

Budgeting & Standard Costing



Q 1

Explain the advantages and uses of budgets.

1. Budgets **formalise** management plans.
2. Budget preparation ensures that all functions of a business are properly **co-ordinated**.
3. Budgets Jan indicate **possible future shortages** of resources so that remedial measures Jan be taken in good time, or other functional budgets modified.
4. Participation by management at all levels in budget preparation induces a **sense of commitment** by all of them to the budget.
5. The preparation of budgets for individual departments, functions etc. is a form of **responsibility accounting**.
6. Budgets provide information for **on-going control** of business activities.

Q 2

Explain how “principal budget factor”(p.b.f) affects the preparation of budgets.

1. A principal budget factor is anything that **restricts** the level of activity.
2. It Jan be sales volume (which is restricted by demand), or resources such as availability of materials or labour hours or machine capacity.
3. The budget for the activity **restricted by the p.b.f** should be prepared **first**.
4. If a p.b.f. becomes apparent during a budget period, the budget should be revised.
5. The effect of a p.b.f. on **contribution** Jan lead management to reconsider the advisability of continuing production or **to rank products** in a different order to maximise profit.

Q 3

State four advantages that Jan arise from preparing budgets from standard cost.

Advantages of using standard costs

- Standard cost (when kept up-to-date) can be used to facilitate the preparation of **realistic** budgets
- **Variations** between budgeted and actual activity Jan identified/explained
- **Responsibility** for variances Jan be allocated to persons involved
- Standard costs facilitate the preparation of estimates for new **products\quotations** for jobs.
- Standard costs are acceptable for **stock valuation**.

Q 4

Identify one possible reason for each of the following variances.

- (i) the **Favorable** direct material usage variance;
- (ii) the **Adverse** direct material price variance;
- (iii) the **Adverse** direct labour efficiency variance;
- (iv) the **Adverse** direct labour rate variance;

- (i) use of better quality materials
- (ii) use of better quality materials costing more
- (iii) less skilful labour being used
- (iv) pay rise awarded to workers

Q 5

Discuss the possible links between Material & Labour variances.

- More expensive, better quality materials being used which have cost more than expected.
- Employment of unskilled workers who are paid at a lower wage rate than anticipated at a time when unions have negotiated a pay rise.

Q 6

Explain two reasons why a system of “standard costing” might be introduced into a business.

- Makes budgets **easier** to prepare
- Makes budgets more **realistic**
- **Differences** between actual expenditure and budgeted expenditure is easy to identify
- Essential for **responsibility** accounting
- Can help in calculating costs for **quotations** and orders

Q 7

Explain two differences between a cash budget and a cash flow statement.

- A cash budget is a **forecast** whereas a cash flow statement is an **historical** document
- A cash budget **not required** as a standard; a cash flow statement is **required** as a standard
- A cash budget is used for planning and control purposes(**internal**); a cash-flow statement is used to report to all stakeholders (**external**)
- A cash budget can be prepared **frequently** e.g. weekly, monthly or semi-annually; a cash-flow statement is prepared **yearly** (at end of accounting period)
- A cash budget can be **customized** according to needs of a business; a cash-flow statement is prepared only in accordance with **standard format** (FRS-1/ IAS-7)

Q 8

Explain one measure that the managers of a business might adopt if they are faced with a cash deficit in one month of an annual cash budget.

- Do nothing it can only be a short term problem
- Arrange overdraft facilities
- Reschedule some of the payments e.g. dividends, purchase of machinery etc.

Q 9

Explain the interrelationships between the labour and material variances.

As the material was more expensive, it may be of better quality, so there was less material used; but the labour force used more hours to make the production, perhaps spending longer on being more careful with the use of the material; or as their pay was unchanged, there may be a lack of skills.

Q 10

Describe two actions that could be undertaken which would fund the proposed increase in direct labour costs.

- increase the selling price but also do not exceed market expectations
- find a cheaper supplier of materials as long as quality is maintained
- find cheaper materials with lower quality

Q 11

Explain the term "variance".

Variance – the calculated difference between the **budgeted** (expected) cost/revenue and the **actual** cost/revenue.

