

Chapter 1

Q1 Accounting can be defined in a number of different ways but it is generally accepted that the term includes the following activities:

- (a) collecting and recording financial data relating to a business enterprise
- (b) processing this data to produce useful financial information
- (c) communicating or reporting this financial information to interested parties (the “users”) and interpreting it for their benefit.

For example, one of the more obvious accounting tasks is to calculate the amount of profit made by a business during an accounting year. This task will involve:

- (a) collecting and recording data about the income and expenditure of the business during the year
- (b) processing this data to compute the profit for the year
- (c) reporting this information to those who are interested (e.g. the owner(s) of the business and the tax authorities).

Accounting is necessary because the users mentioned above require accounting information in order to make important economic decisions. For instance, the tax authorities cannot decide how much tax should be paid by a business until profits have been calculated. Similarly, investors cannot decide whether to maintain, increase or reduce their level of investment in a business unless they are provided with financial information relating to the profitability and financial position of that business.

- Q2**
- (a) Companies must comply with the Companies Acts and with a variety of other legislation. The Companies Acts require companies to produce regular financial statements and specify the required contents and format of those statements. The production of financial statements is a legal requirement in its own right and the information given in the financial statements (which must be independently audited unless the company is small) provides evidence that a company is meeting (or failing to meet) other legal requirements.
 - (b) It is the responsibility of the accountant to collect, record and process data relating to financial transactions. For instance, data relating to a company’s sales of goods or services to a customer must be recorded so that the amount owed by the customer can be calculated. This data will also feed through to the end-of-year financial statements, which will show the total sales for the year. This is a necessary figure in the computation of the year’s overall profit figure.
 - (c) One way in which society in general can monitor the activities of a large, powerful company is to examine the company’s financial statements. The accounting information given in these statements may (for instance) help to determine whether or not the company is charging excessive prices and so making excessive profits. The information given in the financial statements may also provide some clues as to the company’s policies on matters such as pollution control and the employment of disabled people.

Chapter 2

- Q1**
- (a) Variable cost per unit is £3 ($\text{£}1.10 + \text{£}1.40 + \text{£}0.50$).
 - (b) Fixed cost per unit if 25,000 units are produced is £6, giving a total cost per unit of £9.
 - (c) Fixed cost per unit if 50,000 units are produced is £3, giving a total cost per unit of £6.
 - (d) Contribution per unit is £5 ($\text{£}8 - \text{£}3$).
 - (e) The break-even point is reached when total contribution equals fixed costs. This occurs when production is 30,000 units (since $30,000 \times \text{£}5 = \text{£}150,000$).
- Q2**
- (a) If an item of stock is bought for £100, the business adds a gross profit of £25 (25% of £100) giving a selling price of £125. Therefore the gross margin is $\text{£}25/\text{£}125 \times 100\%$ which is 20%.
 - (b) If an item of stock is sold for £100, the business makes a gross profit of £15 (15% of £100) so the item must have cost the business £85. Therefore the markup is $\text{£}15/\text{£}85 \times 100\% = 17.65\%$ (approximately).
 - (c) Markup is defined as gross profit divided by cost price. Gross margin is defined as gross profit divided by selling price. Since (in general) selling price will be greater than cost price, this means that markup always be greater than gross margin.

Chapter 3

Q1 (a) The contribution made by each contract is as follows:

	<i>Contract A</i>	<i>Contract B</i>
	£	£
Cost of material X	800	1,200
Cost of material Y	400	240
Cost of labour	480	360
	<hr/>	<hr/>
Total costs	1,680	1,800
Contract price	2,240	2,520
	<hr/>	<hr/>
Contribution	560	720

In general terms, contract B would be selected since it makes the greater contribution to fixed costs.

- (b) Contract A uses 80 kg of material X and makes a contribution of £560. This is a contribution of £7 per kg used. Similarly, contract B makes a contribution of £6 per kg used. If material X is in short supply, contract A should be selected since it makes a greater contribution per kg used.
- (c) Contract A uses 50 kg of material Y and makes a contribution of £560. This is a contribution of £11.20 per kg used. Similarly, contract B makes a contribution of £24 per kg used. If material Y is in short supply, contract B should be selected since it makes a greater contribution per kg used.
- (d) Contract A uses 40 labour hours and makes a contribution of £560. This is a contribution of £14 per hour. Similarly, contract B makes a contribution of £24 per hour. If labour is in short supply, contract B should be selected since it makes a greater contribution per labour hour.

