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Business Finance Unit 2 - Practice Questions

- MCQs

1
Ans (B) the shareholders

2
Ans (A) to express an opinion on the financial statements

3
Ans (A) the board of directors.

4
Ans (A) The auditor wishes to draw attention to an important matter that has disclosed in the notes to the financial statements

5
Ans (D) The company should apply logic in any accounting standard that deals with broadly comparable circumstances, even though that standard is not directly applicable

6
Ans (B) disclaimer of opinion

7.

Ans. (C) the shareholders.

8.

Ans. (B) Financial statements prepared by an entity should be comparable from year to year.

9

Ans. (C) The auditor is unable to express an opinion on the truth and fairness of the financial statements.

10

Ans. (B) to show historical inflows and outflows of cash.

11

Ans. (C) no effect on the statement of profit or loss and a cash outflow in the cashflow statement

12

Ans. (B) £32,500

13

Ans. (C) a summary of changes in capital and reserves attributable to the equity holders.

14

Ans. (D) Comprehensive income includes unrealised gains that are excluded from profit.

15.

Ans (a) An independent auditor is an independent third party that gives out an opinion on the truth and fairness of the financial statements

(b) One such type of opinion is a qualified ~~opin~~ opinion

(c) In the case of a qualified opinion, the auditor states that the financial statements give a true and fair view but raises concern on a particular figure or an accounting treatment indicating that this ~~ff~~ is not right.

(d) Examples would be as to how the company does accounting for inventory revaluation or any financial figure

(e) The readers of such audit opinion would lose their confidence in the aspects that are being raised as concerns by the auditors

(f) They may not make decisions or will rely not completely on such financial figures reported by the company

(g) The rediars might actually infer conclusions regarding what are the consiquences of such uncertain aspects in the financial statements

16

Ans. (a) The main purpose of financial statements is generally to convey the firm's financial position to the shareholders and to help the stakeholders in making more informed decisions

(b) The accounting standards such as IFRSs ensures consistency among the financial statements of different businesses. Thus, enabling the stakeholders to easily compare the financials of businesses in the same industry.

(c) Accounting standards have somewhere reduced agency problems.

(d) Since, financial statements are a way, the shareholders can know the position of the business and also track the performance of the directors, the management might be more keen to manipulate the numbers.

(e) But since there are accounting standards in place; the auditors can actually analyze according to the standards used and give an opinion.

(f) The discussion process that leads to a standard being issued focuses on the areas of improvement. Thus, this leads to the development of accountancy profession.

17

Ans (a) The money measurement concept of accounting restricts the financial statements to assets or entities that can be measured objectively in monetary terms.

(b) This rules out the inclusion of valuables like the company's workforce, the customer loyalty and brand ~~nam~~ name, etc.

(c) These alone can be worth more than all the

assets in the financial statements put together.
(d) There might also be cases where the future aspects of the business are bright. For instance, the healthcare industry during the times of covid.
(e) Thus, there might be many others who would want to invest in the business.
(f) In such cases, in order to get controlling interest, much higher amount would have to be paid than the assets on the company's financial statements.

18.

Ans (a) An auditor's report is a statutory requirement in most of the company's financial statements.
(b) An external auditor is an independent third party who checks and verifies the truth and fairness of the financial statements.
(c) The main responsibility of the external auditor is to give an opinion on the financial statements.
(d) For a limited company, the external auditor verifies and examines the transactions and business records that lead up to the numbers in the financial statements handed over to them by the management.
(e) Basis on this, they will question the directors if needed, check on the accounting methodology used and give an unqualified opinion, emphasis of matter, qualified, disclaimer of opinion or adverse opinion.
(f) Their opinion gives a validity to the financial statements.

(g) They help reduce the agency problem between the management and the shareholders.

19

Ans (a) For a company not preparing financial statements in accordance with relevant accounting standards, the external auditor in extreme cases would give out an adverse opinion or disclaimer of opinion.

(b) This would be interpreted by the equity shareholders as a red flag

(c) There might be the reason that the business is not performing well because of which there was failure to compliance and manipulation by the management

(d) Firstly, the company will face regulatory actions which might include penalties.

(e) The stakeholders won't be in a position to make any material inferences from the financial statements.

(f) The equity shareholders and other investors would lose confidence resulting in the stock markets reacting adversely.

(g) The share prices of the company may go down.

(h) Also, it would be difficult to raise further funds for quite some time.

20

Ans (a)(i) An external auditor in it's report can give an unqualified opinion, emphasis of matter, qualified opinion, disclaimer of opinion or adverse opinion.

