

ACCOUNTING FUNDAMENTALS

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Introduction

This assessment is to be completed based on the knowledge of accounting fundamentals. The methods of financial accounting are to be used in this assessment to evaluate the answers to the given questions. The first question will require the preparation of the income statement and balance sheet of Wales Plc for the year ending 31st December 2021. Given data of trial balances will be used in that prospect. A short description will be given on the reason behind the balance of the financial position statement of a company. The next question will require a ratio analysis of the given ratios to make comments on the financial performance, positioning, and efficiency of Sweets Plc for two different years 2020 and 2021.

Accounting Fundamentals are related to accounting principles and methods. The term 'Accounting' is the recording of financial transactions and preparation and modeling of the financial statements that are further used by external and internal users to make relevant business decisions. There are two parts of accounting- financial and management accounting. Methods and ideals used in these two segments of accounting such as keeping financial records, reporting, etc. are considered in the fundamentals of accounting (Tally Solutions, 2022).

Question 1

a) Income statement and statement of financial position of Wales Plc preparation

Income statement of Wales Plc:

An income statement is considered one of the financial accounting reports that are prepared following the principles of accounting and to help external users assess the financial outcomes of the company for a particular financial year. The statement consists of all incomings and expenses of the company that have taken place in the same financial year. The income statement takes into account whether the company has made a profit or not in that particular financial year. An income statement is said to be a really important financial report that is prepared using accurate data of the financial transactions that the business entity has made. The statement is said to be used by external users such as investors and future potential investors, lenders and creditors, competitors, employees, and tax regulatory authorities as well. As the statement is published regularly, therefore, all financial transactions can be recorded so that the records can be used for

future reference. The financial performance of the company is assessed by the users through ratio analysis; hence they can make appropriate decisions regarding the business and investments. An income statement helps to figure out the potential risks and opportunities associated with the business (Zoho books, 2021).

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In the books of Wales plc					
For the year ended 31/12/2021					
Income Statement					
Particulars	£	£	Particulars	£	£
To purchase	578650		By Sales		800,000
To gross profit C/d	221,350				
Total	800,000		Total		800,000
			By gross profit b/d		221350
To Admin exp	30,000				
To interest paid	2,000				
To director's remuneration	5,000				
To distribution costs	28,000				
To pay of ordinary dividend	20,000				
To pay of preference dividend	30,000				
To corporation tax	100,000				
To outstanding comission	3,000				
To net profit	3,350				
	221350				221350

Fig. 1: Income statement of Wales Plc for 2021

(Source: Prepared by self, 2023)

Above is the income statement of Wales Plc for the year ended 31st December 2021. The evaluation of Gross profit, sales, cost of sales, and net income are to be shown in the following calculation part-

Sales and cost of sales: Sales of a company is the value the company has generated from the sale of different quantities of a product. Cost of sales is the production costs such as labor cost, cost of materials, etc. Here, Wales plc is said to have generated a sales value of £800,000 and the cost of sales accounted for £578,650.

Gross Profit: A company's gross profit is the income that has been generated from the sales value without considering the cost of sales, but other expenses are there associated with the sales. Wales Plc is said to have a gross profit = of £800,000 - £578,650 = £221,650.

Net Profit: Net profit is the profit after tax and interests that have been accumulated by the company in a particular financial period. Other expenses of Wales plc is £218,000, so the value of net profit is = £221,350 - £218,000 = £3,350.

Statement of financial position of Wales plc

In financial accounting, the statement of financial position is mostly termed as the balance sheet which is one of the 3 financial reports of fundamental accounting. This statement is used to address a view of the financial position of the company in a given financial year. In other words, the total value of the assets and total value of the liabilities of the company in that period are displayed by the balance sheet of a company. There are two sides of a balance sheet that can be seen- one is the assets side, and another is the liabilities side. As per the accounting equation, the total value of liabilities and equity should be equal to the total value of the assets at the end of the balance sheet (Corporate Finance Institute, 2022).

