

University of Wales Trinity Saint David

Business Management

LCBB4001

Accounting Fundamentals

Lecturer: Dr. Emad Elkhashen

Student Name: Georgi Dimitrov

Student ID: 1917423

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Introduction

Business keep records for many reasons like measuring performance, identify profitability or not, visualize future and most important to gaining information about business. From journal to post closing trial balance all information are important for business. Financial statement is one of them, which give combination of all information in an understandable form. Company is interacted with many people; they may inside of company or outside. They address as a user of business information and to satisfy their information demand is a reason to prepare financial statement. In this report, we will identify main users and the reason of their demand for financial statement. Some application of this statement and its limitation also.

Question 1

Wales plc

Income Statement

For the year ended 31, December 2019

Particulars	Amount£,000	Amount£,000	Amount£,000
Sales		30300	
Less: cost of sales	16220		
Depreciation of plant	2560		
		18780	
Gross profit			11520
Less: Administrative expenses	2920		
(+)Depreciation of building	320		
		3240	
Distribution expenses		2160	
Insurance expenses		500	
Debenture interest		240	
Irrecoverable debt	240		
(+)Allowance	160		
		400	
			(6540)
Add: Land revalued gain			5000
			9980
Less: Income tax			1600
Net profit			8380

Workings for allowance for debt		
Trade receivable	8240	
Less: Irrecoverable debt	240	
	8000	
Allowance for debt @ 2%		160

Wales plc**Statement of Financial Position****For the year ended 31, December 2019**

Particulars	Amount£,000	Amount£,000	Amount£,000
Current asset:			
Trade receivable	8240		
Less: Irrecoverable debt	240		
Allowance for debt	160		
		7840	
Bank		320	
Ending inventory		3120	
Total current asset			11280
Fixed asset:			
Land		20000	
Buildings	16000		
Less: accumulated depreciation (4260+320)	4580		
		11420	
Plant cost	25600		
Less: accumulated depreciation (4960+2560)	7520		
		18080	
Total fixed asset			49500
Total asset			60780

Liabilities and owners' equity			
Current liabilities:			
Trade payable		4480	
Accrual insurance premium		500	
Unpaid income tax		1600	
Total current asset			6580
Long term liabilities:			
12% Debenture			4000
Owners' equity			50200
Total liabilities and owner's equity			60780

Workings for owner's equity	
Ordinary shares	29000
Share premium	5000
Retained profit	8380
	42380
Net income	8380
	50760
Less: Dividend paid	560
	50200

Question 2

(a) Ratio analysis for Jerry plc

Formula	2019£m	2018£m
(1)Return on capital employed = $\text{EBIT}/(\text{Total asset} - \text{Current liabilities}) \times 100$	$=23/(286.1-153.9)$ $= 23/132.2$ $=0.174$ $=17.4\%$	$=29.7/(293.8-156.5)$ $=29.7/137.3$ $=0.216$ $=21.6\%$
(2)Return on equity = $(\text{Net income}/\text{equity}) \times 100$	$=12.9/93.2$ $=0.138$ $=13.8\%$	$=18.3/80.3$ $=0.228$ $=22.8\%$
(3)EPS = $(\text{Net income}/\text{Average outstanding share})$	$=12.9/17.8$ $=0.7247$	$=18.3/17.8$ $=1.0281$
(4)Gross profit margin $= (\text{Gross profit}/\text{Revenue}) \times 100$	$=191.8/501.3$ $=0.3826$ $=38.26\%$	$=186.9/486.8$ $=0.3839$ $=38.39\%$
(5)Asset turnover = $(\text{Revenue}/ \text{Total asset})$	$=501.3/286.1$ $=1.752$	$=486.8/293.8$ 1.657
(6)Stock holding period = $\text{Income} + (\text{End of period value} - \text{Initial value})/\text{Initial value}$	$=\{12.9 + (17.8 - 17.8)\}/17.8$ $=12.9/17.8$ $=0.725$	Initial value is unavailable for 2018

