

Accounting fundamentals

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Module Title: Accounting Fundamentals

Assignment Title: Accounting Fundamentals Assessment 2

Your Module: BA(Hons)Business Management

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Table of Contents

Question 1 3

Question 2 6

Question 1

- a) Calculation of break-even point (in units and in revenues) for product A for Walk about Ltd

Calculation of contribution

Product A	
	£
Selling price	11
Variable cost	<u>6</u>
Contribution	5

Fixed costs = £350,000

The break-even point can be calculated by dividing fixed expenses with contribution per unit.

Break-even point (in units) = Fixed cost / contribution

$$= 350000 / 5 = \mathbf{70,000 \text{ units}}$$

Hence, the break-even in the units will be 70,000 units.

Break even (in revenues) = Break even (in units) * selling price

$$= 70,000 * 11 = \mathbf{£770,000}$$

The break-even (in revenues) will be £770,000.

- b) Calculation of profit

	Profits on 75000 units		
	Total revenues	11*75000	825000
less	Variable costs	6*75000	<u>450000</u>
	Contribution		375000
Less	Fixed costs		<u>350000</u>

	Profit		25000
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Hence, on selling 75,000 units the profit will be £25,000.

c) Calculation of the new profit for improved product

	Profits on 80000 units		
	Total revenues	13*80000	1040000
less	Variable costs	7*80000	<u>560000</u>
	Contribution		480000
	Fixed costs		
	Previous costs	350000	
	Advertisement costs	<u>10000</u>	360000
	Profit		120000

Hence, when the sales are 80,000 units, the selling price is increased to £13, variable price to £1 and additional fixed costs of £10,000 are included as advertisement costs, the resultant profit will be £120,000.

d) Limitations of break-even analysis

- i) It provides a partial view by considering only cost information; it does not tell what the sales are likely to be in case different prices are charged.
- ii) It does not take into account the fluctuations in the inventory, as it assumes all that is produced will be sold.
- iii) In break-even analysis variable costs are kept constant per unit, however prices can be negotiated with the suppliers when production level is increased.

iv) Fixed costs are kept constant throughout the production, no matter how many additional units are produced. But it is evident that when production is increased, the capacity of fixed resources of business is needed to be increased, which results in increment of fixed costs.

v) Some costs are semi-variable in nature, for which the decision is not easy to bifurcate them into fixed and variable.

vi) Break-even analysis is viewed as a planning tool rather than a tool for decision making, as it does not take into account other costs such as increase in labor costs due to overtime of labor force, opportunity loss cost etc.

vii) Sales price is also not fixed and bears the influence of competitor's price strategies.

viii) It might be time consuming to prepare break-even analysis when a number of products are produced or the company is into manufacturing modified or specialized products as per customer demands.

Question 2

a) Importance of management accounting

The importance of management accounting can be understood from following points:

- i) It is important for the internal staff of the company or its managers to help them in decision making.
- ii) It provides essential tools to the managers such as budgeting, costing and performance analysis so that various business activities can be controlled.
- iii) It provides the base for planning activities. Various business plans are made on the basis of results from management accounting reports.
- iv) It promotes better control on business activities by the managers. It provides the managers essential information and work as a guide as to what can be done to improve business productivity.
- v) Management accounting techniques such as inventory management, ABC analysis, price optimization etc. helps a company to perform better and realize its business objectives.
- vi) Management accounting compiles the scattered data from different sources in a way so that it could be useful for the management of the company.
- vii) It facilitates the communication within the internal people of the organization. The reports cannot be prepared until different departments do not co-operate with one another.

How management accounting is different from financial accounting:

It can be understood with the help of following base points:

Base Point	Management Accounting	Financial Accounting
1. Importance	To exercise better internal control in the company on the basis of management accounting reports.	The chief objective here is to record transactions and present them into financial statements to calculate profit/loss in the business.

2. Statutory requirements	Management accounting is a company's own choice and is not required to be followed due to the influence of any governing body.	It is required by the governing authority that a company must publish its annual reports and prepare financial statements in the prescribed formats.
3. Duration	Management accounting can be used anytime as per the demands of a business. For example, a budget can be prepared when a new activity is shortly getting started.	The financial statements are prepared in a fixed duration, be it annually, semi-annually or quarterly reports.
4. Users	The users are internal people of a company, usually those who are vested with the authority to access management accounting information.	Information of financial accounting can be accessed by all the stakeholders of the company, be it its suppliers, customers, shareholders or the government.

b) Three techniques which can be used by management accountants are:

- i) **Budgeting:** A budget is prepared to estimate the expenditures to be incurred in an activity. It is a statement that presents the distribution of costs over a given period of time. It can also include the estimated profits once the activity is finished and starts to generate returns.
Budget is essential to help a business achieve its objectives. It helps in cost saving as budget preparation involves deep study on costs. The production level can be determined and costs which can be reduced or eliminated altogether can also be identified. Further when the activity is over, the budget reports can be prepared, which will facilitate the management accountant to compare actual and budgeted costs, and look into the causes of variances.
- ii) **Standard costing:** It is a technique used by management accountants to set standards for an activity. The standard or expected costs are compared to the actual costs of the

activity. This technique is an essential feature of manufacturing companies where variances such as price variance, material variance etc. are calculated based on the difference of standard and actual costs. The variance reports can be prepared and action is taken to control the variances from next time. Hence, one major goal here is to control the variances, as they should not scatter much beyond the estimated costs.

- iii) **Marginal costing:** It is a costing method which is used to see the impact on change in total prices when the company produces one additional unit of a product. It is helpful in determination of break-even as this system clearly sets apart the fixed and variable costs. The contribution calculation is an essential feature of this technique, on the basis of which other calculations such as break-even, margin of safety, PV ratio etc. are calculated.

The aim of management accounting is to help business in decision making. Hence this technique gives an idea on how much units are to be sold to cover fixed costs (break-even point), how many units are to be sold for earning the desired profits, profits at an increased level of production etc.