In the books of Wales plc					
For the year ended 31/12/2021					
Statement of financial position					
Liabilities	£	£	Asset	£	£
Share capital					
Ordinary share	1,000,000		Fixed Asset		
Pref share	400,000		Plant		1,250,000
Total	1,400,000		Current asset		
Add: Net profit	3,350		Trade receivable		170,125
Add: retained earning	132,000		Cash and bank		176,250
		1,535,350	Stock		430,600
Debenetures		200,000			
Current liabilities					
Outstanding expenses		3000			
Corporation tax		100000			
Trade payable		188625			
Total		2,026,975	Total		2,026,975

Fig. 2: The balance sheet of Wales plc for 2021

(Source: Prepared by self, 2023)

Following are the calculations used in the balance sheet of Wales Plc-

Total assets: Assets are the resources that have a financial value. There are different categories of assets such as current assets, non-current or fixed assets, tangible and intangible assets, etc. Wales Plc seems to have a fixed assets plant of value £1,250,000 and the total value of current

assets is £776,975. So, the total assets of the company have a value of $£1,250,000 + £776,975 = £2,026,975$.

Total liabilities and equity: Shareholders' equity is the capital and shares invested by the owners themselves while liabilities are the obligations that the company faces. Wales plc's total value of liabilities and equity is $£1,535,350 + £491,625 = £2,026,975$.

So, both sides of the balance sheet match for Wales plc.

b) Reason behind balancing the sides of a financial position statement

A balance sheet is prepared following the equation of accounting which is 'Assets = Liabilities + Shareholders' equity'. The equation thinks that two sides of the balance sheet should always match to justify the accuracy of the statement and the accounting information used in it. It is stated that each financial transaction of a company of a particular period impacts both sides of a balance sheet. The interpretation behind this rationale is that the source and destination of the money used in the transactions are described in the balance sheet. So, as a double-entry accounting system is followed, the results of the two sides will be the same. Hence, the balance sheet will always be in balance if it is prepared correctly (Brixx, 2023).

Question 2

a.) Ratio analysis of the statements of Sweet's plc and evaluation of the ratios

A ratio analysis is to be done by assessing the financial statements of a company. The ratios calculated from the analysis will help the external users to understand how the company is doing financially and what needs to be done. Sweet plc's financial ratios are evaluated below -

1- ROCE:

ROCE or Return on Capital Employed is a profitability ratio that shows the earnings of the company that are coming from the use of its capital. The higher the value of ROCE, the higher will be the profit of the company. A ratio of around 20% or more is said to be a good one for a company. It's calculated by dividing the operating profit by the difference between total assets and current liabilities or capital employed (My Accounting Course, 2023).

Calculation of Return on capital employed		
Particulars	2021	2020
Earning before interest and tax (EBIT)	805	699
Total Asset	9,736	10,087
Current liabilities	2,511	3,046
Capital employed	7,225	7,041
ROCE= EBIT/ Capital employed	11.14186851	9.927567107

Sweets plc is said to have made higher profits from the capital in 2021 compared to 2020.

2- ROE:

Return on Equity (ROE) is another profitability ratio that is used to measure the earnings of the company from the shareholders' equity. A high value of ROE indicates better returns for a company from the capital invested by the shareholders (Heikal, Khaddafi & Ummah., 2014).

Calculation of Return on equity (ROE)		
Particulars	2021	2020
Net income	431	366
Shareholders equity	300	300
ROE= Net income/Shareholders equity	1.436666667	1.22

Here too, the company has improved in 2021 as the ratio is higher in 2021 than in 2020.

3- Earnings per share:

EPS is used to address the profit the company makes from its shares. The ratio is evaluated from the division of net profit by the average outstanding shares of the company (The Motley Fool, 2023). A company having an EPS of 0.25 or more is said to have a good EPS ratio.

Calculation of Earning per share		
Particulars	2021	2020
Net income	431	366
Outstanding shares	300	300
Average outstanding shares	300	150
EPS= Net income/ Average outstanding shares	1.436666667	2.44

As the value is showing, Sweets plc earned less from its shares in 2021. In 2020, the company used to have a good EPS ratio.

4- Net Profit Margin:

One of the most important profitability ratios is the Net profit margin which is used to calculate net profit from per unit value of sales (Heikal, Khaddafi & Ummah., 2014). This ratio is particularly assessed by investors, creditors, and employees. A company having a net profit margin of 5% or more is said to have a good net profit margin. It is calculated using the following formula - Net profit margin = (Net profit/ revenue)*100.

Net profit margin		
Particulars	2021	2020
Net profit	431	366
Total revenue	6738	6441
Net profit margin= (net profit /revenue)*100	6.396556842	5.682347462

Sweets plc has become financially profitable in 2021. The ratio is higher in 2021 than in 2020.