Q2 (a) The contribution made by each item is as follows:

	<i>Item A</i>	<i>Item B</i>	<i>Item C</i>
	£	£	£
Cost per unit	20	30	40
Selling price per unit	30	42	51
Contribution per unit	10	12	11
Total contribution	100,000	120,000	110,000

This gives a total contribution of £330,000.

- (b) Item B makes the greatest contribution per unit, followed by item C and then by item A. Therefore the company should try to maximise sales of item B, then item C, then item A. This would mean selling 9,000 units each of items B and C and 6,000 units of item A. Contributions would be as follows:

	<i>Item A</i>	<i>Item B</i>	<i>Item C</i>
	£	£	£
Contribution per unit	10	12	11
Total contribution	60,000	108,000	99,000

This gives a grand total contribution of £267,000. The £63,000 reduction in total contribution from the previous figure of £330,000 is caused by the reduction of 4,000 units in sales of item A (lost contribution £40,000) and 1,000 units each in sales of B and C (lost contributions £12,000 and £11,000 respectively).

Chapter 4

Q1

ASSETS		LIABILITIES	
Motor vehicles	7,250	Capital	10,000
Stock (3,500 - 1,750)	1,750	Long-term loan	5,000
Bank (10,000 + 5,000 - 7,250 + 2,200)	9,950	Creditors	3,500
EXPENSES		REVENUE	
Cost of goods sold	1,750	Sales	2,200
TOTALS	20,700	TOTALS	20,700

- Q2**
- (a) Bank balance (asset) and long-term loan (liability) both reduced by £10,000.
 - (b) Bank balance (asset) and shareholders' funds (liability) both reduced by £30,000.
 - (c) Land and buildings (asset) increased by £250,000. Bank balance (asset) reduced by £25,000 and long-term loan (liability) increased by £225,000.
 - (d) Bank balance (asset) increased by £4,200. Trade debtors (asset) reduced by £4,200.
 - (e) Bank balance (asset) reduced by £6,400. Trade creditors (liability) reduced by £6,400.
 - (f) Bank balance (asset) reduced by £2,700. Wages (expense) increased by £2,700.
 - (g) Motor repairs (expense) and trade creditors (liability) both increased by £420.

Q3 Total assets are $£200,000 + £50,000 + £18,190 + £320 + £29,990 = £298,500$.

Total liabilities are $£27,420 + £7,440 + £120,000 = £154,860$.

Therefore capital is $£143,640$ ($£298,500 - £154,860$).

Chapter 5

Q1 (a) *FIFO method*

		£
Sold 10 November	7,000 litres @ 40p	2,800
	3,000 litres @ 42p	1,260
Sold 17 November	2,000 litres @ 42p	840
	3,000 litres @ 44p	1,320
Sold 21 November	3,000 litres @ 44p	1,320
	9,500 litres @ 45p	<u>4,275</u>
Cost of goods sold		<u>11,815</u>
Closing stock	2,000 litres @ 45p	900
	3,500 litres @ 47p	<u>1,645</u>
		<u>2,545</u>

(b) *LIFO method*

		£
Sold 10 November	5,000 litres @ 42p	2,100
	5,000 litres @ 40p	2,000
Sold 17 November	5,000 litres @ 44p	2,200
Sold 21 November	11,500 litres @ 45p	5,175
	1,000 litres @ 44p	<u>440</u>
Cost of goods sold		<u>11,915</u>
Closing stock	3,500 litres @ 47p	1,645
	2,000 litres @ 40p	<u>800</u>
		<u>2,445</u>

Q2 (a)	<i>Cost</i>	<i>Depreciation for year</i>	<i>Accumulated depreciation</i>	<i>Net book value</i>
Year 1	16,000	3,750	3,750	12,250
Year 2	16,000	3,750	7,500	8,500
Year 3	16,000	3,750	11,250	4,750
Year 4	16,000	3,750	15,000	1,000