(ii) The external auditor of company Z ltd if has given disclaimer of opinion then it means that the auditor is uncertain about the entire financial statements provided to him by the management

(iii) The auditor cannot justify or deny the truth and fairness of Z ltd's financial statements

(iv) In such cases, the external auditor would step down as the auditor and Z ltd will have to find another auditor who can justify the truth and fairness of the financial statements

(b) (i) These are extreme cases where an auditor have to give ~~an~~ a disclaimer of opinion

(ii) Cases where the evidences and records provided by the management are so insufficient and vague, that the auditor cannot certainly form an opinion

(iii) When the information is unavailable due to system crash or improper maintainance of evidences etc can be examples where the external auditor will give ~~an~~ a disclaimer of opinion

~~18~~ 21

Ans (a) An auditor is an independent third party who is hired to audit the financial statements of the company.

(b) The external auditor must be registered with the respective regulators.

(c) The external auditors perform their role and give an opinion with a view that they are reporting to the company's equity shareholders.

(d) The auditors are generally chartered accountants who have great expertise in accountings.

(e) They inspect, analyse, scrutinise and cross verify the financial numbers in the statements with the evidences provided by the management.

(f) They also perform the role about commenting on the handling and maintainance of the records.

(g) They have certain prescribed methods and tests which the financial statements have to undergo.

(h) They look into whether the appropriate concepts, laws and standards are complied with or not.

(i) Only after rigorous checking and scrutinising they give a firm and final opinion in the annual report as an auditor's report which is a statutory requirement.

(j) In this way, the work of an external auditor adds credibility to the financial statements.

22

Ans (a) There are numerous problems that come in the way of an external auditor in reporting on the fair presentation of financial statements.

(b) The most basic problem would be that 'true and fair' is not properly defined. The auditor's may be in a confusion as to which qualities should the financial statements possess in order to give a 'true and fair' view.

(c) The accounting treatment for a particular entity may ~~be~~ take time for the auditor to understand as

IFRSs are open to interpretation and multiple treatments for aspects whose accounting standards are not issued.

(d) Subjective from business to business, the entries that are material may be different. For instance, the accounting methodology of insurance companies is different from other businesses. This will lead to the external auditor requiring more time to understand the accounting treatment.

(e) The auditor's opinion in rare cases, might have different interpretation by the equity shareholders.

(f) There might also be a problem that the shareholders ~~may~~ infer the financial statements in a different manner than the auditor and might actually disagree with the auditor's report

23

Ans (a) Notes to accounts are a statutory requirement to have in the financial ~~s~~ books of the company i.e. the annual report

(b) Notes to the financial statements provide a greater detail and calculations about the financial numbers published in the statements.

(c) They might also give details on qualitative matter that the statements do not

(d) Notes help the stakeholders in understanding specific areas of performance by the company. For example, if someone wants detail on the inventory's opening and closing stock, then one can find them on notes in contrast to just cost of sales in the financial statements.

(e) One can even get an idea about the ~~ee~~ accounting standards and methods followed.

(f) Experts who wish to get a detailed knowledge of the financial statements can further go and read the notes. Whereas, for non-experts who don't want detailed calculations can stick to the financial statements.

24

Ans (a) A company's profit and loss statement works on accruals and realisation concept.

(b) Accrual concept and realisation concept might give a false sense of financial numbers to the stakeholders.

(c) The cashflow statement works on actual cashflow basis.

(d) The major outflow of cash in the cashflow statement whether or not is a topic of concern depends on why was the cash outflow taken place.

(e) The cash outflow might be to invest in assets or properties which give a long term benefit in terms of inflow to the company.

(f) There are multiple times where the company will have to invest in assets because of which there will be a large outflow in the cashflow statement.

(g) But, this investment might generate greater profits in the long run.

25
Ans Repeated question.
Same as that of Q.17. in these practice questions

26
Ans (a) A cashflow statement is a type of financial statement that provides details about the cash inflows and outflows by the company during the period
(b) While a profit and loss statement gives information about the income and expenses on realisation and accrual basis respectively, a cashflow statement is prepared basis on the actual cash inflows and outflows
(c) A cashflow statement is categorised as cashflows from operating activities, cashflows from investing activities and cashflows from financing activities
(d) Thus, any stakeholder actually comes to know how much cash the company had in the beginning of the period and how much cash does it have at the end of the period considering the net cashflow for the period.
(e) A cashflow statement gives an insight to the stakeholders that even the business ~~a~~ is profitable, does it have enough cash to meet the liabilities

27.
Ans (a) Every financial statement has some significance with the view of the stakeholders
(b) When the opening and closing bank balance is known, we can only get the net cashflow and not particularly the

reason and detailed use of that cash.