Q 12

Explain one possible cause of each of the following variance.

Material price – adverse

higher price paid due to a change in supplier (which is more expensive), shortage of resources, or a higher quality product used, or discounts not achieved perhaps for bulk buying.

Material usage – favourable

- less material used, better quality material may have less wastage, better production process or more highly skilled workforce.

Labour rate – favourable

- less paid per hour to workforce due to less highly skilled workforce.

Labour efficiency – adverse

- more hours taken due to less highly skilled workforce, production breakdowns or lower quality material, so more wastage.

Sales price – adverse

- sold for lower selling price, more discount given to customers or lowered price due to competition.

Sales volume – favourable

- more sold perhaps due to a lower selling price, higher quality material may make product more appealing to customers.

Q 13

Explain two uses of the statement reconciling the standard total direct cost of the actual output with the actual total direct cost.

Uses

- to explain the effect of the variances on total cost
- to identify whether the flexed cost for actual production is greater or less than actual cost
- to identify whether the net variance is adverse or favourable, and the corresponding effect on total cost.

Q 14

Define the term “standard cost”.

A cost which should have been incurred as opposed to a cost which actually happened. An expected cost which contain direct cost and indirect cost.

Q 15

Explain why each of these variances may have occurred.

Sales price variance

- lower price
- due to competition
- increase market share (marketing strategy)

Sales volume variance

- sold more
- lower price may make product more attractive to customer
- lower price than competitor

Q 16

State one possible cause of each of the following variances and explain any possible relationship between them.

Materials price variance (adverse)

- arose as price paid for materials used was higher than the price budgeted for.

Materials usage variance (favourable)

- arose as the materials were used more efficiently than budgeted,
- perhaps because a higher price had been paid for better quality goods which resulted in less waste.

Labour rate variance (favourable)

- arose as less was paid to the workforce than originally budgeted for.

Labour efficiency variance (adverse)

- arose as the workforce were less efficient than budgeted for and took longer,
- perhaps because a lower rate had been paid for less skilled labour which had resulted in less efficiency.

Q 17

Explain two advantages of budgeting.

Planning - the use of resources, including cash, can be planned for future periods to maximize efficiency.

Control - the use of all resources can be controlled over a period to ensure that they are not over- or under-used.

Co-ordination - different departments can co-ordinate their activities to achieve overall company objective.

Communication - to enable a unified activity, the departments must communicate with each other and pass information.

Aids decision making - the budgets produced can provide vital information for managers.

Evaluation of performance - each department or manager can be evaluated on their achievement or non-achievement of their budgets.

Q 18

Evaluate the significance of preparing cash budgets when making investment decisions.

Cash budgets show:
the availability of cash, the amount of financing required
the ability to meet debt repayments.

Evaluation – without budgets may make serious errors, could lead to closure of the business, difficult to justify any decision taken if budgets not prepared

Cash Flow Statements



Q 1

Explain why a cash flow statement is important to shareholders.

Cash flow statements are important to shareholders because they show:

- the ability of a business to **generate cash internally**
- how much cash has been **raised externally**
- the **causes** of change in liquidity or cash inflows cash outflows
- **viability** whether business can generate cash to service finance, pay tax and maintain its fixed assets going concern
- **stability** of business reliance upon internal sources external sources for financing
- **profitability and liquidity reconciled** as shareholders Jan confuse profitability with liquidity
- **indication of future** cash flows ; capital investment (expansion of activities) and its effect on future cash flows

Q 2

Explain how cash flow statements differ from cash budgets.

Cash Flow Statement

- Based on historical data
- An account of the directors' stewardship of funds
- Cannot (legally) be manipulated Management
- A requirement for companies
- Produced annually
- Presented in a standard format

Cash Budget

- Based on future plans
- For internal use
- Jan be adjusted to reflect policy
- Desirable for management purposes
- Jan be prepared for any period
- No formal lay-out is required

Q 3

Explain how a company can make a loss but still have an increase in cash. General discussion of the differences between cash and profit:

Timing differences – profits are recorded in the profit and loss account when the transaction is made but the cash may not be received for some time.

Other payments – payments for fixed assets result in cash leaving the business but do not reduce profit.

