Accounting Theory.

In recent years the amount of theory being asked on the Leaving Certificate paper has steadily increased. This is a trend that is likely to continue. Below is an outline of the likely theory that can be asked, as well as all of the theory questions (and answers) that have come up over the 12 year history of the course.

What is Accounting?

Accounting is the process of collecting, recording and analysing financial information. Organisations can do this for their own benefit (to assess how well they are performing, to identify areas of the business that are doing badly, etc.), or to fulfil particular requirements (to comply with tax rules, to prepare accounts as required by company legislation, etc.). Accounting information is used by owners, mangers, shareholders, investors, lenders, employees and other interested parties.

What are the Characteristics of Good Accounting Information?

Relevant: Enable good decisions to be made.
Reliable: Should be accurate and creditable.
Easy to Understand: Well presented and correctly laid-out.
Comparable: Prepared so that comparisons can be made with previous years and other companies.

Why Do Farmers / Clubs / Firms / Anyone Prepare Accounts?

To calculate profit.

To assess the effectiveness of different parts of the organisation.

To use as a business plan when trying to attract investment.

To calculate the tax liability of the organisation.

What Are Accounting 'Concepts'?

These are the basic guidelines that apply to all types of accounting:

Going Concern Concept: When preparing accounts, the accountant should always assume that the firm will continue to exist indefinitely.

Accruals Concept: Revenue and expenses should be included in accounts as soon as they are earned or incurred, regardless of whether the money has been actually received or paid yet.

Consistency Concept: The method a firm uses to deal with particular accounting issues should be the same every time.

Prudence Concept: When preparing accounts revenue should not be overestimated and expenses should not be underestimated. The accountant is expected to record information somewhat 'pessimistically'. (e.g. Stock is valued at the lower of cost and selling price).

<u>There are other less important accounting concepts…</u>

Entity Concept: The understanding that the firm and the owners are two separate entities.

Money Measurement Concept: The acceptance that accounts only show money-related issues. e.g. Non-financial items aren't included in accounts.

Double-entry Concept: Every debit should have a corresponding credit. Or in other words, Assets = Liabilities.

Objectivity Concept: The accounts should not be influenced by personal bias.

<u>What Are Accounting 'Bases'?</u>
These are the methods used to implement the accounting concepts. e.g. We use depreciation (an accounting base) to apply the concept of prudence.

<u>What Are Accounting 'Policies'?</u>
These are the strategies used to apply the accounting bases. e.g. We can apply depreciation using the 'straight line' policy or the 'reducing balance' policy.

<u>Accounting Regulation.</u>

The way in which accounts are prepared and presented is regulated in several ways:

- By the government, through laws such as the Companies Act 1963-90
- By the accounting profession, through SSAP's (Statements of Standard Accounting Practice) and FRS's (Financial Reporting Standards).

- By the stock exchange, through their listing rules.
- By the European Union, through regulations and directives.

In order to ensure that the various requirements have been met, companies in Ireland are required to have their accounts ‘audited’. The role of the auditor is to confirm that the accounts presented to them represent a ‘true and fair’ view of the financial position of the company – that all of the relevant information has been included, that the accounts have been prepared in accordance with the legislation, that the figures included are accurate, etc.

Different companies face different legal requirements in terms of how much information they need to prepare. This is based on whether they are a ‘small’, ‘medium’ or ‘large’ company, which is in turn based on the value, sales and number of employees in the company.

<u>Company Size.</u>

	Small Company	Medium Company	Large Company
Balance Sheet Total	< €1.9		> €7.6
Turnover	< €3.8		> €15.2
Avg. No of Employees	< 50		> 250

A firm must meet two out of three of the criteria to be considered either small, medium or large.

<u>Reporting Requirements.</u>

	Small	Medium	Large
P&L Shareholders	Short	Short	Full
P&L CRO	None	Short	Full
B.Sheet Shareholders	Abridged	Full	Full
P&L CRO	Abridged	Abridged	Full

Theory from Various Topics.

Budgets.

Outline The Advantages of Budgeting To A Business.

- Provide advance warning of potential difficulties.
- Provide a method of comparing budgeted with actual performance.
- Are helpful when trying to attract investment.
- Can be used as a decision-making resource.
- Are useful for providing direction and motivation to staff.

Why Are Flexible Budgets Prepared and What Do They Show?
Flexible budgets are used to show how costs are likely to change at different levels of production. They show the different variable and mixed costs at different production outputs and also enable the firm to predict profit at these outputs. Actual costs can later be compared with these budgets to measure performance and plan for the future.

What Is An Adverse Variance and What Does It Show?
This is where the difference observed between an actual cost or revenue and the previously budgeted amount is worse (e.g. budgeted expenses turn out to be higher or budgeted income turns out to be lower).