(b)	<i>Cost</i>	<i>Depreciation for year</i>	<i>Accumulated depreciation</i>	<i>Net book value</i>
Year 1	16,000	8,000	8,000	8,000
Year 2	16,000	4,000	12,000	4,000
Year 3	16,000	2,000	14,000	2,000
Year 4	16,000	1,000	15,000	1,000

Q3	<i>Cost</i>	<i>Net realisable value (NRV)</i>	<i>Lower of cost and NRV</i>
	£		£
Lorry 1	12,000	$96\% \times 14,000 = 13,440$	12,000
Lorry 2	15,600	$96\% \times 16,500 - 400 = 15,440$	15,440
Lorry 3	23,200	$96\% \times 26,000 - 1,000 = 23,960$	23,200
Lorry 4	18,400	$96\% \times 20,000 - 900 = 18,300$	18,300
			<u>68,940</u>

Chapter 6

Q1 The main purpose of financial statements is to provide information to a wide range of users which will help them to make better economic decisions. The financial statements generally contain information about financial performance during an accounting period (e.g. the amount of profit made in the period) and financial position at the end of that period. The main users of a company's published financial statements are as follows:

- (a) **Investors.** The shareholders of a limited company use financial information to help them assess whether or not the company is being well-managed (are the directors doing a good job?) and to decide whether to maintain, increase or decrease their level of investment in the company.
- (b) **Managers.** The managers of a company need frequent, detailed financial information to help them to make management decisions and to monitor and control the company's operations. Since the financial statements are generally published only once per year and contain only a summary of the company's financial affairs, managers cannot rely upon the financial statements alone to fulfil their information needs. For this reason, managers rely mainly upon internal management accounting information produced especially for their purposes.
- (c) **Lenders and banks.** Lenders are at risk of losing their money and will use the company's financial statements to help them to assess the company's ability to service and repay loans. Similarly, potential lenders might use the financial statements to help them decide whether or not to lend money to the company.
- (d) **Suppliers and trade creditors.** These user groups might review a company's financial statements before agreeing to supply goods and services on credit.
- (e) **Government and its agencies.** The Government (in the form of the Inland Revenue) uses the information provided in financial statements as a basis for computing the company's tax liability. This information is also used for business monitoring and the production of national economic statistics.
- (f) **Customers.** Customers who need a secure source of supply may examine a company's financial statements before placing a long-term contract with the company. Customers

may also be concerned about a company's future survival and its ability to comply with the terms of warranties, guarantees etc.

- (g) **Employees.** Employees (or unions acting on their behalf) may consult financial statements to determine whether or not employees are fairly paid and to obtain information to justify future pay claims. Employees are also concerned about job security and may use the financial statements to help them to determine whether or not their employer is likely to continue in business for the foreseeable future.
- (h) **The public.** A large company may have a significant impact on the local or national economy and on the physical environment. A study of the information provided in a company's financial statements may (for example) help the public to determine whether or not the company is abusing monopoly powers or following unacceptable environmental policies.

One set of financial statements is unlikely to satisfy the needs of all user groups for a number of reasons. These include:

- (a) The information needs of managers are very different from those of all other users, to the extent that an entire branch of accounting (management accounting) has been developed to meet managers' needs.
- (b) Some users need historical information (e.g. the Inland Revenue) whilst others need forecasts and projections (e.g. potential lenders).
- (c) The ability of users to cope with complex financial information differs widely. Some users (e.g. bankers) are able to interpret this information whilst others (e.g. the general public) require information which is presented in a more simple form.

Q2 The financial statements will provide information about the financial performance of the company during the years in question and about its financial position at the end of each of those years. The financial performance information will be found mainly in the company's profit and loss account whilst the financial position information will be found in the balance sheet. These financial statements will be supplemented by a voluminous body of notes and accompanied by a Chairman's report, directors' report and audit report.

Although this information will undoubtedly be useful in making the investment decision, the financial statements will not provide all of the information which the individual would like to see. Some of the main reasons for this are:

- (a) The financial statements contain mainly historical information, whereas the individual concerned would probably be more interested in forecasts for the future.
- (b) The financial statements show only quantifiable information. Items that cannot be measured in money (e.g. the skill of the workforce) are not shown.
- (c) The financial statements may show only the historical cost of the company's assets and provide no information about their current worth.

