

## Tutorial 1 Paper 2 Solution

### Question 1

#### (a). Income Statement for the year ended 30 June 2015

Revenue			526000
<b>Less cost of sales</b>			
Opening inventory		37500	
Add Ordinary goods purchased		342000	
		379500	
Less closing inventory		(29400)	(350100)
Gross Profit			175900
<b>Less Expenses</b>			
Selling and distribution expenses		37510	
Administrative expenses		36130	
Depreciation on warehouse buildings (4 % X 300 000)		12000	
Depreciation on motor vehicles (25 % X 70 000)		17500	
Depreciation on office equipment [10 % X (25 000 - 1 500)]		2350	
Bad debt		200	
Increase in provision for doubtful debt {[5 % X (5 020 - 200)] - 125}		116	(105806)
Profit from operation			70094
<b>Less finance cost</b>			
Debenture Interest (5 % X 25 000)			(1250)
Profit for the year			68844

**(b).Statement of financial position as at 30 June 2015**

	COST	DEP	NBV
<b>Non-Current Assets</b>			
Warehouse buildings	300000	24000	276000
Motor Vehicles	70000	30000	40000
Office equipment	25000	3850	21150
	395000	57850	337150
<b>Current Assets</b>			
Closing inventory		29400	
Trade receivables (5 020 - 200)	4820		
Less provision for doubtful debts (5 % X 4 820)	(241)	4579	
Cash and cash equivalents		27200	61179
<b>TOTAL ASSETS</b>			398329
<b>Equity and Liabilities</b>			
<b>Equity</b>			
140 000 Ordinary shares of \$1		140000	
General reserve (25 000 + 25 000)		50000	
Retained earnings (W1)		176434	
Total equity			366434
<b>Non-Current Liabilities</b>			
5 % Debentures (2021 - 2025)			25000
<b>Current Liabilities</b>			
Trade payables		6270	
Other payables:			
Debenture interest due (1250 - 625)		625	6895
<b>TOTAL EQUITY AND LIABILITIES</b>			398329

**Working 1 (W1): Retained profit****Statement of changes in equity for the year ended 30 June 2015**

Retained earnings	
Balance at start	140990
Add Profit for the year	68844
	209834
Less transfer to general reserve	(25000)
Less interim ordinary dividend paid	(8400)
Balance at end	176434

- (c). The current ratio shows the amount of current assets available to cover for the current liabilities. It does not give the liquidity position of a business as it includes closing inventory. It provides a judgement on liquidity by comparing current assets with current liabilities.

(d).

(i). Working capital

Repayment of debentures will have the following effect:

- Bank will reduce by \$25 000 from \$27 200 to \$2 200 ( $27\,200 - 25\,000$ )
- Current Assets will fall by \$25 000 from \$61 179 to \$36 179 ( $61\,179 - 25\,000$ )
- Working capital will fall by \$25 000
- Current ratio will now be 5.77: 1 [ $36\,179 / (6\,895 - 625)$ ]

(ii). Return on capital employed

- Capital employed will fall by \$25 000
- Return on capital employed will increase from 17.91 %  $\{[70094 / (366434 + 25000)] \times 100\}$  to 19.13 %  $[(70094 / 366434) \times 100]$  if profit is maintained.

(e). Repayment of the debentures will reduce the amount of bank. This will seriously weaken the cash position. Interest on the debenture is very low at \$1 250. The debentures have to be repaid in a minimum of 5 years' time. If the debentures are repaid, the business will have to obtain a new loan. The new loan might be at a higher interest rate which will reduce profit in the future. Repayment of debentures will reduce interest on debentures and hence will increase profit.

The directors should not repay the loan as it can easily cover the interest on debentures which is very low.

## Question 2

(a). Revaluation Account

Revaluation Account			
Inventory	4 000	Non-Current Assets ( $270\,000 - 230\,000$ )	40 000
Capital Account: Revaluation gain			
- James ( $1/2 \times 36\,000$ )	18 000		
- Lewis ( $1/2 \times 36\,000$ )	18 000		
	40 000		40 000

(b). Capital Account

Capital Account							
	James	Lewis	Ahmed		James	Lewis	Ahmed
Goodwill written off	$(\frac{1}{3} \times 60\,000)$	$(\frac{1}{3} \times 60\,000)$	$(\frac{1}{3} \times 60\,000)$	Balance b/d	200 000	70 000	
	20 000	20 000	20 000	Bank			80 000
Balance c/d					$(\frac{1}{2} \times 60\,000)$	$(\frac{1}{2} \times 60\,000)$	
				Goodwill	30 000	30 000	
				Revaluation gain	18 000	18 000	
	248 000	118 000	80 000		248 000	118 000	80 000
				Balance b/d	228 000	98 000	60 000

(c). Advantages

(a). Interest on capital

- To the partners: They will get a reward for investing in the partnership.
- To the partnership: Partners will put more capital to get higher interest. The partnership will have more capital to invest and hence grow.

(b). Interest on drawings

- To the partners: The partners will reduce their drawings.
- To the partnership: Less drawings by partners will result in less cash going out of the partnership and hence the business will have a better cash position.