5- Assets turnover:

This is an efficiency ratio that is used to evaluate how well the assets are deployed by a company to generate more sales. It is one of the determinants of the financial performance of the company. The sales generated by the company from its assets are evaluated from the assets turnover ratio. The formula is- Assets turnover = Total revenue/ average total assets.

Asset turnover		
Particulars	2021	2020
Total revenue	6738	6441
Total Asset	9,736	10,087
Average total asset	9911.5	5043.5
Asset turnover= Revenue/average total asset	0.6798163749	1.277089323

The ratio of assets turnover was higher in 2020 than in 2021.

6- Stock holding days:

Another efficiency ratio, stock holding days is used to be the number of days in which the inventory of a company is held before the company sells it. The lower the value of stock holding days, the higher the efficiency of the company. The ratio is calculated from the division of

closing stock by the cost of sales. Inventory days are calculated by multiplying this ratio by 365 (Indeed, 2023).

Stock holding days		
Particulars	2021	2020
Closing stock	708	659
Cost of goods sold	3235	3096
Stock holding days= (Closing stock/cost of goods sold) x 365	79.88253478	77.69218346

The number of stock holding days has increased in 2021 than in 2020.

7- Debtors collection period:

Debtors' collection period is said to be another efficiency ratio that implies the meantime that is taken to collect the trade debts. A company is said to have increased efficiency when the mean time taken reduces. The formula of debtors collection period is given as Debtors collection period= (Amount owed by debtor/annual credit sales)*365.

Calculation of debtors collection period		
Particulars	2021	2020
Amount owed by Debtors	1,249	1,287
credit sales	6,738	6,441
Debtors collection period= (Amount owed by debtor/annual credit sales)*365	67.65880083	72.93199814

8- Current ratio:

The current ratio is often regarded as the liquidity ratio that gives an idea about the liquidity of the company (Bowlin., 1963). A company having a good current ratio means that the company has enough liquid or current assets available to mitigate short-term obligations. A current of 1.5 to 2 is said to be a good one but the ratio shows different figures for different industries.

Calculation of current ratio		
Particulars	2021	2020
Current asset	2,303	2,355
Current liabilities	2,511	3,046
Current ratio= current asset/ current liabilities	0.9171644763	0.7731451083

The figures of the current ratio have improved in 2021 compared to 2020.

9- Gearing ratio:

A gearing ratio is used to compare some form of the equity of the owners to the debt that the company has borrowed. The financial leverage of the business is measured using this ratio. The ratio is calculated using the formula- Gearing ratio= loans and borrowings/shareholder equity (AccountingTools, 2022).

Calculation or gearing ratio		
Particulars	2021	2020
Loans and borrowings	4137	4129
Shareholder equity	3,088	2,912
Gearing ratio= loans and borrowings/shareholder equity	1.420673077	1.417925824

The gearing ratio of Sweets plc has increased a bit in 2021 compared to 2020.

10- Interest cover:

Interest cover is a financial ratio that is used to evaluate the ability of how well the interest due on outstanding debt can be paid by a firm. If the ratio values are higher, then the ability of the company to pay interest is said to be better as well. The formula of interest cover is Interest cover= EBIT/Interest expenses (WallStreetMojo, 2022).

Calculation of interest cover		
Particulars	2021	2020
Earning before interest and taxes	805	699
Interest expenses	226	181
Interest cover= EBIT/Interest expenses	3.561946903	3.861878453

b.) Analysis of the financial ratios of Sweets Plc

Analysis of the financial ratios will help to figure out how well Sweets plc has done in terms of profitability, financial stability, and efficiency in 2021 compared to 2020. Starting with the aspect of financial performance, the profitability ratios evaluated here show that the company has done well in 2021 compared to 2020. Sweets plc seems to have generated more sales, more net profit, and higher returns on shares and equity as well. Although the utilization of assets to generate sales has not been maximized. A higher current ratio in 2021 indicates that the company has a better current financial position than in 2020. An increase in stock holding days means that the

company has lost its operational efficiency a bit but now the company takes less time to trade its debts. So, in terms of financial performance and positioning Sweets plc has improved while the financial efficiency aspect has to be improved more in the coming financial year.

Conclusion

This assessment of accounting fundamentals has been completed and all given tasks are covered. The balance sheet and income statement of Wales Plc will help its investors and other users to get a clear idea of the profitability and positioning of the business. Sweets plc's financial assessment is done using ratio analysis. The data for the analysis is taken from the financial accounting reports of the company which comes under the fundamentals of accounting.

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