

ACCOUNTING FUNDAMENTALS

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QUESTION 1

Walk About Ltd makes and sells product A. The current selling price is £11 and the total of variable costs per unit is £6. The fixed costs of production are £350,000 and the company currently sells 75,000 units.

Required:

(a) Calculate the break-even point (in units and revenues) of product A for Walk About Ltd.

Break even point units = Fixed costs/Contribution per unit

Contribution per unit = Selling price per unit - VC per unit

Contribution per unit = 11 - 6 = 5

Break even point units = 350.000 / 5 = 70.000

Break even point revenue = Fixed costs / Contribution ratio

Contribution ratio = 5 / 11 = 0.45

Break even point revenue = 350.000 / 0.45 = 777.777,77

(b) Calculate the profit made on sales of 75,000 units.

Revenue = Selling price x Total units sold

Revenue = 11 x 75.000 = 825.000

Variable cost = Var cost x Total units = 450.000

Contribution = Revenue – Variable Cost = 375.000

Profit/Loss = Revenue – (Var cost + Fixed cost) = 825.000 - (450.000 + 350.000) = 825.000 - 800.000 = 25.000

(c) The company will make an advertising campaign costs £10,000 and will improve the product specifications, which will increase the variable cost per unit by £1. This is expected to allow the company to increase the selling price to £13 and the sales is expected to be 80,000 units. Calculate the new profit figure for the improved product.

Total Profit = Total Contribution – Total FC

Total FC = FC + Advertising = 350.000 + 10.000 = 360.000

Total contribution = Contribution per unit x expected sales next year

Contribution per unit = Selling price - VC = 13 - 7 = 6

Total contribution = 6 x 80,000 = 480,000

Total Profit = Total Contribution - Total FC = 480,000 - 360,000 = 120,000

120,000 > 25,000 The advertising campaign is worth to be undertaken

(d) Discuss the limitations of break-even analysis

Definition

In simple words, the break-even point can be defined as a point where total costs (expenses) and total sales (revenue) are equal. Break-even point can be described as a point where there is no net profit or loss. The firm just “breaks even.” Any company which wants to make abnormal profit, desires to have a break-even point. Graphically, it is the point where the total cost and the total revenue curves meet.

Calculation (formula)

Break-even point is the number of units (N) produced which make zero profit.

Revenue – Total costs = 0

Total costs = Variable costs * N + Fixed costs

Revenue = Price per unit * N

Price per unit * N – (Variable costs * N + Fixed costs) = 0

So, break-even point (N) is equal

$$N = \text{Fixed costs} / (\text{Price per unit} - \text{Variable costs})$$

About Break-even point

The origins of break-even point can be found in the economic concepts of “the point of indifference.” Calculating the break-even point of a company has proved to be a simple but quantitative tool for the managers. The break-even analysis, in its simplest form, facilitates an insight into the fact about revenue from a product or service incorporates the ability to cover the relevant production cost of that particular product or service or not. Moreover, the break-even point is also helpful to managers as the provided info can be used in making important decisions in business, for example preparing competitive bids, setting prices, and applying for loans.

Adding more to the point, break-even analysis is a simple tool defining the lowest quantity of sales which will include both variable and fixed costs. Moreover, such analysis facilitates the managers with a quantity which can be used to evaluate the future demand. If, in case, the break-even point lies above the estimated demand, reflecting a loss on the product, the manager can use this info for taking various decisions. He might choose to discontinue the product, or improve the advertising strategies, or even re-price the product to increase demand.

Another important usage of the break-even point is that it is helpful in recognizing the relevance of fixed and variable cost. The fixed cost is less with a more flexible personnel and equipment thereby resulting in a lower break-even point. The importance of break-even point, therefore, cannot be overstated for a sound business and decision making.

However, the applicability of break-even analysis is affected by numerous assumptions. A violation of these assumptions might result in erroneous conclusions.

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QUESTION 2

(a) Discuss the importance of management accounting, and how it differs from what financial accounting provides.

Management accounting is a distinct type of accounting from financial accounting or bookkeeping. It's closely related, but it's more concerned with providing financial information that helps managerial decisions.

This means that management accounting goes beyond the day-to-day tallying of finances, and focuses more on forecasting and longer term business decisions.

Another key role of management accounting is to help managers decide on the prices of products, by providing all the information regarding costs, market factors, and profitability. Similarly, management accountants can help determine the lifecycle of current products and the viability of new products too.

Essentially, management accountants provide key insights that help a company's management team make many of their decisions. They also support decision making within a company by providing a wealth of financial and statistical information, often assisted by powerful accounting software.

(b) Discuss three techniques by which the management accountant can achieve the objectives of management accounting.

Management Accounting: Technique # 1. Financial Planning:

Financial planning is the act of deciding in advance about the financial activities necessary for the concern to achieve its primary objectives. It includes determining both long term and short term financial objectives of the enterprise, formulating financial policies and developing the financial procedure to achieve the objectives.

The role of financial policies cannot be emphasized to achieve the maximum return on the capital employed. Financial policies may relate to the determination of the amount of capital required, sources of funds, govern the determination and distribution of income, act as a guide in the use of debt and equity capital and determination of the optimum level of investment in various assets.

Management Accounting: Technique # 2. Analysis of Financial Statements:

The analysis is an attempt to determine the significance and meaning of the financial statement data so that a forecast may be made of the prospects for future earnings, ability to pay interest and debt maturities and profitability of a sound dividend policy.

The techniques of such analysis are comparative financial statements, trend analysis, cash funds flow statements and ratio analysis. This analysis results in the presentation of information which will help the business executives, investors and creditors.

Management Accounting: Technique # 3. Historical Cost Accounting:

The historical cost accounting provides past data to the management relating to the cost of each job, process and department so that comparison may be made with the standard costs. Such comparison may be helpful to the management for cost control and for future planning.