

Standard Costing:

Question: 01 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.

Question: 02 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

Question: 03 Explain the term "variance".

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

Question: 04 Explain one possible cause of each 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.

Question: 05 Explain two uses of this 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.

Question: 06 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.

Question: 07 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

Question: 08 State one possible cause of each of the above 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.

Marginal Costing:

Question: 01 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.

Question: 02 Define the term 'contribution'.

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

Question: 03 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.

Investment Appraisal:

Question: 01 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

Question: 02 Define the term "payback".

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

Question: 03 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.

Question: 04 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.

Budgeting:

Question: 01 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.

Question: 02 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

Limited Companies:

Question: 01 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.

Question: 02 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.

Question: 03 Distinguish between the roles of the directors and the auditors in the preparation of the published accounts of a limited company.

Descriptor

Identify the role of the directors

Explain the role of the directors in relation to the published accounts

Identify the role of the auditors

Possible answers

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

Explain the role of the auditors in relation to the published 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

Clear distinction between the role of the directors and auditors

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

Question: 04 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.

Question: 05 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 life cycle, quality of workforce/management.

Question: 06 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.

Question: 07 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.

Question: 08 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.

Question: 09 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.

Question: 10 Identify and explain two reasons why public limited companies publish their accounts.

Descriptor	Possible answers
Identify two reasons	Law Publicity Potential investors Shareholders
Explain/develop each reason	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.

Question: 11 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.
After mortgage is repaid ownership rests with Genspec plc.
Repayments will be less onerous as time elapses in real terms
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

Question: 12 Evaluate three appropriate sources of finance to meet the cash outflow.

Possible sources:
Long term - probably better due to amount of financing required

Type of finance	Advantages	Disadvantages
- long term		
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	Advantages	Disadvantages
- short term		
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

Question: 13 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.

Absorption Costing:

Question: 01 Define the 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.

Question: 02 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.

Question: 03 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.

Accounting Standards:

Question: 01 Explain why it is important for the users of published accounts to know that the accounts are prepared in accordance with accounting standards.

Descriptor	Possible answers
Explain that users are interested in accounts to make decisions	All are using accounts to make decisions such as to invest or to sell shares or to lend money
Judgement of the purpose of accounting standards in general	Accounting standards provide guidance for those preparing accounts in situations where there are alternative accounting treatments or decisions to be made
Examples of areas where alternative treatments are possible	For example, the valuation of stock
Explanation of the need for accounts to show 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 supporting the true and fair view	FRS 10 ensures that only externally generated goodwill is capitalised, this helps to prevent manipulation of the accounts
Judgement of the significance of accounting standards in aiding comparability	Accounting standards ensure that similar items are dealt with in similar ways in different companies
Examples supporting judgement	For example, FRS 15 ensures that all fixed assets are depreciated

Question: 02 Outline the objectives of FRS 18 (Accounting policies) with regard to the selection, review and disclosure of accounting policies.

FRS 18 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.

Question: 03 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.

Question: 04 State the Accounting Standard involved and explain the correct accounting treatment for each item.

1 FRS 10 Goodwill and intangible assets

Only purchased brands should be capitalised and then they should be amortised over their economic life.

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 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.

Therefore the asset value should be increased by £10,000,000 and a revaluation reserve created. Depreciation at 2% per annum should be charged on the revalued amount.

3 SSAP 9 Stock and long term contracts

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).

Question: 05 Explain, with reference to FRS 10, the general accounting treatment of intangible assets.

Descriptor

Explanation of intangible assets

Possible answers

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

Explanation of the treatment of purchased intangible assets

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.

Explanation of the treatment of non-purchased intangible assets

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.

Explain the accounting treatment of the brand in Extract 1 - asset life is infinite

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

In this case, the directors believe that brand Kronenbourg has an infinite life.

A Level Ratios:

Question: 01 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.

Question: 02 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.

Question: 03 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.

Question: 04 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.

Question: 05 Discuss the impact that each of the two 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.

Question: 06 Explain three limitations of using ratios when making investment decisions.

Limitations:

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

Question: 07 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.

Cash Flow Statement:

Question: 01 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.

Question: 02 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.

Question: 03 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.

Question: 04 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. (reward examples from recent business events).

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.

Question: 05 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 plus example and balance sheet plus example. 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, explanation

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.

They show the uses of finance, explanation

This allows the users of accounts to make more informed judgments about business performance.

Question: 06 Explain the difference between a cash flow statement and a cash budget.

Cash flow statements are:

a statutory requirement for plcs

historic

prepared for external users

prepared to show sources and uses of cash

Cash budgets are:
prepared for internal users
forecasts
used to plan and control cash flows and to obtain financing
when needed

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Accounting Basics:

Question: 01 Explain limitations of financial statements.

Financial statements only measure the monetary aspects of business e.g. those transactions which can be valued in money terms for example - sales, assets, liabilities. There are many aspects of business which are important, which are not shown, for example the quality of the management or the levels of motivation of the workforce, the quality of research and development, impact on environment, ethical considerations etc. All of these would affect the performance of the business but are not fully reflected in the financial statements.

The financial statements are for an accounting period and are prepared after the year-end; by the time they are published they are likely to be at least 3 months out of date. The financial statements focus on what has happened and do not consider what is likely to happen in the future for development e.g. changing markets or economy which could have a significant impact on the performance of the business.

Question: 02 Explain two reasons why the closing stock as shown by a computer print-out may differ from that shown by a physical stock-take.

Stealing not recorded on stock records but 'missing' at stock-take
'Natural causes' breakages other examples e.g. evaporation, deterioration etc. Not recorded on stock records but 'missing' at stock-take

Incorrect entries on stock records plus, Incorrect physical stock-take plus

Question: 03 Explain the effects that over-stating the cost of stock would have on the final accounts and balance sheet of a company.

Over-stating of stock would:

- (i) over-state profit, because closing stock is higher the cost of goods sold is reduced and therefore gross profit increased;
- (ii) over- state asset values on the balance sheet the business could appear to be more stable or more valuable than it actually is.
- (iii) makes it difficult to compare performance over time as the overvalued stock will distort successive years;
- (iv) Could have a significant impact on decision making.

Question: 04 Explain the difference between cash and profit.

Cash = physical amount (tangible) in bank or till

Profit = calculated figure

= includes non-cash items e.g. depreciation

= does not include capital items e.g. drawings.

Question: 05 Explain, giving examples, why despite making a profit a business may have a shortage of cash.

Timing differences - the profit and loss account is produced using the accruals basis which does not necessarily reflect actual cash flows.

Purchase of fixed assets - when a company buys fixed assets this can result in an outflow of cash which would not be reflected in the profit and loss account.

Other payments - the company may make other payments such as tax, loan repayments or dividends - these will not be reflected in the profit and loss account.