GCE A level

325/01

# BUSINESS STUDIES
# BS5a

A.M. WEDNESDAY, 11 June 2008

1½ hours

**ADDITIONAL MATERIALS**

In addition to this examination paper, you will need:

- a calculator;
- a 12 page answer book.

**INSTRUCTIONS TO CANDIDATES**

Answer the **one** compulsory question in the separate answer book provided.

You are advised to spend approximately 30 minutes reading the information provided and making rough notes before you answer the question.

**INFORMATION FOR CANDIDATES**

Mark allocations are shown in brackets.

Candidates will be assessed on their quality of written communication i.e. the structure and presentation of ideas; the clarity of expression; grammar, punctuation and spelling. Up to three marks will be awarded for written communication.

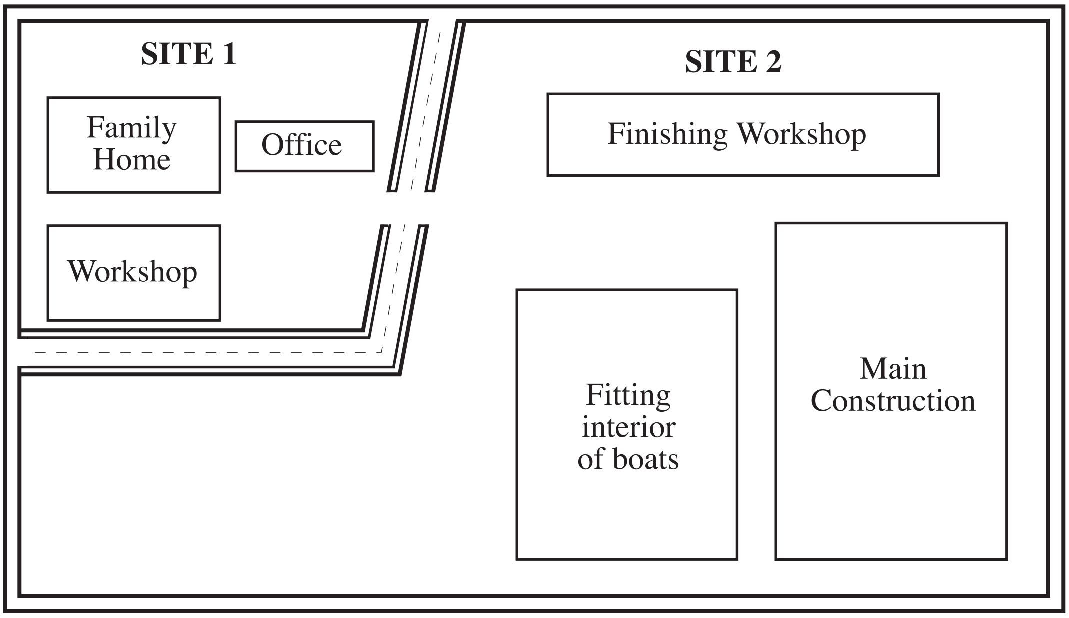
**1.** Study the information below and then answer the question that follows.

**SUTTON LTD**

**The Background**

Sutton Ltd is a family-run business which builds and repairs canal boats. It has two sites. The first site, valued at £1 million, consists of the family home, an office and a small workshop for carrying out boat repairs. Sutton Ltd rents the second site and it is here that the boat-building operation takes place. The company employs twenty-four workers.

The company has five shareholders; all are members of the Sutton family and they each take an active role in the day-to-day running of the business. Ian Sutton became the Managing Director three years ago.




Ian's time as Managing Director has proved to be frustrating. There have been problems in recruiting new employees to replace experienced workers, several of whom had retired or were due for retirement. Little investment had been made in recent years in new technology and this further reduced the attractiveness of the company for potential new employees.

There were disagreements in shareholder meetings about the business and a reluctance to make decisions which Ian believed were vital to ensure that the company continued to exist. In Ian's opinion, some of the shareholders were blinded by the fact that the company workshops were always full.