Other receipts – share issues or loans received will increase cash but are not shown in the profit and loss account.

Non-cash items – provisions are made in the profit and loss account that do not involve the movement of cash e.g. depreciation.

Q 4

Explanation of how a company can make a loss and still increase cash balance:

Non-cash items - provisions for depreciation or bad debts will reduce the profit figure but have no effect on cash for example.

Timing differences:

the company may have recorded purchases but not paid for them yet for example.

Other receipts:

The company may have issued shares or taken out loans during the year and these will increase the cash balance but not affect the profit figure for example.

Q 5

Discuss the extent to which cash is more significant for business survival than profit.

Cash is essential for short term survival. Without cash, a business may not be able to meet its liabilities and therefore may lose profit or even be forced into liquidation by its creditors. Also the business may not be able to pay dividends and hence lose the confidence of shareholders.

Profit is needed for long term survival to ensure that funds are generated to enable the business to invest and to pay dividends to shareholders.



Explain to what extent a cash flow statement is essential in judging the financial performance of a company.

Focus on cash

The cash flow statement focuses on cash. Cash is the lifeblood of a business. It is possible for a business to survive for a significant period of time whilst making losses: however, without cash a business can fail quickly.

Profit can be distorted, but cash is more difficult to manipulate.

Cash is also seen as being a more certain figure and harder to manipulate, therefore it may be seen as a more accurate measurement of business success or failure. Profit can be distorted because decisions need to be made about:

examples such as recognition of sales distinguishing between capital and revenue expenditure depreciation.

Profit is significant

Investors are interested in profit as this is the source of dividends and significant for the long term survival of the business.

Judgment:

The cash flow statement is important in judging the financial performance of the business - it shows:

- ✓ liquidity
- ✓ solvency
- ✓ financial adaptability.

However, the remaining statements also show significant information e.g. profits/losses and assets and liabilities.



Explain why public companies publish cash flow statements.

- Cash flow statements are published to comply with FRS1.
- Cash flow statements provide information that is not contained in the profit and loss account and balance sheet. They are necessary to provide a fuller understanding of business performance.
- Cash is seen as a more certain figure than profit as it is easier to verify and less subject to estimation plus example.
- Cash flow statements focus on cash, which is essential to the short-term survival of business.
- They show the uses of finance.
- They show the sources of finance – internal and external and long and short term; they show how much cash is generated from trading and how much from other sources.
- This allows the users of accounts to make more informed judgments about business performance.

Process Costing



Q 1

Explain what is meant by the following and how they are treated in process accounts:

- (i) by-products
- (ii) waste products

Product	Accounting Treatment
By-product: A by-product is one that is produced incidentally in a process and that has an insignificant sale value compared to the main products.	If the sale value is very low, the processing costs can be reduced by any revenue derived from the sale.
Waste product: Waste products are processing debris.	Revenue derived from the sale of waste is deducted from total process costs.

Limited Companies



Q 1

Explain the reasons why the shareholders may agree to “Capital Reduction scheme”.

- ✓ The capital reduction merely **recognizes** the reality of the situation.
- ✓ Reduction in the nominal value of each share **does not entail** any further loss to the shareholder.
- ✓ The shareholder will stand to **receive dividend** as soon as the company realizes the profits forecasted by the directors.
- ✓ If the shareholders had **rejected** the scheme, they would have had to **wait** for many years before the expected profits would have **eliminated the debit balance** on the P&L account to enable dividend to be paid.

Q 2

State five items which should be contained in the directors’ report which accompanies the final accounts of a company.

- (i) **Review of business** during the year. Position of business at end of year.
- (ii) **Principal activities** of the company during the year. Significant changes in the business activities during the year. (continued/ discontinued operations)
- (iii) Particulars of important **events** affecting the company since the end of the financial year.
- (iv) An indication of likely **future developments** in the business of the company.
- (v) Amounts of **recommended dividend**.
- (vi) Proposed **transfers to reserves**.
- (vii) **Name of directors** and their **holdings of the shares and debentures** in the company, pensions, share options etc
- (viii) Political and charitable **donations**

Q 3

State four actions the directors could take to avoid the overdraft limit being exceeded.

