ADVANCED GCE

BUSINESS STUDIES **F294/RB**

Accounting

RESOURCE BOOKLET

To be given to candidates at the start of the examination

Monday 24 January 2011
Afternoon

Duration: 2 hours

INSTRUCTIONS TO CANDIDATES

- The information required to answer questions 1–6 is contained within this resource booklet.
- Do not hand this resource booklet in at the end of the examination. It is not needed by the Examiner.

INFORMATION FOR CANDIDATES

- This document consists of **4** pages. Any blank pages are indicated.

INSTRUCTION TO EXAMS OFFICER / INVIGILATOR

- Do not send this resource booklet for marking; it should be retained in the centre or destroyed.

In The Soup Ltd

In The Soup Ltd (ITSL) manufactures fresh soups. All the soups are currently packaged and sold in 600g cartons. ITSL's customers include several national supermarket chains and numerous independent retailers.

Harry Crawford, a qualified food technologist, formed ITSL in early 2006. Harry's market research indicated that there was a growing interest in healthy eating and he was convinced that soups made from fresh quality ingredients would prove to be highly profitable.

From a sales point of view, ITSL's first five years of trading have been encouraging; ITSL receives positive feedback from retailers and consumers alike. However, despite sales revenue always being well above Harry's targets and production close to 100% capacity utilisation, net profit continues to be well below Harry's expectation of a 15% net profit margin. Harry is unsure whether the disappointing net profit margin is due to the direct costs of manufacturing or the cost of overheads. To make matters worse, there are clear signs that retailers, facing an increasingly competitive market, are looking to suppliers to reduce their prices. See Table 1 for an extract from ITSL's latest audited accounts.

Table 1
Extract from ITSL's Profit and Loss Account for the year ending 31 December 2010

Sales	£526,720
Gross Profit	£289,685
Net Profit	£31,603

Harry is concerned about the future of ITSL; he knows that his strengths lie in marketing and selling. At the same time, he knows his weaknesses lie in cost control and with understanding the complexities of ITSL's final accounts. Four years ago, Harry had appointed ITSL's auditors, Black and Grey Partners, on the basis of 'value for money'. However, he is beginning to question the quality of the service the auditors provide.

On several occasions Harry has been frustrated by Black and Grey's practices; for example, the auditors continue to be concerned by the credit worthiness of several customers and have included a provision for bad debts in the latest accounts. In addition, Harry has always been annoyed by the level of detail the auditors require when establishing the value of ITSL's closing stock. Is it really necessary, Harry thinks, to place a value on every single stock item regardless of quantity and cost? Even more frustrating is that the auditors regularly value stock well below Harry's estimate.

Harry discussed his concerns with a former colleague, Claire Short, who recommended that Harry should consider appointing a consultant to review ITSL's accounting practices. Claire explained to him that she had used the consultant, Sheryl Blake, to give her advice and, despite the significant cost, had found Sheryl's input invaluable.

A month later, and following several visits to review ITSL's manufacturing process and accounting data, Sheryl met with Harry to discuss her findings and observations (see Appendix 1).

Harry was keen to learn more about each of the proposals; on reflection he was ready to admit that his autocratic leadership style meant that his employees were not always involved in decision-making. Furthermore, Harry accepted that he often tried to solve all of ITSL's operational problems himself. One such problem, for example, the continuing unpredictability of the cost and supply of key ingredients such as vegetables, especially when many of the vegetables are imported.

However, from Harry's perspective, there is an even more pressing issue. Despite the quality of its soups and growing brand recognition, Harry is aware of the competition ITSL faces on a day-to-day basis. Long-term contracts are hard to secure and so Harry is keen to listen to a proposal from a potential new customer, JR Stores, a leading supermarket in the south of England.

JR Stores' proposal is to offer ITSL a one-month trial contract to supply soups to 10% of its stores. The supermarket chain wants to sell the soups as part of JR Stores' own label premium range. The contract is for 30,000 cartons at an average price to JR Stores of £0.88. ITSL's normal average price to retailers is £1.06. JR Stores also wishes to secure 60 days credit terms, as opposed to ITSL's normal 30 days credit terms.

Harry is unsure about the decision he should make. He is only too aware that this contract could, in the long-term, help to occupy ITSL's expensive new equipment which will begin to be used next month and which will increase capacity by up to 50%. On the other hand, there are several other companies showing a keen interest in stocking ITSL's soups.

His position was made even more difficult when JR Stores insisted that Harry made a decision within seven days. Harry and his accounting department quickly prepared the following figures to help him with the decision (see Table 2).

Table 2
Financial calculations relating to the JR Stores' potential contract

Average contract price per carton	£0.88
Direct materials cost per carton	£0.44
Direct labour cost per carton	£0.21
Fixed overheads per carton	£0.20

Appendix 1

Extracts from Sheryl Blake's Report

1. Depreciation Policy

   Your auditors have applied a declining (reducing) balancing method of depreciation*. I would question whether this is the most appropriate method for ITSL. For example, this year you have made a significant investment in new production equipment (£125,000). You reported to me that this equipment is of a high standard and should last for 15 years. You also told me that, even after 15 years, the equipment could be sold for 10% of its purchase price.

   * At present ITSL's fixed assets are depreciated at a rate of 30% per annum.

2. Standard Costing

   There is clearly a problem with the costing of your products; I carried out a standard costing trial. See Table 3 for direct materials usage and standard cost. Calculations are based on a 5,000 carton production run for carrot and coriander soup.

Table 3
Standard Costing: Carrot and coriander soup (600g carton)

Materials Usage per 600g carton			**Cost per 600g carton**	
Ingredient	Standard Quantity (g)	Actual Quantity (g)	Standard Cost £	Actual Cost £
Carrots	252	256	0.24	0.28
Onions	54	50	0.06	0.05
Fats	10	12	0.05	0.06
Herbs	5	5	0.03	0.06
Other ingredients	279	277	0.02	0.03
Carton	–	–	0.04	0.04
Total	**600**	**600**	**0.44**	**0.52**

3. Establish a Budgeting System

   You, personally, continue to set realistic sales targets but there is no evidence of budgeting. This is borne out by interviews with employees from your product development, production, purchasing, marketing, accounting and human resource departments. There is a general feeling that you negotiate new contracts and then impose additional production demands without considering the direct and indirect cost implications. For example, a recent contract required overtime working at a higher hourly labour rate and accessing ingredients at a higher cost.