

Chapter 1 Lecturer Additional' Questions & Answers

QUESTIONS

Question 1 Dunster Hussain Limited

1. Dunster Hussain Limited was established five years ago by Steve Dunster and Mohammed Hussain who each own 50% of the company. The company is a clothing retailer which currently owns half a dozen shops in and around a large city in the North of England. The business has done well and has profited from favourable economic conditions and an increase in the disposable income of the 18-25 age group. The two directors are both keen to expand the operations of the company into other cities, but they realise that they will need a great deal of assistance and advice on issues such as supply logistics, personnel recruitment and management of a substantially increased business. They will also need a substantial investment of cash, estimated at around £0.5 million for the scale of expansion they wish to undertake. The company currently has minimal borrowings. It owns three of the six shops from which it conducts its operations.

You are employed as a business adviser and the directors have approached you for advice. You are required to suggest two possible alternative approaches to financing the expansion. You should present brief notes in respect of both alternatives, setting out the advantages and disadvantages of the schemes you propose.

Question 2 Janice Horsfall

You are a small business adviser working for a business agency which has been set up by the government in association with the local authority, in order to encourage business enterprise. Janice Horsfall has arranged to see you to talk through her idea for establishing an office cleaning business. At the first meeting you discuss many issues with Ms Horsfall, amongst them the question of the most appropriate form of business organisation. It turns out that she has strong views on the subject:

‘My brother-in-law’s accountant set up a company for him and it’s been a disaster from start to finish. Jim says he’s constantly being hassled to provide information for the taxman and the VAT people. Every year he has to pay the accountant to produce a lot of useless information to send to

the Registrar of Companies. The accountant told him it was better to have the business as a company rather than being a sole trader but Jim thinks he's been given bad advice'.

Advise Janice on the pros and cons of setting up in business as a limited company.

Question 3 Attributes of financial information

Financial information should be relevant, reliable, comparable and understandable. Explain what each of these attributes means in the context of financial information. Give two examples of problems which may prevent financial information from fulfilling all of these characteristics.

Question 4 Aretha

Aretha is an employee of Catchpole Cormorant Enterprises plc, a large listed company that employs many thousands of people. She also holds a few shares in the company which she acquired a few months ago when the company issued shares to employees with over five years in service. She has received a set of financial statements from the company, somewhat to her surprise. As she doesn't know much about financial matters she has turned to you for answers to the following questions:

'I've worked for this company for years, but they've never sent me a copy of the accounts before. Why now?'

'Can I use the accounts to predict how well the company's going to do next year?'

'I know that there are dozens of people working in the management accounting department of this company because it occupies the office building next door to the human resources section where I work. Do you mean to tell me that all those people are employed just to produce this booklet? If not, what do they do all day?'

Chapter 1 *Lecturers' questions*

Answer 1: Dunster Hussain Limited**a) Borrowing**

It may be possible to finance the expansion, in whole or in part, through borrowing. Because the business is successful and has an established trading record going back over 5 years, a bank may be willing to lend quite a substantial sum. A bank will probably require security but this may be relatively easy to arrange. The company owns three shops and it may be possible to secure a loan against these, and/or against other items of value which are owned by the business. The directors themselves may be willing to give personal guarantees if there is any shortfall in security.

The cost of borrowing is, of course, the regular interest payment which will be required by the lender. Steve and Mohammed must build into their financial plans both the need to pay regular interest and also the ultimate need to repay the borrowings.

The advantage of borrowing is that the financial obligations can be easily estimated. If the business expansion is successful the directors will be able to pay off the loans relatively quickly and they will be in a position to reap the rewards of success themselves. They will continue to control and run the company. Although the bank will be interested in the performance of the new business, the bank manager will not wish to take an active part in running the company.

However, there are some disadvantages. The directors actually need advice and help to manage the business expansion. Although the bank manager may be able to give some useful advice about financing the involvement of the bank will remain fairly limited. In order to obtain the advice and help they need in respect of, for example, personnel management and recruitment in the expanded business, the directors are likely to have to purchase outside help from business consultants. This is likely to be an expensive course of action.

Answer 2 Janice Horsfall

First, it is fair to say that setting up as a limited company does involve some additional paperwork, and it is certainly true that financial information must be produced for the Registrar of Companies. There is no equivalent requirement for sole traders. However, Janice's brother-in-law does not seem to realise that he would be required to provide information for tax and VAT purposes whether his business is a limited company or a sole trader. He really can have no grounds for complaint on that score.

Jim has not explained to Janice any of the advantages of setting up as a company, and Janice needs to be aware of these before she makes a decision. The advantages include:

Limitation of personal liability. Shareholders in a company stand to lose no more than their original investment. Sole traders, by contrast, are expected to make up any shortfall in the business resources from their own personal funds.

The potential for spreading the ownership of the business amongst several people; this may be helpful if Janice wishes other members of her family to have an ownership interest in the business, for example

Janice should also realise that businesses and individual circumstances differ. Advice that is appropriate for her in respect of business formation may not be appropriate for another person, and vice-versa.

Answer 3 Attributes of financial information

Relevant: this means that the financial information should be relevant to decision-making.

Shareholders, for example, need financial information in order to help them decide on whether or not to sell their shares.

Reliable: financial information should be properly prepared and should be free from error or bias. Larger companies require an annual audit, and this may help to reassure shareholders and other users that the financial information is reliable.

Comparable: it should be possible to make valid comparisons between the financial statements of more than one period in the same business. This means that they must be prepared using the same bases.

Understandability: the information contained in financial statements should be capable of being understood.

Two problems:

- a) it takes time to prepare financial information in the form of annual accounts. By the time it is available for interested parties to use, it may already be out of date. Therefore, there is a problem in ensuring that the information is *relevant*.
- b) the financial information of large companies, in particular, is often very complex. Even experienced users of accounting information can find that it is difficult to understand everything in a set of large company financial statements. *Understandability* is not, therefore, always achieved.

Answer 4 Aretha

Companies may choose to issue their employees with copies of the annual financial statements but there is no obligation to do so. However, they must, by law, provide their shareholders with a copy of the annual statements; this is why Aretha has, for the first time, received the financial statements from the company.

Annual financial statements may be useful to predict, in broad terms, how the company is likely to perform in the coming year. If, for example, the company under its current directors, has achieved strong profit growth for the last five years, it may be quite reasonable to predict that the next year will also produce strong growth. However, it should be realised that the annual accounts contain historical information – i.e. it all relates to the past, and the past may not be a satisfactory guide to the future. It is important not to rely too heavily on historical accounting information.

Management accounting and financial accounting are distinct areas of activity. Financial accounting produces the figures which are used to report periodically to shareholders via the annual financial statements. Management accounting information, on the other hand, is the accounting that the organisation carries out for its own use, to assist management in controlling the business and in making decisions. It can be very detailed and complex, especially in large manufacturing organisations, and it is quite feasible that dozens of people may be involved in its

production. Because of its bias towards the production of information for use internally, the management accounting department is unlikely to have anything to do with the production of the annual financial statements.