Ian had recently obtained the following statistics from the workshop manager. It seems that over the last three years, Sutton Ltd had been put in the position of turning away potential customers (see Table 1), who were prepared to buy new boats from the company. All his workshop manager said was “We just don’t have the room to do the amount of work we could”.

**Table 1** - Number of boats made and number of firm orders received 2005-2007

| | 2007 | 2006 | 2005 |
|---|---|---|---|
| Boats made | 20 | 17 | 16 |
| Orders received | 28 | 22 | 18 |

Of much greater significance was the knowledge that the owners of the second site wished to re-develop it.

**Sutton Ltd’s Current Financial Position**

The financial situation of the company is summarised in the table below.

**Table 2** - Extracts from the Trading, Profit and Loss Account and Balance Sheet of Sutton Ltd from 2005 to 2007

| | 2007 | 2006 | 2005 |
|---|---|---|---|
| | £ | £ | £ |
| Sales revenue | 1 568 000 | 1 309 000 | 1 232 000 |
| Cost of sales | 1 074 000 | 812 000 | 730 000 |
| Gross profit | 494 000 | 497 000 | 502 000 |
| Expenses | 378 000 | 344 000 | 240 000 |
| Net profit | 116 000 | 153 000 | 262 000 |
| Capital employed | 494 000 | 491 000 | 465 000 |

The company accountant had warned that the upward pressure on the world price of timber and steel would continue to have an impact on the company’s financial position for some time to come.

**The Future**

Ian and the Board of Directors had several meetings with the owners of the second site, but it became increasingly clear that they wished to sell it to a property development company for a sum of money which Sutton Ltd simply could not match.

The Board had to consider the future and looked at three options:

- A merger with another boat builder.
- Moving production overseas and retaining the site it owns for repairs and fitting.
- Relocating to a new site.

**Option 1 - The Merger**

Anchor Shipyards Ltd is located forty-five miles away from the present site of Sutton Ltd. It is another family-owned business employing twenty-five workers. It has developed expertise and a reputation for building small fishing boats and leisure craft, e.g. yachts. European Union fishing regulations have seen demand for its fishing boats decline and the majority of its work is now in building leisure craft.

The overall level of orders received for its fishing boats and leisure craft is disappointing and the numbers made do not match its capacity.

**Table 3** - Anchor Shipyards Ltd - capacity and production of fishing boats/leisure craft 2005-2007

| | 2007 | 2006 | 2005 |
|---|---|---|---|
| Capacity | 35 | 35 | 35 |
| Fishing boats/leisure craft made | 14 | 15 | 18 |

Anchor Shipyards Ltd has large workshops and it is this which is attractive to Ian Sutton and the Board of Sutton Ltd. Its buildings are in far better condition and their layout would allow for greater flexibility in production than those at Sutton Ltd's current site. There would also be savings in buying raw materials, as more can be stored at this new location.

The most recent balance sheet for Anchor Shipyards Ltd is shown below.

**Table 4** - Balance Sheet for Anchor Shipyards Ltd as at 31 December 2007

| | £ |
|---|---|
| **Fixed Assets** | |
| Leasehold property | 160 000 |
| Machinery and fixtures | 1 700 000 |
| Vehicles | 60 000 |
| | 1 920 000 |
| **Current Assets** | |
| Stocks | 80 000 |
| Debtors | 12 000 |
| Bank and cash | 24 000 |
| | 116 000 |
| **Current Liabilities** | |
| Trade creditors | 64 000 |
| Tax due | 42 000 |
| | 106 000 |
| **Working Capital (Net current assets)** | 10 000 |
| **Assets Employed** | 1 930 000 |
| | |
| **Financed by** | |
| **Long Term Liabilities** | |
| Bank Loan | 1 000 000 |
| **Shareholders' Funds** | |
| Ordinary Shares | 760 000 |
| Reserves | 170 000 |
| **Capital Employed** | 1 930 000 |

In general, the majority of the directors of Sutton Ltd are encouraged at the prospect of a merger with Anchor Shipyards Ltd and they can see definite benefits. However, Ian is concerned that the ethos and cultures of the two companies are quite different. In addition, he did not like the way in which the Managing Director of Anchor Shipyards Ltd, John 'Popeye' Smart, dominated proceedings when the Board of Directors met to open initial merger talks.