Why Might An Adverse Variance Arise in Direct Materials?
If the purchase price increased.

If higher quantities were required.

Explain With Examples, 'Controllable' and 'Uncontrollable' Costs.
Controllable costs are costs over which the firm exercises power, such as wages, whereas an uncontrollable cost falls outside the direct power of the firm, such as price of raw materials.

What Factors Does The Firm Take Into Account When Calculating Their Budgeted Sales Figure For The Year?

- Last year's sales.
- The state of the economy.
- Sales of competing firms.
- Results of market research.
- Trends in the market.

Explain 'Principle Budget Factor.

This is the element that restricts the firm from expanding indefinitely. This might be the demand for the product or the production capacity of the factory or the availability of capital.

Explain What Is Meant By A Capital Budget.

A capital budget consists of the large-scale or long-term revenue and expenditure that a firm expects to incur. These items are normally once-off events such as the construction of a building or the receipt of a Government grant.

Define 'Cash Budget' and Describe Two of Its Advantages.

A cash budget is an estimate of the future income and expenditure of the firm. Cash budgets enable the firm to identify periods of time in the future when difficulties may arise and also provide a method of comparing the firm's actual performance with the previously budgeted figures.

Explain How Budgeting Solves The Problem of Mixed Costs.

A mixed cost is one that is partly fixed and partly variable. The 'High-Low' method is used in budgeting to separate these two elements of the cost and to make it possible to make predictions about changes to the mixed cost as production levels vary. The 'High-Low' method finds the difference between the costs and units and then divides one into the other to give us the variable portion of the cost. This then makes it possible to identify the fixed portion.

Explain the Term Budgetary Control.

This is the process of preparing a budget, observing whether the actual outcomes exceed or fall short of the budget, identifying the reasons for the observed differences, and then deciding what courses of action should be taken before preparing the next budget.

Costing.

What's the difference between financial and management (cost) accounting?

Financial accounting records transactions that have already happened whereas management accounting deals with estimates and predictions for the future.

Financial accounting is compulsory, since firms are required by law to provide accounts for tax and legal purposes. Management accounting is an optional strategy for firms.

Financial accounting is often aimed at external stakeholders (such as the government, investors or banks) whereas management accounting is normally completed for internal decision-makers such as managers.

<u>Give Three Reasons for Product Costing.</u>
It is used to decide the selling price of the product.

It is used to calculate the value of closing stock for the balance sheet.

It enables budgeted or predicted costs to be compared with actual costs.

<u>What Are The Limitations of Marginal Costing (Cost-Volume-Profit Analysis)?</u>
The assumption that variable cost per unit remains the same will not always hold true at every level of production, since economies of scale may set in once certain production levels are reached.

Equally, selling price will not always remain the same as the firm expands, since it may become possible to take advantage of high volume discounts on purchasing, by reducing the selling price to the consumer.

Fixed costs rarely remain completely fixed and are more accurately described as 'step-fixed' i.e. they will increase in stages as production increases (e.g. rent will go up as a bigger factory will need to be used).

Equally, marginal costing assumes that mixed costs can be neatly separated into their fixed and variable components. This is not necessarily the case at every level of production since either component may change as volume increases or decreases.

<u>What's The Difference Between Marginal and Absorption Costing?</u>
Closing stock is valued differently under each system. In marginal costing fixed costs are not included when calculating the cost of a product, whereas in absorption costing the cost of the fixed asset is 'absorbed' into the cost of the product. Absorption costing should be used as it agrees with standard accounting concepts.

<u>List and Explain Two Assumptions of Marginal Costing.</u>

It is assumed that fixed costs will always remain the same but in reality they are likely to be 'step-fixed' – i.e they will probably change at some level of production.

It is also assumed that selling price remains constant but again there are issues (such as discounts or unpredicted increases) that may change this.

<u>Name Three Overhead Absorption Rates and State Why They Are Based on Budgeted Rather Than Actual Figures.</u>

The overhead absorption rates are:

- Per labour hour
- Per machine hour
- Per unit

They are based on budgeted figures because actual figures may not be know until the end of the year and the firm will not be able to wait until then to decide the cost of the product.

<u>Explain the Difference Between Allocation and Apportionment of Costs.</u>

Allocation occurs where *direct* costs are linked specifically to the item being produced.

Apportionment occurs where *indirect* costs are divided out using a suitable basis.

<u>Illustrate and Explain What is Meant By A Step-Cost.</u>

This is a cost that might initially be regarded as fixed, but which at some point may actually change. The rent of a factory for example might be seen as a fixed cost but if the company continues to expand, they might need to rent a second factory and the cost that was previously fixed at a particular level will therefore be increased by the additional rental charge.

<u>**Cash-Flow Statements.**</u>

<u>Why Are Cash-Flow Statements Prepared?</u>

To measure the cash inflow and outflow for the year.