Where possible state the effect of each of the actions on the bank balance.

Actions to keep bank balance within overdraft limit

- reduce stock
- **delay purchase** of machine, alternatively **hire** machine
- increase **selling prices** if this can be done without decreasing volume increasing revenue
- reduce cost of purchases by **obtaining discounts** or buying from cheaper suppliers
- delay payment of **dividend**
- give **incentives to customers** to purchase for cash
- **negotiate longer credit** from suppliers if possible without loss of confidence
- issue **shares**
- issue **debentures**

Q 4

State four “exceptional items” that should be included in a company’s Profit and Loss Account.

Four exceptional items:

- **Reorganisation** expenses due to the **acquisition/ disposal** of a business segment.
- **Redundancies:** expenses of discharging personnel on reorganisation due to acquisitions/disposals
- **Profit/ loss** on sale of discontinued operation
- **Significant losses of un-insured stock.**

Q 5

State five matters which should be included in the directors report.

Give one reason why each of the matters you have identified is important.

Q 6

Identify and explain one factor that the court would consider before agreeing to the “Capital Reduction Scheme”.

- ✓ Share holders not discriminated (protection of minority interest)
- ✓ Creditors not disadvantaged
- ✓ Business will be profitable after the reconstruction

Q 7

Explain briefly one possible reason why the partners decided to change their business into a limited company.

- Limited liability
- Access to greater sources of finance
- Any other sensible reason acceptable

Q 8

After the preparation of the draft final accounts for BSS Ltd for the year ended 31 Dec, 2008, the following items were revealed, all of which need to be included in the final accounts.

- 1 On 1 Jan 2008 BSS Ltd purchased the business of a rival retailer. As part of the purchase price BSS paid \$180,000 for goodwill. The directors were unsure how to treat the goodwill. It had been entered in a suspense account. It is estimated that the economic life of the goodwill will be 4 years.
- 2 BSS's sales have doubled over the past few years and the directors believe that they have a very good business reputation. As a result they propose to introduce a further \$120 000 as additional goodwill.
- 3 The directors of BSS Ltd valued stock at cost. The closing stock at 31 Dec 2008 has been valued at \$60,000. Included in the closing stock were 6 air conditioning units that had been damaged in a recent flood. The units

cost \$220 each and normally sell for \$350 each. The 6 damaged units could be sold for \$250 each after undertaking total repair costs of \$400. The 6 units could be replaced for \$200 each.

- 4 On 1 Jan 2008 the business premises were re-valued from a net book value of \$500,000 to \$750,000. Premises are depreciated at 2 % per annum. The revaluation had not been included in the books of account.
- 5 No provision has been made for doubtful debts. The directors feel that 10% would be appropriate.

REQUIRED

Identify the appropriate accounting standard for each of the items 1-5.

FRS	10	IAS 38	Intangible assets
FRS	10	IAS 38	Intangible assets
SAP	9	IAS 2	Inventories
FRS	15	IAS 16	Property plant and equipment
FRS	18	IAS 1	Presentation of Financial Statements
		37	contingent liabilities and contingent assets



State one reason why the directors of a limited company would prepare a cash flow statement.

It is a requirement; it completes the financial picture i.e. profits, state of affairs, cash; shows cash inflows and cash outflows important for survival; shows how efficiently or inefficiently cash has been used throughout the year; shows clearly internal and external financing etc.

Q 10

Explain the difference between the “Retained profits as at 1 January 2003” and the “Profit for the year ended 31 December 2003”.

Retained profits – this is the balance of unappropriated profits brought forward from the previous year.

Profit for the year – this is the net profit brought down from the main profit and loss account for the year ended 31 December 2003.

Q 11

Explain why profits are appropriated into:

(i) the general reserve;

General reserve – the directors may decide that some of the profits should not be included in the calculation of how much should be paid out as dividends. These profits are transferred to reserves if there is no specific reason for the transfer, the amount is transferred to a general revenue reserve account. This can be later used for a bonus issue or as a contingency.

(ii) a dividend.