(c) The cashflow statement is divided into three parts namely - cashflows from operating activities, cashflows from investing activities and cashflows from financing activities

(d) As an investor, we are not just interested in the opening, closing or net cashflow positions.

(e) Instead how the capital is used in the business is way more important since, today's investments are likely to determine the future position of the company.

(f) And, since we ~~don't~~ get the information about the cash inflows and outflows in the cashflow statement, it is not appropriate to say that the cashflow statement is unnecessary.

28

Ans (a) A cashflow statement is a statutory requirement by national company laws as one of the financial statements in the annual report.

(b) A cashflow statement records any business cash inflow and outflow occuring during that period.

(c) A cashflow statement is divided into the following categories.

(i) Cashflows from operating activities

(ii) Cashflows from investing activities

(iii) Cashflows from financing activities

(d) A cashflow statement is recorded for when there is actual gain and transfer of cash unlike the balance sheet and profit and loss statement which is recorded on accrual and realisation concept basis.

(e) With the help of a cashflow statement, the investors can actually and more precisely know as to where are their investments being utilised. Also, whether any new fund issue was done by the company or not.

(f) Thus, a cashflow statement actually gives the change from ~~open~~ opening cash balance to closing cash balance.

29.

Ans (a) The key objective of maximising shareholder wealth can be fulfilled if the company is profitable.

(b) On the other hand, liquidity is the concept that how easily can the company convert it's assets to meet the liabilities.

(c) Both, profitability and liquidity are of utmost significance. If a company is profitable but ~~not~~ having low liquidity, then it may not be able to meet it's current liabilities and vice versa.

(d) The shareholders might be in a dilemma that if the company is profitable then it can sustain any liquidity that comes forth.

(e) But this generally might not be the case. The company would have majority of non-current assets which have low liquidity. Thus, even if it is profitable it is possible for the company to run into financial difficulties because of low liquidity.

30
Ans (a) The primary objective of any company is to maximise shareholder wealth. And this would be possible if the company is making profits.
(b) Thus, the directors could create a misleading impression of their company's profitability in the published financial statements.
(c) One example would be that the directors record low amount for net realisable value of closing inventory. This would intern boost the profitability figure.
(d) It might also be the case that the company's directors, might not record for bad debts. Since, they will still form part of assets in balance sheet and sales in the profit and loss statement.
(e) We know, that IFRSs are not applicable to all companies in all circumstances.
(f) Thus, the directors will find loopholes in the standards thus ~~pern~~ making it possible for them to alter the profitability figure.

31
Ans (a) Since, there are numerous accounting concepts and statements that offer alternate treatments in some cases, the financial statements needs to be prepared on the basis of certain assumptions and estimates. For example, depreciation
(b) The directors can mislead these assumptions such that they overstate the profit figures.
(c) We know that in some cases there is a certain

ambiguity in accounting policies which are based on accounting standards.

(d) Thus, wherever there are loopholes in accounting standards, the directors might overstate the profit figures without risking the legal and other penalties that would be imposed in such cases.

32.

Ans(a) The annual report of any company are prepared by the directors and the auditors give out the audit report. But here it should be noted that these are done with a view to address the equity shareholders.

(b) Also, we know that according to the cost concept, the assets are recorded at their historic costs less depreciation to date. So, the lenders would exactly not have the idea of the current value of assets if the company was to wind up.

(c) With the help of the annual reports, the lenders come to know about the profitability of the companies and hence get ~~a~~ bit some idea as to whether the company will be in a position to service the debt.

(d) The Lends can get information about the company's capital structure and how much geared the company is.

(e) In this way, the lenders can actually come to know few material aspects but there are a few limitations as well.

33.

Ans (a) It is the statement of financial position that gives the information about the company's liquidity at a particular point in time.

(b) Since, the balance sheet is prepared at a particular moment in time and generally at the end of the financial year, it gives a snapshot of the company's liquidity position only at the year-end and not over the year.

(c) Also, the statement of financial ~~the~~ position is prepared at year end but ~~not~~ published even later. And at that instant of time, it might be the case that the company's liquidity is not the same anymore.

(d) Also, according to certain accounting concepts, the assets and liabilities stated in the financial statement ~~no~~ are not recorded at their realisable fair value.