(7)Debtors collection period = (Debtors/Sales)*365	= $(114.9/501.3)*365$ =0.2292*365 =83.66	= $(114.7/486.9)*365$ =0.2356*365 =85.99
(8)Current ratio = (Current asset/Current liabilities)	=153.9/151.0 =1.09	=156.5/148.4 =1.055
(9)Gearing = (Long-term debt/Shares equity)	=41.9/93.2 =0.45	=65.1/80.3 =0.811
(10)Interest cover = (EBIT/Interest expenses)	=23/0.2 =115	=29.7/3.5 =8.49

(b) Evolution of ratio

1. Return on capital employed was highest in 2018, 21.6% than 2019. That means in 2019 euro invested in capital earn less profit than last year.
2. Last year ROE was 22.8%, which is higher than present year 13.8%. About 9% less profit generates by company.
3. Company's EPS also decrease by 0.303% this year. Which is not a good indicator for company.
4. Gross profit relatively equal both years.
5. Asset turnover only increase by 0.09%
6. Stock holding period also less by around 5 days. It means they
7. In 2019 debtors collection come lower by 2 days, which is good for company.
8. Current ratio in both years are not standard level 2:1, moreover in 2019 it comes low.
9. Gearing in 2019 is relatively two times lower than 2018.
10. Interest cover ratio is very high in 2019; 115 times interest can cover by company's earnings. The company high enough to cover its debt interest.

Question 3

(a) Three different users' groups of company accounts

Different company related users need company accounts for analyses and get their necessary information about company. Accounts like financials statements contain company's information about financial position and capability. Internal and external users want to know about company's position in many reasons. Following the discussion of three users and the reasons of their need (Schroeder, 2019).

Management: Management are the top internal user of company's accounts. One of the reasons of preparing financial accounts is for use of management. Management operate business for gaining profit for owners. That is why they need to know all inside and outside performance of business. Financial accounts carry lots of relevant information for managers to manage activity easily. With this information, management can identify their lacking and can develop with taking effective steps (Epstein, 2014).

Management also come to know whether a project is profitable or not for company. If the project is profitable, they can continue it. If the project is not profitable, they have two option. Management can visualize the progress of projects in future they can run it by changing some area like cost control, proper marketing. However, if management can see no progress of project in future they drop the project. All this decision taken by analysing accounts of the project or company. This type of decision depends on proper presentation of accounts and these reasons make accounts curtail for management (Planas, 2013).

Investor: Every investor wants safe investment. Investment decision is very difficult as market change continuously. Therefore, investors are very concern about investment. Whenever they want to invest, they analyse the company. For this company analysis, they need financial accounts. They need to know companies' assets, liabilities, earnings and others information. They also want to know riskiness of that investment (Huang, and Pearce, 2015).

Past profit records also important for knowing the earning capacity of the company. They analyse the debt paying ability. Whenever they invest, after ending of period how quickly they can repay their liabilities. All this need for investor before invests money. That reasons make important

accounts for investor and company also make those accounts properly to attract investor. It also needs to continue of investment (Scholes, 2014).

Rating agencies: Rating agencies gives rate on the performance of credit activity of any company. Credit rating is very important for a company. Rating agencies analysis companies past credit record. Clearance of credit, time it took for payment, satisfaction of creditors, ability of payment of future credit and present earning capability of company. After analysing all information, agencies rates the company. High rate satisfy creditor and low rate discourages creditor for credit (Saha, and Paul, 2017).

Company takes credit for many reasons. They take supplies on credit from suppliers, take bank loan for investment in business. For this credit advantages high rate helps to get credit easily. Special for bank loan, they want rating certificates form agencies and satisfaction rate of credit pass the loan application of company. Investor also ask credit rate to see the honesty and ability of company. Suppliers want to ensure about repayment of his credit supplies and credit rate gives this assurance (Immergluck, 2016).