A dividend – the directors will decide that some of the profits will be included in the calculation of how much should be paid out as a dividend to shareholders. The amount appropriated is stated as an amount per share held, being a reward for the shareholders investment.

Q 12

Distinguish between the roles of the directors and the auditors in the preparation of the published accounts of a limited company.

Directors are appointed by the shareholders to run the business on their behalf

The directors are required by law to prepare accounts for the shareholders which show a true and fair view of the state of affairs and of the profit or loss for the year

Because of the divorce of ownership and control, auditors are appointed by shareholders to check the accounts

The auditor’s report to the shareholders to assure them that the accounts show a true and fair view, and that they comply with the Companies Acts and have been prepared in accordance with accounting standards

The directors’ role is to prepare the accounts, while the auditors’ role is to check them and report their findings to the shareholders

Q 13

Explain two reasons why public limited companies publish their accounts.

- ✓ To provide information for **users** (e.g. investors/shareholders, potential investors, creditors) to assess the performance of the business to allow them to make decisions e.g. to continue investing, to invest or not or to trade or not.
- ✓ To provide **publicity** for development e.g. using the accounts to advertise products, and present information in its best light.
- ✓ **Legal** requirement for development e.g. required by law because of the divorce of ownership and control, and to inform potential investors.

Q 14

Discuss two limitations for potential investors of using published accounts.

- ✓ Based on historical information for development e.g. figures may not reflect current trading position, impact of inflation etc.
- ✓ Total figures for development e.g. figure may not reveal the performance of parts of the business or individual products.
- ✓ Published some months after the year end for development e.g. figures may be out of date.
- ✓ Potential for window dressing for development e.g. accounts shown in their best light and do not reflect the real trading position.
- ✓ Lots of other relevant information not revealed for development e.g. product-range, product-lifecycle, quality of workforce/management.

Q 15

Define a rights issue of shares.

A rights issue is a means of raising finance where **existing** shareholders are given the right to buy new shares.

The shareholders can re-sell the "right". It is usually **cheaper** than a public issue of shares and does not affect the control of the business.

Q 16

Explain why rights issues of shares are frequently offered at a discounted price.

The discount makes the share more **attractive** to the shareholders, thus persuading them to take up their rights.

The deeper the discount, the better the offer appears and the more **likely** the shareholder is to take up his/her rights.

Q 17

Assess the relative merits of a rights issue of shares and a public issue of shares as a means of raising finance.

A rights issue will maintain the current **control** of the business if the rights are taken up, however, if issued at a discount then **less cash** is raised.

It is generally a **cheaper** way of raising finance than a public issue and is more **flexible** than other sources of finance such as debentures and loans.

Q 18

Evaluate the use of a rights issue as a means of raising finance for a limited company.

A rights issue means that existing shareholders are given the right to buy new shares in the company.

It is a means of raising long term finance without increasing gearing or changing control of the business.

It is an effective way of raising finance, provided the shareholders are willing to take up their rights.

Rights issues are often made at a discount to encourage the shareholders to subscribe. However, this may mean that less cash is raised.

Rights issue have the benefits of any share issue, that there is no repayment and dividends do not have to be paid.

Evaluation.

For example: as they are a long term source of finance they are not really appropriate to meet short term cash problems such as paying dividends. However, they would be appropriate to finance the purchase of fixed assets and to repay loans - this would have the effect of reducing gearing.

Q 19

Identify and explain two reasons why public limited companies publish their accounts.

Law - legal requirement of the Companies Act 1985 required because of the divorce of ownership and control – the directors report to the shareholders on the performance of the business.

Publicity – to persuade current investors to retain their shares, potential investors to invest. Potential investors – show the results and plans for the future to persuade investors to invest.

Q 20

Advise the directors, giving your reasons, which method of raising the required finance they should use.

Mortgage interest and capital must be repaid or factory may be repossessed.

