakeholders and sources (for example share capital and profits) or from external financing (like bank lend, trade creditors).

Equity of a company is another important figure in a balance sheet, that relates to the total amount of money that a company's stakeholders would receive in exchange in case that all the assets were dissolved and all the debts were paid off. Likewise the liquidation, the equity can be addressed in case of acquirement, which represents the difference between an entity's value (assets) and the liabilities owed by the company in the situation they weren't integrated into sales.

Liabilities represent a sum of money, services or goods that a company owes after an economic exchange instead of a benefit. Usually the liabilities are registered under loans, mortgages, accruals and obligations. Liability obligations can be classified into short-term borrowings (up to 12 months) or long-term loans (more than 12 months).

In our case, balance sheet is balancing due to suitable and correct book recording at the end of the year and the total amount of £804,980, including current and non-current assets, equals to the total amount of liabilities and share capital at the end of the year 2019.

In other words, if all the records of a company are registered and written correctly, the statement of financial position will be balanced, otherwise, the company risks to fail in managing its profitability, liquidity and increase its capital loss in future. As a result of the comments listed above, the basic Accounting equation (Assets = Equity + Liabilities), can be understood better and applied into the detailed structure and functioning of a company.

QUESTION 2

- a. Prepare a schedule of ratios for Chocco plc for 2019 and 2018.

INVESTMENT RATIOS

$$\text{Return on capital employed} = \frac{\text{Profit before interest}}{\text{Assets employed}} \times 100\%$$

RATIOS	2019	2018
ROCE	$805 / (6738 - 3235) \times 100\% = 22,98\%$	$699 / (6441 - 3096) \times 100\% = 20,9\%$

Return on capital employed has increased considerable for Chocco plc and it means that the company has generated with 2 pounds more profit in 2019, comparing to the same capital in 2018. Consequently, the Chocco plc became more profitable in the 2019 and this would be possible due to paying off debts, reducing costs or increasing sales.

$$\text{Return on equity} = \frac{\text{Earnings}}{\text{Ordinary share capital and reserves}} \times 100\%$$

RATIOS	2019	2018
Return on equity	$(431 / 3088) \times 100\% = 13,96$	$(366 / 2912) \times 100\% = 12,57\%$

The improvement in ROCE, is followed by the increase of ROE, with 1,39% in 2019, due to the growth of the retained profits. The rise of ROE can be as a result of a suitable management of the entity's share capital and increase of the Chocco plc income.

$$\text{Earnings per share} = \frac{\text{Earnings}}{\text{Number of ordinary shares}}$$

RATIOS	2019	2018
EPS	$431 / 300 = 1,44$	$366 / 300 = 1,22$

The EPS ratio, also increased, in 2019, with 22 percentage points, therefore Chocco plc became more attractive for investors due to the increase of the profit for the year and the increase of average share price.

$$\text{Price earnings ratio} = \frac{\text{Market price}}{\text{Earnings per share}}$$

RATIOS	2019	2018
P/ E Ratio	1324/1,44 = 919,44	1274/1,22 = 1044,26

The price earning ratio has reduced with 124,82 units in the new year, compared to 2018. It is an indicator which shows us what is the value of a stock on the market related to the company's income. The decrease of P/E ratio can be explained that the price of the current stock has lowered, which lead to a higher income and had a positive impact on the company.

PROFITABILITY RATIOS

$$\text{Gross profit margin} = \frac{\text{Gross profit}}{\text{Sales}} \times 100\%$$

RATIOS	2019	2018
Gross profit margin	(3503/ 3235) x100% = 108.28%	(3345/ 3096) x100% = 108.04%

Gross profit margin has stayed slightly increased, with 0.24%, and this ratio shows to the investors how much gross profit will a company earn with every pound of its revenue. The almost invisible improvement of the gross profit margin ratio can be considered due to the increase of the cost of sales.

$$\text{Net profit margin} = \frac{\text{Net profit}}{\text{Sales}} \times 100\%$$

RATIOS	2019	2018
Net profit margin	(805/ 3235) x100% = 24.88%	(699/ 3096) x100% = 22.58%

Net profit margin ratio has increased with 2,3% due to increase of the sales and the decrease of the distribution costs, which resulted as an improvement of converting the sales into net profit.