To show the difference between cash-flow and profit.

To aid in financial planning and to attract possible investment.

What Is A Non-Cash Item?
A non-cash item is an expense or gain that effects profit but doesn't involve cash inflow or outflow. Depreciation for example is recorded as an expense in our accounts but doesn't actually involve any money being spent. Another example of a non-cash expense would be a bad debt provision and an example of a non-cash gain would be a gain on the sale of a fixed asset.

Explain Why Profit Does Not Always Mean a Corresponding Increase In Cash, and List Two Non-Cash Items.
Profit does not always mean a corresponding increase in cash because there are many items that influence the profit of a firm (as recorded in the accounts) but that do not involve an inflow or outflow of cash. Depreciation and changes in bad debt provisions are two examples of items that change our profit but not our cash-flow.

Write a Note on the Accounting Standards Board. In Your Answer Refer to the Main Activity of the Board and How It Has Influenced the Preparation of Cash Flow Statements.
The Accounting Standards Board was set up by the six accounting bodies in Ireland and the UK as a system of self-direction and governance. Their primary function is to set and regulate the SSAP's – Statements of Standard Accounting Practice, which inform accountants of how specific accounts or items within accounts should be dealt with. In respect of Cash-Flow Statements, the Board have clarified exactly how they should be both prepared and presented.

Explain the Term Solvency.
A firm is solvent if total assets exceed all outside liabilities. The greater the excess of assets over outside liabilities, the more solvent the firm is deemed to be.

Correction of Errors (Suspense Accounts).

State Five Errors Not Revealed By The Trial Balance.
Error of Omission: When the accountant completely omits a transaction from the books.

Error of Commission: When a transaction is recorded in the wrong account (e.g. the accounts of two people are mixed up).

Error of Principle: When the incorrect type of account is used (e.g. a fixed asset is bought and recorded as 'purchases').

Reversal of Entries: When a transaction is recorded in the correct accounts but on the incorrect sides.

Error of Original Entry: When a transaction was treated as something it wasn't (e.g. a purchase was recorded as a sale).

Club Accounts.

How Might The Club Finance An Extension?
Increase subscription fee or charge a levy.

Attract new members.

Attract sponsorship.

Apply for a lottery grant.

Sell investments.

What Is The Difference Between a Levy and a Subscription Fee?
Levies are extra funds provided by members for the specific purpose of purchasing or financing new fixed assets. The levy is recorded in the financed by section of the balance sheet.

Subscriptions are the regular fees paid by members, normally charged annually, to cover the day-to-day running costs of the club. Subscriptions are recorded in the income section of the profit and loss account.

Indicate the Points You, as Treasurer, Would Make If the Members Proposed to Reduce the Subscriptions.
Subscription, entrance fees and sponsorship income are not guaranteed and therefore reducing subscriptions ourselves may not be a good idea (since all of these things may fall unexpectedly and we'd then be left in a very difficult situation).

If the reduction does not attract new members, income will fall immediately.

If members are willing to pay the current subscription rate, maintaining this level would enable us to save excess income for future development.

Explain With The Use of an Example What Is Meant By A Special Purpose Profit and Loss Account.

This is an account for transactions outside the normal day-to-day running of the club. For example, if the club decided to award life memberships to certain people, a separate account would be used to record this and the balance would then be transferred to the regular profit and loss account.

What Advice Would You Give The Treasurer?

(This obviously depends a bit on the accounts you've just prepared, but in general you can say…)

- If the club has large investments or savings, maybe use them to improve club facilities.
- If there is a steady excess of income over expenditure the club might consider offering new services to members (free floodlights use or subsidised food in the bar).
- If they are struggling financially and wish to develop, they might consider the introduction of a levy.
- They could try to attract sponsorship.
- Etc.

Published Accounts.

What is an Audit?

This is an independent examination of a firm's accounts, aiming to clarify whether the accounts represent a 'true and fair' picture of the financial state of the organisation.

List Four Items On Which Auditors Must Express An Opinion In Their Reports.

- Whether or not the accounts represent a true and fair view of the firm's financial records.
- Whether the Director's report is consistent with the accounts.
- Whether the company have kept adequate records during the year.
- Whether the Profit and Loss Account and Balance Sheet have been prepared correctly and accurately.

State Three Items Which Should Be Included in a Director's Report.

A description of the precious year's performance.

A statement of future plans, such as purchases or mergers.

Recommended dividends for pay-out this year.

What is a 'Qualified' Auditor's Report?

This is when an auditor is not satisfied that the accounts have fully complied with all of the necessary requirements and that they must 'qualify' their report with this concern (as opposed to an 'unqualified' report, where they sign off that the accounts in their view represent a true and fair view of the financial position of the firm). The auditor may qualify his/her report for one of several reasons. e.g.