Sale and lease back – immediate loss of ownership leaser can impose restrictions on use may increase rent can refuse renewal of lease Rental may be less than mortgage payments Which may have less impact on liquidity and profitability

Q 21**Evaluate three appropriate sources of finance to meet the cash outflow.**

Type of finance long term	Advantages	Disadvantages
Share issue	Dividends – don't have to pay and can vary	Change of control
Debentures	Often cheaper than shares e.g. reduced tax Don't have vote	Have to pay interest
Long term loans	Can be cheaper	May have to offer security
Sale of investments	No interest to pay	Lose income - permanently

Type of finance short term	Advantages	Disadvantages
Overdraft	Flexible – only borrow the amount needed	Repayable on demand Can be expensive
Bank loan	Can be cheaper than overdraft	Have to use all of loan Fixed repayments

Q 22**Outline two limitations of using published accounts to make investment decisions.**

- ✓ The figures are historic and may not actually reflect the future.
- ✓ The accounts take time to prepare and may not reflect the current state of markets.
- ✓ The figures are total and do not reflect the performance of individual parts of the operation.
- ✓ The accounts are purely financial and do not necessarily reflect the performance of the management, workforce, new products, etc.

Marginal & Absorption Costing



Q 1

Assess how the change in profit, resulting from the adoption of the absorption method, could affect the shareholders.

Profit will be higher using the absorption method of cost accounting in periods of increasing stock levels (over the short term).

Higher stock values will lead to higher profits – shareholders would perceive this as an indication of business success, suggesting higher dividends being available for ordinary shareholders.

However, over the long term, profit is the same regardless of method. In the short term, market price of shares may rise, increasing the demand for shares and possible capital gain.

Q 2

Define the term 'contribution'.

Contribution is calculated by SP-VC. Total contribution is used to cover fixed costs and then towards profit.

Q 3

Compare the advantages of using absorption costing with the advantages of using marginal costing to set a selling price.

Absorption costing consists of marginal costs plus fixed overheads: however, OAR is based on either labour or material hours, which, although subjective and often not accurate, is a reasonable estimate. The method promotes full cost recovery. The mark-up percentage is therefore smaller than would be used in marginal costing to achieve the same selling price.

The marginal costing method ignores overheads in the calculations (fixed), so mark-up has to be larger when fixing a selling price. It is easier to calculate and understand. Uses contribution for decision making e.g. make or buy decisions/special orders.

Q 4

Explain one reason why a manufacturing business might continue to manufacture goods despite the fact that it may be cheaper to purchase the goods from an outside supplier.

- ✓ to keep resources working to cover fixed costs
- ✓ to avoid dependence on external supplier
- ✓ to retain the skilled labour
- ✓ to maintain customer confidence etc.

Q 5

Define the following terms:

- (i) **allocation;**
Costs assigned to an individual cost centre.
- (ii) **apportionment;**
Costs assigned to two or more cost centers.
- (iii) **absorption;**
The allocation of all production direct and indirect expenses to products.

Q 6

Distinguish between fixed, semi-variable and variable costs. Give one example of each.

Fixed costs

- costs that do not change when the level of activity changes e.g. rent.

Semi-variable costs

- costs where a part of the cost acts as a variable cost, and a part acts as a fixed cost e.g. telephone bill.

Variable costs

- costs where the amount varies in proportion to the activity level when the activity level changes e.g. materials.

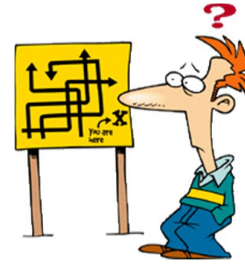
Q 7

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Investment Appraisal



Q 1

State the advantages and disadvantages of using the following methods:

- (i) accounting rate of return (ARR)
- (ii) payback period
- (iii) internal rate of return (IRR).

Accounting rate of return

Advantages

- profitability of a project may be compared with present profitability of business
- it is relatively easy to calculate

Disadvantages

- average annual profit may not be typical of any year
- timing of cash inflows and outflows is ignored
- it ignores the payback risk factor
- it ignores the time value of money
- 'profit' is subjective (provisions for depreciation, bad debts etc.)
- no commonly accepted method of calculating capital employed
- ignores duration of project

Payback period

Advantages

- it is relatively easy to calculate
- calculation of net cash flows is less subjective than calculation of profitability
- where competing projects are being considered, the risk factors May be compared
- short payback periods benefit business's liquidity and facilitate faster growth

Disadvantages

- life expectancy of project is ignored
- different projects May have similar payback periods but different patterns of cash flows
- time value of money May be ignored

Internal rate of return

Advantages

- indicates return actually to be expected from expenditure
- May assist in ranking different proposals
- often used in businesses
- recognises time value of money

Disadvantages

- more difficult to calculate than NPV
- NPV is usually more useful in ranking different projects

Q 2

Explain two limitations of using payback as a method of capital investment appraisal.