EFFICIENCY RATIO

$$\text{Asset turnover} = \frac{\text{Turnover}}{\text{Assets employed}}$$

RATIOS	2019	2018
Asset turnover	6738/3235 = 2.083	6441/ 3096 = 2.080

The asset turnover ratio is relatively stable, increasing only with 0.003 points in 2019, thereby, for every pound of assets Chocco plc owns, it generates 2.083 pounds of revenue. The bigger asset turnover ratio is the better for the company is.

$$\text{Stock holding period} = \frac{\text{Inventory}}{\text{Cost of sales}} \times 365$$

RATIOS	2019	2018
Stock holding period	(708/ 3235) x365 = 80 days	(659/ 3096) x365 = 78 days

Stock holding period has increased with 2 days in 2019, which means that the inventory will stay longer in the warehouse. This ratio could have been increased because of a lazy turnover, which has stayed stable in 2019 compared to previous year and the company might have invested too much into high-volume inventory.

$$\text{Debtors collection period} = \frac{\text{Trade receivables}}{\text{Credit sales}} \times 365$$

RATIOS	2019	2018
Debtors collection period	(1249/ 6738) x365 = 68 days	(1287/ 6441) x 365 = 73 days

The debtors collection period has decreased, with 5 days in 2019. These dynamics can be considered positive for the company's evolution and it can be interpreted as a faster collecting of it's receivables, but at the same time a more aggressive collection policy has to be adopted, to shorten that period, which is above 60 days.

$$\text{Creditors payment period} = \frac{\text{Trade payables}}{\text{Credit purchases}} \times 365$$

RATIOS	2019	2018
Creditors payment period	(583/ 3235) x365 = 66 days	(655/ 3096) x 365 = 77 days

While the stock holding period has increased, the debtors collection period and creditors payment period, have decreased, with 5 and respectively 11 days. These dynamics can be considered positive for the company's evolution and it can be interpreted as a faster collecting of it's receivables, but at the same time a more aggressive collection policy has to be adopted, to shorten that period, which is above 60 days.

LIQUIDITY RATIO

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

RATIOS	2019	2018
Current ratio	2303/ 2511 = 0.92	2355/ 3046 = 0.77

Current ratio for 2019 has increased with 0.15% comparing to year 2018, but it still remained below one, which means that the company might not have the capital on hand to meet its short-term obligations if they would be all due at once.

$$\text{Quick asset ratio} = \frac{\text{Current assets} - \text{Inventory}}{\text{Current liabilities}}$$

RATIOS	2019	2018
Quick ratio	(2303-708)/ 2511 = 0.63	(2355-659)/ 3046 = 0.56

Quick ratio has slightly increased as well, in 2019, with 0.07p, which lead to a higher company's capacity to pay it's current liabilities without needing to sell it's inventory or get additional financing.

FINANCING RATIOS

$$\text{Gearing ratio} = \frac{\text{Debt}}{\text{Debt} + \text{Equity}} \times 100\%$$

RATIOS	2019	2018
Gearing	$4137 / (4137 + 3088) \times 100\% = 57.3\%$	$4129 / (4129 + 2912) \times 100\% = 58.6\%$

Gearing and interest cover ratios have decreased in 2019, and these factors are still considered to be in acceptable shape to cover the equity necessities with financing. The Gearing ratio has gone down with 1,3% and this can be related to a better policy, adopted by the company, in paying its debts and reducing the period of paying the creditors.

$$\text{Interest cover} = \frac{\text{Profit before interest}}{\text{Interest charges}}$$

RATIOS	2019	2018
Interest cover	$805 / 226 = 3.56$	$699 / 181 = 3.86$

Interest cover ratios have decreased in 2019, but these factors are still considered to be in acceptable shape to cover the equity necessities with financing. Even if a declining interest coverage ratio can indicate that a company may be unable to pay its debts in the future, this ratio still maintains the 1.5 above position, which, in generally, is considered the bare minimum acceptable ratio for a company.

In conclusion, after analyzing all the ratios above, the Chocco plc dynamics have improved considerable and all the changes that took part during 2019, compared to the previous year, have affected positively and directly the company's profitability, liquidity, flexibility and at the same time reduced its debts and other borrowings. All the improvements listed above have lead to a higher income in the year 2019.

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