(d).

- (i). James will benefit as he has a higher capital, hence will get higher interest on capital. He makes less drawings, hence will pay less interest on drawings.
- (ii). Lewis will not benefit as he has a lower capital, hence will get lower interest on capital. He makes more drawings, hence will pay more interest on drawings.

**Question 3**

**(a). Double Entry**

Name of the account	Dr	Cr
	\$000	\$000
Bank (200 000 X 0.7)	140	
Ordinary share capital (200 000 X 0.5)		100
Share Premium [200 000 X (0.7 – 0.5)]		40
Retained earnings (W1)	112	
Bank		112
Share Premium (W2)	200	
Ordinary share capital		200

**Working 1: dividend paid**

Number of shares at 31 December 2014 =  $(1\,400\,000 / 0.5) = 2\,800\,000$

Dividend paid =  $2\,800\,000 \times 0.04 = \$112\,000$

**Working 2: Bonus Issue**

Existing shares =  $2\,800\,000 + 200\,000 = 3\,000\,000$

Bonus Shares =  $(3\,000\,000 / 15) \times 2 = 400\,000$

Par value bonus shares =  $400\,000 \times 0.5 = \$200\,000$

**(b). Schedule showing movement in share premium**

	\$000
Share Premium at 1 January 2015	260
Add new issue on 1 February 2015	40
Less bonus issue on 1 June 2015	(200)
Add right issue on 1 August 2015 (W3)	34
Share premium at 31 December 2015	134

**Working 3: Right Issue**

Existing shares =  $3\,000\,000 + 400\,000 = 3\,400\,000$

Right shares =  $(3\,400\,000 / 10) \times 1 = 340\,000$

Premium on right issue =  $(0.6 - 0.5) \times 340\,000 = \$34\,000$

**(c). Reasons to make a bonus issue:**

- To capitalize reserves
- Less expensive than a right issue or an ordinary issue of shares
- It enables the company to match long-term assets with long term capital
- In a period of low profit, a bonus issue can be made instead of paying dividend to shareholders

**(d). Differences between ordinary shares and preference shares**

- Preference shareholders receive a fixed rate of dividend whereas the dividend for ordinary shareholders depend on profit
- Preference shareholders do not have voting rights whereas ordinary shareholders have voting rights
- Preference shareholders receive dividend before ordinary shareholders
- In case of bankruptcy, preference shareholders are repaid before ordinary shareholders

**Question 4**

**(a). Point A and point B**

- (i). Point A – Break-even point units
- (ii). Point B – Fixed cost

(b). The P/V ratio is a measure of much contribution is earned from each \$1 of sales

**(c). Benefits and drawbacks of CVP analysis**

Benefits:

- It is useful for planning
- It provides quick estimates
- Changes in costs can be easily incorporated
- Forecasts profit at various levels of output
- Identifies breakeven point
- Charts provide a clear way of presenting information which is better for non-accountants

Drawbacks

- Can be time consuming to prepare charts
- Assumes fixed costs are constant which is not true as fixed costs changes after a given level of activity
- Assumes variable costs per unit are the same at all levels of output. Variable costs do change.
- Assumes selling price per unit is the same at all levels of output. Selling price does change.
- Assumes production and sales are same. Business often keeps inventory
- Ignores uncertainty in estimates of fixed costs and variable costs

**(d). Contribution per unit and total profit or loss for each product**

(i). Contribution per unit

	X	Y	Z
Selling Price	8	10	7
Variable cost	(5)	(4)	(2)
Contribution per unit	3	6	5

(ii). Profit or loss for each product

	X	Y	Z
Contribution per unit	3	6	5
X number of units	15 000	5 000	8 000
Total contribution	45 000	30 000	40 000
Less fixed costs	(60 000)	(25 000)	(30 000)
Profit / (Loss)	(15 000)	5 000	10 000

(e). The business should continue producing all three products as they have a positive contribution which will help in covering the fixed costs. Y has the higher contribution, hence its sales should be maximized. X has the lowest contribution, so the company should consider on increasing its selling price to increase contribution.

(f). Contribution gained or lost

Option 1

Total revenue		10 000
Less variable costs		
- X (1 000 X 5)	5 000	
- Y (1 000 X 4)	4 000	
- Z (1 000 X 2)	2 000	(11 000)
Lost in contribution		(1 000)

Option 2

	X	Y	Z
Selling price	6	5	4
Less variable cost	(5)	(4)	(2)
Contribution	1	1	2
X Number of units	1 000	1 000	1 000
	1 000	1 000	2 000

Gained in contribution = 1 000 + 1 000 + 2 000 = \$4 000

(g). Order 1 should be rejected as the selling price does not cover the variable costs. The business will be making a negative contribution.

Order 2 should be accepted as the business is making a positive contribution. The lower selling price are covering the variable costs. Fixed costs does not change, hence has no effect on decision making. As long as the proposed selling price is higher than the variable cost, the order can be accepted

(h). Reasons to plan for the future:

- To provide a map for the future.
- To provide details on how to achieve growth
- To be able to manage the cash flows