Before the next meeting Ian and the other directors intended to analyse Anchor Shipyards Ltd's balance sheet for 2007 and in particular its gearing and liquidity.

It is estimated that the merged company would operate with a total workforce of thirty-five employees.

**Option 2 - Moving Production Overseas**

The Aqualine factory based in the Gdansk shipyard in Poland has been dealing with a number of individual UK canal boat builders for some years. It has the capacity to build up to thirty boats a year for Sutton Ltd. Production times are two-thirds those of Sutton Ltd and better raw materials are used – a better product at lower cost per unit. Everything except the carpets and curtains is completed in Poland and then the boat is delivered by lorry to the UK.

Aqualine wants to develop a more formal agreement with one of the UK canal-boat builders instead of working with a number of different ones. It has indicated it would be prepared to enter into a fixed contract whereby Sutton Ltd agrees to buy thirty canal boats for each of the next three years at an average fixed price, including delivery costs, of £40 000 per boat.

If this were to be Sutton's preferred option it would mean that Sutton Ltd would keep the family home, the office and the small workshop. Four members of the existing workforce would be retained to fit the carpets and curtains and paint the exterior of the boats to suit individual customer needs. It would mean making twenty staff redundant at an average cost of £25 000 each.

Ian feels that this is an opportunity that is too good to miss and recognises the potential benefits from an arrangement of this type. The other directors are more reluctant to see what to them amounts to, the end of the business. In addition, the success of Sutton Ltd has been built on the "made in the UK" label and there are concerns about what might happen in the Polish economy over the next ten years and what will happen when the three-year contract with Aqualine comes to an end.

Ian had done some preliminary calculations. He estimated that, taking all costs and expenses into account, they could "customise" each canal boat from Poland for £10 000 on top of the £40 000 they would have to pay Aqualine for each boat. They would need to sell all thirty, but the recent trend in orders suggested a continued increase in sales. The average sales price over the next three years he estimated would be £70 000 per boat.

**<u>Option 3 - Relocating To A New Site</u>**

This option will involve selling the site that Sutton Ltd owns for £1 million and moving to a new one.

Due to the relocation of a Japanese electronics' firm, a site had become available on an Industrial Park some ten miles from Sutton Ltd's present location. The buildings are an ideal size for Sutton Ltd and offer greater capacity than the present site. The local authority will let them on a thirty-year lease for a reasonable sum, provided Sutton Ltd take on some of the workers who were made redundant when the Japanese firm left.

Most of Sutton Ltd's machinery is coming to the end of its useful life and the business would need to invest heavily in new machinery which would have a life span of eight years. If they sold their current site for £1 million, they would still need, in addition to this,a substantial loan of £800 000 to equip the new workshops.

Ian was confident that there was potential for growth and with additional sales of both canal boats and leisure craft, he had estimated the net returns from the £1 800 000 investment. These are set out in the table below. The Board of Directors had decided that a discount factor of 10% should be applied, so they could calculate the net present value of the project before it even considered the qualitative factors of such a move.

**Table 5** - <u>Estimated net returns from investment</u>

| Year | Net Return in pounds (£) | Discount Factor |
|---|---:|---|
| 0 | (1 800 000) | 1.00 |
| 1 | 275 000 | 0.91 |
| 2 | 300 000 | 0.85 |
| 3 | 350 000 | 0.75 |
| 4 | 370 000 | 0.68 |
| 5 | 400 000 | 0.62 |
| 6 | 400 000 | 0.56 |
| 7 | 420 000 | 0.51 |
| 8 | 420 000 | 0.47 |

**Write a report (using report format) to Sutton Ltd, comparing the three options and, on the basis of your analysis, make recommendations as to the most appropriate way for the business to proceed. [50]**

**N.B. Your recommendations will need to be backed up by sound arguments.**