34.

Ans. Same question type as Q. 30.

35.

Ans. (a) An auditor's report is a statutory requirement to be included in the company's annual report by the national laws.

(b) The external auditor reports with a view that the report is going to be addressed to the equity shareholders.

(c) The auditor is not expected or even responsible to comment on the performance and profitability of the company.

(d) The job of the external auditor is to form an opinion on the published financial statements

(e) Auditor's report is very important since, the shareholders basis on their opinion draw informed decisions basis the financial statements

(f) The external auditor should ensure that their report must be specific and should clearly state any limitations or uncertainty in the financial statements

36 (i)

Ans (a) An external auditor in it's auditor's report forms an opinion just on the 'truth and fairness' of the financial statements

(b) They nowhere specify the performance or profitability of Subb or Parrent

(c) Neither, does the external auditor going to cover or guarantee payments if Subb defaults on the ~~on~~ trade credit payments

(d) Thus, the directors of Gryffe should consider the audit report only to the extent that the financial statements give a 'true and fair view' and nothing over that

(ii) (a) In the event that Gryffe grants Subb's request, Gryffe should take a written and legal guarantee that Parrent would compensate for the payments if Subb defaults

(b) A maximum credit limit could be set, above which there won't be a trade credit facility being offered.

(c) Gryffe can ask Parrent and Subb that in cases when the trade payable is above a predefined limit, equal value of assets will need to be provided as security (collateral)

37 (i)

Ans

Income statement of Maker plc for year ended 31 March 2009

Particulars		£m Amount	£m Amount
Sales			1200
~~Cost of goods sold~~ Raw materials		~~424~~ 440	
Manufacturing costs		34	
Depreciation		132	
Wages - manufacturing staff		124	
			~~774~~ 730
Gross profit			~~486~~ 470
Selling and distribution expenses			
Running costs for delivery vehicles		80	
Wages - delivery drivers		28	
			108
General and administrative expenses			
Administrative expenses		24	
Wages - administrative staff		42	
			66
Operating profit			~~312~~ 296
Finance Costs			120
Profit before tax			~~192~~ 176
Tax			0
Profit after tax			176

Balance sheet of Maker plc as at 31 March 2009

Particulars	£m Amount	£m Amount
Assets		
Non Current Assets	~~686~~	
Factory	~~18~~ 686	
Machinery	362	
Delivery vehicles	180	
		1228
Current assets		
Inventory	16	
Trade receivables	140	
		156
Total assets		1384
Equity and liabilities		
Equity		
share capital	220	
Reserves and surplus	506	
Total equity		726
Liabilities		
Non current liability		
Long term loan		600
current liabilities		
Bank Overdraft	6	
Trade Payables	52	
		58
Total equity and liability		1384

Notes:

1 Depreciation adjustment for factory

Cost of factory	600
Less: Cummulative depreciation	(64)
Pre-revaluation cost of factory	536
Revaluation	164
Opening balance of factory	700
Depreciation for current year	(14)
Closing balance of factory	686

2 Depreciation adjustment for delivery vehicles and machinery

	Delivery vehicles	Machinery
Cost of non-current asset	380	580
Less: Cummulative depreciation	(140)	(160)
Opening balance	240	420
Current year depreciation	(60)	(58)
Closing balance	180	362

3 Total depreciation

Depreciation on	
Factory	14
Delivery vehicles	60
Machinery	58
	132

4 Reserves and Surplus

Opening balance	166
Revaluation	164
Profit for current year	176
Closing balance	506

(ii)

Ans (a) The biggest advantage of revaluing the factory is that the equity shareholders now have a better idea about the value of the factory.

(b) This is in contrast to the historic cost concept And this is the accurate value of the factory since, revaluation is done only when the analyst is 100% certain

(c) One of the disadvantages of revaluation is that the depreciation for current year on factory has increased.

(d) And this might be open to manipulation as well.

(iii)

Ans (a) There are many reasons as to why the balance in bank account has gone from £4m to overdraft of £6m.

(b) There might be a possibility that the amount was used to repay a loan or pay the trade payables. Since, they are not mentioned in the ~~profit~~ balance sheet because of balance sheet getting prepared at the end of the year.

(c) Thus, these transactions have not been accounted for in the balance sheet
(d) It can be traced back to the cashflow statement.
(e) Since, Maker plc has had a profit of £176m in the current year, it does not necessarily mean that this profit is in form of cash.
(f) This is because, both profit and loss statement and balance sheet is accounted for on accruals and realisation basis.