- (d) The financial statements will almost certainly have been prepared with no attempt to adjust for the effects of inflation. The fact that a company's profits have risen by 2% in each of the last five years might seem encouraging but if this is set against a background of 3% inflation, profits have actually fallen in real terms.

Chapter 7

- Q1** Some of the main reasons for which (in general) profits may not be matched by similar increases in the business bank balance are as follows:
- (a) The sales revenue shown in a profit and loss account includes all of the sales of goods or services made during the accounting period, whether or not payment has yet been received. If debtors have increased during the accounting period, sales revenue will exceed the cash received from customers.
 - (b) The expenses shown in a profit and loss account includes all of the expenses incurred during the accounting period, whether or not payment has yet been made. If creditors have decreased during the accounting period, expenses will be less than the amounts paid to suppliers during the period.
 - (c) Stocks are shown as an expense in the profit and loss account in the accounting period in which they are sold (not bought). If stocks have increased during the period, purchases of stock will exceed the cost of goods sold.
 - (d) The purchase of fixed assets will have an immediate impact upon the business bank balance but only a gradual effect on the profit and loss account (as the asset is depreciated over the years).
 - (e) The payment of taxation or dividends has no effect on profits but reduces the business bank balance.
- Q2**
- (a) The purchase of a fixed asset results in a cash outflow but has no immediate impact on the company's operating profit. The subsequent depreciation charges reduce profit but have no cash flow implications.
 - (b) The repayment of a long-term loan results in a cash outflow but has no effect on operating profit (except that interest charges will now cease).
 - (c) Accounting for accrued expenses reduces profit but has no cash flow implications.
 - (d) Investing in fixed asset investments results in a cash outflow but has no impact on the company's operating profit.
 - (e) The sale of stock on credit increases profit but does not result in a cash inflow until the customer pays (if this eventually happens).
 - (f) A corporation tax payment results in a cash outflow but has no impact on the company's operating profit.

Chapter 8

- Q1**
- | | | |
|-----|-------------------------------|--------|
| (a) | $1,490 \div (10,950 + 1,500)$ | 11.97% |
| (b) | $2,920 \div 12,710$ | 22.97% |
| (c) | $(1,490 - 170) \div 12,710$ | 10.39% |
| (d) | $5,230 \div 3,880$ | 1.35 |
| (e) | $2,390 \div 3,880$ | 0.62 |
| (f) | $9,790 \div 2,840$ | 3.45 |
| (g) | $12,710 \div 2,390$ | 5.32 |
| (h) | $1,500 \div (10,950 + 1,500)$ | 12.05% |

- Q2**
- | | | |
|-----|-----------------------|----------------|
| (a) | $45,000 \div 500,000$ | 9p per share |
| (b) | $27,500 \div 500,000$ | 5.5p per share |
| (c) | $5.5 \div 60$ | 9.17% |
| (d) | $60 \div 9$ | 6.67 |

- Q3** The term "overtrading" refers to the rapid expansion of a firm's activities without making adequate provision for the required increase in working capital. Expansion will usually involve an increase in both stocks and debtors and this will put a strain on the company's cash resources. If the expansion is too rapid and not matched by extra financing, the company will run into liquidity problems and have difficulty in meeting its liabilities. In an extreme case, these liquidity problems could force the closure of a profitable business.

Chapter 9

Q1

	£000	£000
Fixed assets (530 +100 - 80)		550
Current assets		
Stock	385	
Trade debtors	<u>360</u>	
	<u>745</u>	
Current liabilities		
Trade creditors	300	
Bank overdraft (balancing figure)	<u>95</u>	
	<u>395</u>	
Net current assets		<u>350</u>
		900
Long-term loans		<u>100</u>
		<u>800</u>
Share capital (250 + 50)		300
Accumulated retained profits (410 + 90)		<u>500</u>
		<u>800</u>

Q2 Budgeted receipts for the year are £300,000. Budgeted payments are:

	£
Suppliers	90,000
Wages	60,000
Rent	20,000
Business rates	10,000
Insurance	10,000
Further expenses	40,000
Fixed assets	50,000
	280,000