Any two limitations of payback from the following:

- ignores the timing of receipts and payments, presumes that they are received at regular intervals throughout the year
- ignores inflation
- ignores the time value of money, unlike net present value method
- ignores weighting of receipts (net inflows); for example, one machine may create regular net inflows, whereas another has a much higher net inflow towards the end of its use
- ignores the length of the life of the asset and only considers the net inflows for a stated period of time

Q 3

Define the term “payback”.

Payback: The length of time taken to generate net cash inflows that are equal to the original cost.

Q 4

Explain two limitations of the payback method when used as a method of capital investment appraisal.

Two limitations:

- ignores time value of money
- ignores the cash flows received after the payback period has been reached
- calculation based on estimated figures.

Q 5

Assess the usefulness of the net present value method of capital investment appraisal.

Net present value involves time value of money and patterns of net cash flow. However, more complex to calculate.

The method relies on estimated future information, which could be wrong. Consideration of all cash flows and the future value of money.

Estimates in the long term may be inaccurate.

Ratios Analysis



Q 1

Explain the term “gearing”.

Gearing is the relationship between the use of debt and shareholders’ funds to finance the business. The gearing ratio measures the amount of long term debt compared to the total capital of the company. If the ratio is greater than 50%, the company is considered to be high geared and therefore high risk. It is considered to be risky because the debt will carry interest payments which have to be paid and this may affect the company’s ability to pay dividends. However, in periods of growing profits, high gearing can benefit the ordinary shareholder for development.

Gearing is using debt as a means of financing the company rather than using share capital. The gearing ratio measures the amount of long term debt compared to the equity investment in the business.

A highly geared company is considered to be a more risky investment as the company has to meet higher debt repayments.

Q 2

Assess the usefulness of the gearing ratio as a guide to investment decisions. Use examples from the information given.

The gearing ratio measures the riskiness of the business from an investors point of view – the higher the gearing ratio the greater the risk. However, in times of increasing profits the benefits to shareholders will increase in a highly geared company.

Investors should consider other information.

Q 3

Evaluate two limitations of using ratios to make investment decisions.

- Ratios based on historical information.
- Based on accounts which are total and do not show the relative performance of parts of the business.
- Focuses on those things that can be measured in money terms and ignores other factors such as workforce, management etc.
- Different accounting policies, Window dressing.

Q 4

Explain how a potential investor would use earnings per share (EPS), given in financial statements, in making investment decisions.

Formula: $\text{Earning}/\text{no. of shares issued}$

Earnings per share measures the profit available to shareholders. The EPS indicates the business' ability to pay a dividend. The potential investor could use this to assess the profitability of the company and to compare alternative investment opportunities.

Q 5

Discuss the impact of the limitations might have on potential investors.

Potential investors are usually seeking a financial return on their investment either in the form of dividends or by buying and selling the shares at a higher price. However, the financial performance of the business will be significantly affected by the non-financial factors which are not quantified in the financial statements.

The investor is looking for future performance, and historical performance as shown in the financial statements is only a guide to future performance.

Therefore, the investor should be very aware of these limitations when making investment decisions, and should investigate all aspects of a business and not rely solely on the financial statements.

Q 6

Explain three limitations of using ratios when making investment decisions.

Need comparison – with past figures; other businesses; industry averages

Only an indicator – it does not tell you the cause of the problem

Based on historical data – past performances are not necessarily an indicator of future performances

Different organizations use different accounting methods, therefore it may be difficult to compare

Based on numerical data only – This may not fully reflect the future performance of the business

Q 7

Explain the purpose of the price earnings ratio.

The PE ratio measures the number of years of earnings that investors are willing to buy. It represents the market's view of the future of the business. The higher the PE ratio, the better the market's view.