- The accounts haven't been prepared in accordance with the Companies Acts;
- All of the relevant information is not included;
- The information provided by the Directors is not sufficient;
- Etc.

Explain The Term 'Exceptional Item' and Give an Example.

These are items that, due to their significant size, must be disclosed separately on the profit and loss account and often require explanation in the Director's Report. An example might be a potential liability in a serious legal case.

State How A Company Would Deal With A Contingent Liability Which Is Possible but Unlikely.

Firstly, expert advice would be sought in order to clarify exactly how likely it is that the liability will fall due. If it were deemed 'likely', the item would be included as a liability in the balance Sheet. If, as in this case, it is deemed to be 'unlikely', it would not appear in the accounts but might merely be noted in the Director's Report.

What Regulations Must Accountants Observe When Preparing Financial Statements for Publication?

Accountants must…

- Provide consistent financial information from year to year.
- Provide information that can be compared with other companies.
- Comply with Irish and European law.
- Ensure that the accounts are audited before publication.
- Include relevant notes and explanations of exceptional items.

Notes To Show When Preparing Published Accounts…

1. Tangible Fixed Assets.

Firstly say that "Depreciation is used to write off the value of the tangible fixed assets over their estimated useful life. Fixed assets are included in the accounts at their revalued amount". Then fully identify the cost, depreciation to date, depreciation this year, disposal of or revaluation of, all of the fixed assets.

2. Stock.

Stocks are valued on a first in first out basis at the lower of cost and net realisable value.

3. Dividends.

Show full breakdown for interim and final dividends for both ordinary and preference shares.

4. Operating Profit.

List each of the expenses that has been taken away in order to arrive at operating profit.

5. Profit on Sale of Property.

Explain in words how we arrived at the profit on sale that appears in the accounts.

6. Interest Payable.

Explain in words how we arrived at the figure for interest in the accounts.

7. Contingent Liabilities.

Explain why a contingent liability has been put in or left out of the accounts. (If the info in the question says we have received advice that it is 'likely' to accrue then put it in as a liability. If the advice we have received says it is 'unlikely' that we'll have to pay it, then it doesn't go in the accounts).

Ratio Analysis.

<u>How Might A Company Overcome Liquidity Problems?</u>

Issue extra shares in order to take in extra cash.

Sell investments (again to take in more cash).

Reduce the level of dividends paid to shareholders.

Sell and leaseback fixed assets.

<u>How Might A Company Overcome Gearing Problems?</u>

Issue more shares and use the income to pay off long-term debt.

<u>Why Might Gross Profit % Fall?</u>

If purchase costs increase but sales price is kept the same.

If closing stock is undervalued.

If stock is purchased but can't be sold.

If stock is stolen or perishes.

If selling price is reduced but sales do not increase.

(The same reasons can be used for a fall in net profit %, but also mention an increase in expenses).

<u>What Would Encourage Shareholders to Buy Shares?</u>

Good liquidity – comfortable payment of short-term debt.

Profitability – Funds available to pay dividends.

An industry with good long-term prospects.

If the firm has ample fixed asset security to cover long-term debts.

<u>What Would Encourage A Bank to Give a Loan?</u>

If the purpose of the loan is for productive reasons.

If fixed asset security is available.

If the firm has a positive history of servicing debt.

If interest cover is currently comfortable.

<u>A Rising Liquidity Ratio Is a Sign of Prudent Management. Briefly Discuss.</u>

A rising liquidity ratio suggests that…
- 'Overtrading' is not a problem and that the correct volume of stock is being ordered.
- Excessive short-term debts are not being incurred.
- Credit control is operating effectively in the firm.

<u>State Three Limitations of Ratio Analysis.</u>

- Ratios only provide a 'snapshot' of the firm at one moment in time. This provides little evidence of past or future performance.
- Ratios only take account of financial information. Important issues such as goodwill or the quality of industrial relations do not appear in these ratios.
- The preparation and calculation of ratios varies from firm to firm and therefore comparisons are not always possible.

What Might An Unfavourable Comparison of Stock Turnover Ratios Indicate?

- Poor stock control.
- Theft of stock.
- Obsolescence of stock.
- Fall in sales demand.

Incomplete Records.

What Information Would Be Available In The Accounts If They Were Prepared Using The 'Double Entry' System?

If the accounts had been prepared correctly we would have know:

- The total sales figure
- The total purchases figure
- The bank balance
- Capital
- Goodwill

What Advice Would You Give The Firm In Keeping Their Accounts?

They should keep a detailed cashbook, supported by an appropriate double-entry system. This would enable them to prepare an accurate trading and profit and loss account and balance sheet. If finances are available it might also be wise to enlist the services of an accountant.