Therefore the expected closing bank balance is £20,000. However, the following quarter-by-quarter cash budget shows that the business will actually have a bank overdraft for much of the year:

	<i>Q1</i>	<i>Q2</i>	<i>Q3</i>	<i>Q4</i>
	£000	£000	£000	£000
Cash from customers	<u>50</u>	<u>50</u>	<u>100</u>	<u>100</u>
Suppliers	15	15	30	30
Wages	15	15	15	15
Rent	5	5	5	5
Business rates	5		5	
Insurance	10			
Further expenses	10	10	10	10
Fixed assets	<u>50</u>			
	<u>110</u>	<u>45</u>	<u>65</u>	<u>60</u>
Balance b/f	0	(60)	(55)	(20)
Balance c/f	(60)	(55)	(20)	20

Chapter 10

Q1

<i>Year</i>	<i>Cash inflow or (outflow)</i>	<i>Discounting factor</i>	<i>DCF</i>
0	(40,000)	1	(40,000)
1	10,000	0.917	9,170
2	10,400	0.842	8,757
3	10,816	0.772	8,350
4	11,249	0.708	7,964
			<u>7,964</u>
			<u>(5,759)</u>

The net present value of the investment is negative and therefore the company should not go ahead.

- Q2** (a) After three years, the investment yields savings of £31,216. After four years, these savings amount to £42,465. Therefore the initial investment of £40,000 is paid back after 4 years.

If the savings were spread evenly over each year (rather than occurring at the end of each year) savings of £40,000 would be achieved at some point during the fourth year. After three years, savings of £31,216 are achieved and so savings of a further £8,784 are required in order to pay back the initial investment of £40,000. Therefore the payback period would be approximately 3.78 years ($3 + 8,784/11,249$).

- (b) The payback method is simple (avoiding complex calculations) and its results are influenced mainly by the expected cash flows in the early years of a project (which can usually be determined with greater accuracy than cash flows anticipated in the longer-term).

However, use of the payback method could result in the rejection of projects which would be very profitable in the long term but which happen to have lengthy payback periods. The payback method also fails to take account of the time value of money.

Chapter 11

- Q1** The term "corporate governance" refers to the need to supervise the actions of company directors and to make directors more accountable for their actions. The term is of particular relevance to large public companies, which typically are managed by one group of people (the directors) but owned by a different group (the shareholders). Corporate governance is rarely an important issue for small, private companies, where the directors and shareholders tend to be very much the same group of people.

Legally, company directors are simply employees of the companies for which they work and are accountable to the shareholders. Effectively, however, the directors control the company's activities on a day-to-day basis and might only rarely be required to account for their actions. So long as a company appears to be profitable and its shares are buoyant, shareholders are unlikely to question the directors' policies. This lack of effective accountability encourages directors to treat the company as their own personal domain and to take liberties (such as paying themselves excessive remuneration).

A proper system of corporate governance should make directors accountable for their actions not only to the shareholders but also to other "stakeholders" such as employees, customers and the general public. The basic idea is to put in place a system of monitoring which ensures that a company is run for the benefit of all stakeholders, not just for the benefit of its directors.

- Q2** The Cadbury Code consists of a set of recommendations with regard to corporate governance. These recommendations were presented in the Cadbury report in 1992. The main features of the Code are as follows:
- (a) There should be a division of responsibility between the chairperson and the chief executive.
 - (b) The board of directors should include a number of non-executive directors who are able to influence company policy.
 - (c) Non-executive directors should be independent and appointed for a fixed term (without automatic reappointment). Their fees should reflect the amount of time spent on company business.
 - (d) Directors' remuneration (including items such as share options and performance-related bonuses) should be fully disclosed.
 - (e) An audit committee should be established, containing at least three non-executive directors. An important function of this committee is to monitor the independence and effectiveness of the company's external auditors.
 - (f) A remuneration committee should be established, composed mainly of non-executive directors.
 - (g) The directors should be required to report on the company's internal control systems.
 - (h) Companies should be required to disclose whether or not they have complied with the Code and, if not, to declare their reasons for non-compliance.