Q 8

Explain two ways in which ratios can be used to assess the performance of a company.

Trend analysis:

compare the trend of each company's performance. Trends indicate, if a company's performance is improving, stagnant or in decline.

Inter company comparison:

Comparison with the average performance of other companies in the same trade provides a useful measure of how efficiently a company is performing.

Q 9

Following the redemption of the debentures and preference shares, the market price of ordinary shares rose from \$1.60 to \$1.85.

Required:

Explain why the redemption of the debentures and the preference shares have caused the market price of the ordinary shares to rise.

Your answer should include a reference to relevant investment ratios.

Following the redemption of the debentures and preference shares, there was expectation that:

- the **earnings** for the ordinary shares (EPS) will increase
- the **dividend cover** will increase
- the **price earnings** ratio (PER) will increase
- the **dividend yield** will decrease
- **gearing** will be reduced to nil

Accounting

Standards



Q 1

Explain why it is important for the users of published accounts to know that the accounts are prepared in accordance with accounting standards.

Reason	Explanation
User's needs	All are using accounts to make decisions such as to invest or to sell shares or to lend money
Purpose	Accounting standards provide guidance for those preparing accounts in situations where there are alternative accounting treatments or decisions to be made
A true and fair view	The users of accounts need to be sure that the accounts show a true and fair view of the profits and the balance sheet figures. If the accounts are prepared in accordance with accounting standards, the user can be confident that they show a true and fair view
Application/examples	FRS 10/ IAS 38 ensures that only externally generated goodwill is capitalised, this helps to prevent manipulation of the accounts
Comparability	Accounting standards ensure that similar items are dealt with in similar ways in different companies
Examples	For example, FRS 15/ IAS 16 ensures that all fixed assets are depreciated

Q 2

Outline the objectives of FRS 18/ IAS 1 (Accounting policies) with regard to the selection, review and disclosure of accounting policies.

FRS 18/ IAS1 states that a company should:

- select accounting policies appropriate to its circumstances to give a true and fair view of its accounts
- review its accounting policies regularly to ensure they are appropriate and change them if new policies become more appropriate
- disclose sufficient information in the accounts so that users can understand the accounting policies adopted and how they have been implemented.

Q 3

Explain why it is essential for a user of published accounts that companies disclose their accounting policies.

Accounting policies decide which facts about a business will be shown in the published accounts and how they will be shown.

This enables users of the published accounts to understand the accounts and to be able to compare different businesses.

It is a legal requirement for development accounting policies will enable users to: understand the accounts rely on the accounts as they are free from bias and therefore make reliable decisions.

Q 4

State the Accounting Standard involved and explain the correct accounting treatment for each item.

1 FRS 10/ IAS 38 [Goodwill and intangible assets]

Only purchased brands should be **capitalised** and then they should be **amortised** over their economic life.(normally 20 years maximum)

Internally generated brands should **not** be capitalized as they do **not** have a market value. Therefore the intangible asset should be treated as an **expense** in the profit and loss account.

2 FRS 15/ IAS 16 [Tangible fixed assets]

When assets have a greater market value than the net book value, they can be revalued. This is done by debiting the asset account and crediting a revaluation reserve.

The revalued amount should be depreciated – buildings should be depreciated.

Depreciation at 2% per annum should be charged on the revalued amount.

3 SSAP 9/ IAS 2 [Stock Valuation]

Closing stock should be valued at the **lower** of cost and net realisable value.

Therefore the stock should be maintained at cost (£20 000) as this is lower than the estimated net realisable value (£25 000).



Explain, with reference to FRS 10/ IAS 38, the general accounting treatment of intangible assets.

Intangible assets are fixed assets that are not physical – such as goodwill, brand names.

Purchased intangible assets can be capitalised on the balance sheet and should then be amortised over their estimated economic life. Alternatively, they could be written off to the profit and loss account immediately, if the directors choose.

Internally generated intangible assets should not be capitalised and should be written off to the profit and loss account unless they have a readily ascertainable market value.

If the company can demonstrate the asset does have an infinite life, it does not have to be amortised.