

OXFORD CAMBRIDGE AND RSA EXAMINATIONS

Advanced GCE

BUSINESS STUDIES

2875

Further Accounting and Finance

Thursday

23 JUNE 2005

Afternoon

1 hour 30 minutes

Additional materials:
8 page Answer Booklet

TIME 1 hour 30 minutes

INSTRUCTIONS TO CANDIDATES

- Write your name, Centre number and candidate number in the spaces provided on the answer booklet.
- Answer **all** questions.
- If you use extra sheets of paper, fasten the sheets to the answer booklet.
- Read each question carefully and make sure you know what you have to do before starting your answer.

INFORMATION FOR CANDIDATES

- The number of marks is given in brackets [] at the end of each question or part question.
- The total number of marks for this paper is 60.
- You will be awarded marks for the quality of written communication where an answer requires a piece of extended writing.

This question paper consists of 3 printed pages and 1 blank page.

James Deacon Ltd (JDL).

James Deacon established his business 25 years ago. Initially he ran a small building and contracting company. Progress was slow but steady. The company now operates as two divisions:

- Public Works Division. This carries out work for local authorities such as sewage work and drain repairs. James regards this as the core business.
- Land and House Purchase Division. The work here is of a middle man type. James buys property for a quick sale to a developer, Knowle and Sons Ltd. 5

The Land and House Purchase Division began 10 years ago when James started working with a property development business. James identifies houses that are in need of repair or which have development potential. He buys the houses often at an auction and then sells them at a 15% mark up to Knowle and Sons Ltd, which then spends money on renovating the properties before re-selling them. 10

Recently, James has been negotiating an option to buy eight semi-detached houses with very large gardens known as The Warwick Road Project. The project would involve demolishing two houses to give access to the land, leaving the remaining six standing. Eight detached houses will then be built on the gardens. James is prepared to offer £100,000 over the market value for each of the existing houses to encourage the owners to sell. James would then sell the entire site to Knowle and Sons Ltd. It would then be able to build the eight new detached houses and sell the remaining six semi-detached properties. Table 1 is a summary of the main financial details. 15

Table 1
Financial details of The Warwick Road Project

		20
Average market value per property	£260,000	
Inducement to sell per property	£100,000	
Total cost of purchases	£2.88 m	
Potential sale price to Knowle and Sons Ltd [15% mark up]	£3.312 m	

James is sure that the venture will lead to a substantial profit. However two problems exist: 25

- Knowle and Sons Ltd will only buy if planning permission for the eight new houses is given. JDL is responsible for gaining planning permission.
- James will find it difficult to raise the £2.88 m needed.

JDL has a weak financial structure. It has capital employed of £5.2 m and a gearing ratio of 75% (calculated as long term debt/capital employed). Table 2 is an extract from the latest balance sheet of the business. 30

Table 2
Extract from James Deacon Ltd Balance Sheet
as at 30 March 2005

		35
Fixed Assets		
Office Premises	£1.2 m	
Plant/machinery	£2.3 m	
Vehicles	£0.6 m	
Current Assets		
Stock	£1.1 m	40
Debtors	£0.9 m	
Cash at bank	£0.2 m	

The Warwick Road Project has raised a great deal of interest with James' business friends. A study of local house prices suggests that detached houses in the area are selling for £475,000. Direct building costs of a detached house would be about £200,000 (excluding land costs and any overheads). 45

“Why sell these semi-detached properties and their gardens to the developer,” said a friend to James. “Buy them and then build the eight detached houses yourself. Don’t forget you’ve only got to demolish two semi-detached houses to give road access to the gardens. You will still have six semi-detached houses to sell.” 50

James is unsure as to what to do. He can see many potential advantages from carrying out the contract independently but he is worried about the cash flow implications and also jeopardising his business relationship with Knowle and Sons Ltd.

To summarise, his options are:

1. buy the properties and sell to Knowle and Sons Ltd. with 15% mark up; 55
2. buy the properties and develop the site by building the eight detached properties himself.

James has been in discussion with JDL’s bank manager. He has advised James to produce a cash flow forecast so that the liquidity implications of the proposals could be better analysed and that proper funding arrangements might be put in place. The bank manager was concerned that the business did not over stretch itself and thus endanger its financial stability. 60

As regards the public works division, James signs a fixed price contract with the local authorities to carry out projects. He has to bid competitively in order to gain the work but recently some of these projects have caused him financial concern. Table 3 gives details of a recent job done for Stafford Council.

Table 3 65
Stafford Council Contract 2004 (£000’s)

	Budget	Actual	
Direct Labour	450	530	
Direct Materials	400	430	
Allocated overheads	500	500	70
Total Costs	1350	1460	
Contract Price	1450	1450	

Footnotes to the contract contained the following information:

Labour Rates [per hour]	£6	£6.625	
Labour hours	75000	80000	75

The management of JDL has been discussing the local authority contracts. James is adamant that they represent the core activities of the business and must be continued. The contracts generate a regular income and help make positive contributions.

The project manager thinks that things must change. “Look at that Stafford contract. We made a loss on that. This simply cannot be allowed to happen again.” James disagreed and argued that the Stafford contract was of financial benefit to the company. 80

Answer **all** questions.

- 1 (a) If JDL increased its long term debts by £1.3 m calculate its new gearing ratio. [4]
- (b) Evaluate the **internal** sources of finance that JDL could use to help fund its land purchase project (option 1). [10]
- (c) Analyse the value of a cash flow forecast as an aid to JDL’s decision making. [6]
- (d) What should JDL do with the Warwick Road site? Justify your answer. [16]

- 2 (a) With reference to Table 3, analyse the direct labour variance experienced on the Stafford Council contract. [6]
- (b) Evaluate James’ statement that the Stafford contract was of financial benefit to JDL. [16]

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