(b) Advantages and disadvantages of highly regulated financial reporting rule

Individual countries have different rule for preparing financial report. However, there is a global accepted format for report but it applies in different countries in with some changes. Some follow highly regulates financial reporting format. Pros and cons are given below-

Advantages

High-regulated reporting format contain all information needed by any user. For this, it is easy to monitor. It gives information about financial position of company. It helps external users to understand the company. Some companies unwilling to show all information about their company. Country rules and regulation of reporting force them to give proper information about company. It helps to reduce manipulation of real information. Regulators authority also get correct information and regulate company according the rules. It also important for foreign business. A global format helps to understand all business report in different countries. It will helpful for newer investor because he will get all information, as his need to invest. Well maintain report attract investor and their loyalty (Vogel, 2018). They feel safe for invest as they come to know all

information about business. Creditors get benefits for getting credit information also. It also easy to calculate tax of the company and authorities get it in proper taxing process. Overall regulation in financial reporting helps all party of the company in local business as well as international business.

Disadvantages

It faces some problems to maintain high regulation for preparing financial report. First of all, it increases cost of business. For maintaining high regulation, it needs an expert to prepare and he will demand high payment for this. Large business can afford it but small and medium business it is very costly. It reduces company's profit for which many small and medium business owner are not willing to maintain high regulation for report. Sometimes it creates risk for company to disclose all information as all parties come to know about business. Every business maintains their own strategies to make profit. Competitors able to know their strategies after some trend analyses of previous financial report. It will create worse situation for business. Sometimes it creates complexity for general people, as many of them are not highly educated to understand all information. They just want some ratios, profits and asset information of the company (Ben-Shahar, and Schneider, 2014). With maintaining high regulation create long report and this create confusion to understand for them.

After analysing pros and cons of highly regulated report it can say that, large business can easily use this report format and expand their business internationally. However, for small and medium business are not willing to use this format as it creates more sufferings rather benefits.

(c) Limitations of Financial statements

We know financial statement contain information of business financial activities and it present in a formal way. However, it cannot contain all true factor of business and user should aware about this factor. Being aware of this limitation of financial statement will help to take right decision by users.

Historical cost: It follow historical cost of asset. It never discloses present value of that asset. However, the value of asset change over time. Sometimes the value reduces a significant amount but financial statement will show the historical value when it was purchased. Therefore, it misleads users about valuation of company (Barth, 2014).

Personal Judgement: Some valuation of asset depends on the preparer of the statement. Like depreciation of asset, preparer can follow different rule for depreciation which may show high or low value than origin. It totally depends on company which format they will use (Yadav, 2014).

Accounting policies: Many policies present in accounting and it is not possible to follow all of them. So which policies will respect by company or users is depends on personal judgement? Same policy may not allow by user but beneficial for company (Reidenberg, 2015). So here creates conflict between users and company.

Intangible asset: Recording of intangible asset is difficult because its measurement is not easy to convert it in monetary term. Some may not record this asset to avoid authority attention for tax and other factors. Some create overvalued to attract investment which manipulate investor decision (Neubig, 2017).

Comparability: As following rules depends on company so, comparing with other companies' financial report may not done. Company base recording system may differ. It is also for international business also (Ameer, and Othman, 2012).

Reliability: Management may change the result of financial report by providing false information about company. Though it goes against rules but they can. To attract investment or financial help they can do this. So all information may not true. It lose its reliability from users for this (Agrawal, 2014).

Effect of inflation: Whenever inflation rate goes up in a country, it will reduce the amount of asset of company relatively. Company do not adjust inflation in their balance sheet so, its information may not match in current market. Investor must concern about these factors (Dalton, and others 2019).

Nonfinancial issues: Financial statements not concern about non-financial issues. However, non-financial factors like government policies, environment, future demand, international rules and facilities are very effective in growth of company. It also may reason of future existence of company. Users not get proper information about company for missing of nonfinancial factors (Frias-Aceituno, 2014).

All this limitation sometimes create confusion to use it. It is not possible to predict future with financial statement. However, it is the first document for knowing about business. User awareness will help them from misleading. Business organization should maintain consistency of reporting and it also increase goodwill of company.

Conclusion

Different use of financial statement makes it demanding report for all type of users. Large companies bound to forecast their statements each year. Though, small companies are beyond this binding. In above discussion we also analyse some limitation of financial statement. Some of them cannot eliminate but some limitation can be minimizing. Organizations should show their responsibility while preparing any statements. They must give proper information as their decision depends on this statement. Users also be aware to use financial statement and before taking any decision they must learn more about company. However, financial statement becomes core information providing step for any organization.

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