
Answers

Section A

- 1 D
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- 3 D
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- 16 B
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Section B

Marks

1 (a) Reconciliation of operating profit to net cash flow from operating activities

	£		
Operating profit	201,086	(working 1)	1
Depreciation	98,750	(per question)	1
Increase in stocks	(43,587)	(working 2)	1
Increase in debtors	(37,842)	(working 2)	1
Increase in creditors	5,371	(working 2)	1
Net cash inflow from operating activities	<u>223,778</u>		1

(b) Cranic Ltd
Cash Flow Statement for year ended 30 April 2003

	£		
Net cash inflow from operating activities	223,778		
Servicing of finance	(8,000)	(interest b/f – paid in year)	1
Taxation	(115,800)	(working 3)	1
Capital expenditure	(135,757)	(working 4)	1
Equity dividends paid	(20,000)	(working 5)	1
Net Cash Flow before financing	(55,779)		
Financing (note 1)	110,000		1
Increase in cash	<u>54,221</u>		1
			<u>12</u>

Note 1 Gross Cash Flows

	£	
Financing		
Repurchase of debenture loan	(200,000)	
Issue of ordinary share capital	310,000	(working 6)
	<u>110,000</u>	

Working 1 Operating Profit

	£
Retained Profit	146,486
Add Taxation charge	27,600
Dividends	27,000
	<u>201,086</u>

Working 2

	2002	2003	movement
	£	£	£
Stock	301,470	345,057	43,587 inc. ∴ outflow)
Debtors	598,315	636,157	37,842 (inc. ∴ outflow)
Creditors (excluding interest)	329,150	334,521	5,371 (inc. ∴ inflow)

Working 3 Taxation

	£
Provision at 30.4.02	115,800
Add Profit and loss charge	27,600
	<u>143,400</u>
Less Provision at 30.4.03	(27,600)
= Amount paid	<u>115,800</u>

Working 4 Capital expenditure

	£	
NBV at 30.4.02	1,028,163	
Less Depreciation for year	(98,750)	
	<u>929,413</u>	
NBV at 30.4.02	1,065,170	
Difference	<u>135,757</u>	= Additions

Working 5 Equity dividends paid

	£
Provision at 30.4.02	15,000
Profit and loss charge	27,000
	<u>42,000</u>
Provision at 30.4.03	22,000
= Amount paid	<u>20,000</u>

Working 6	Ordinary Share Capital £	Share Premium £	Total £
at 30.4.02	650,000	50,000	700,000
at 30.4.03	900,000	110,000	1,010,000
increase	250,000	60,000	310,000

(c) MEMO

From Financial Manager
To Financial Director
Ref Cash Flow Statement
Date 2 June 2003

An examination of the company's cash flow statement for the year ended 30 April 2003 indicates:

- Whilst the company has eliminated the overdraft and had a surplus of cash at 30 April, there are a number of less positive aspects of our performance.
- Although operating activities have generated a reasonably strong positive cash flow of £223,778, based on an operating profit of £201,086, the combination of relatively large outflows in respect of capital expenditure and taxation have led to the net cash flow before financing being negative.
- Indeed if we had not been successful with the issue of additional shares, the cash position would have worsened considerably during the year.
- The issue of additional share capital was an appropriate means of raising funds for the redemption of the debentures, but it is questionable if it was appropriate to also raise additional funds which were effectively used to acquire fixed assets.
- It may have been better to finance the acquisition of fixed assets through alternative means, for example leasing or hire purchase.
- This would mean that the cash to be generated by the use of the fixed assets would be used to repay the related liability.
- In the present circumstances, we are now committed to a continuing future cash outflow in the form of dividends.
- In light of these comments, there may be merit in investigating whether any of our existing fixed assets are suitable for a sale and leaseback agreement. With your agreement I will look into this possibility.
- I would also strongly recommend that any future acquisitions of fixed assets are the subject of an agreed funding strategy.

Allocation of marks: 1 mark for each valid point, to a MAXIMUM of

Total for question

8
20

2 Revaluation of freehold property

- In principle the company is entitled to recognise an increase in the value of fixed assets.
- This is permitted by FRS 15, but there are certain conditions imposed by the FRS.
- These are:
 - if an asset is revalued, the revaluation policy must be applied consistently to all assets in that class
 - a revalued asset must be the subject of a full valuation every five years
 - a full valuation must be carried out by a qualified valuer.
 - if the qualified valuer is an officer or employee of the company, the valuation must be reviewed by a qualified external valuer
 - any gain arising on revaluation is not realised and therefore must not be included in the calculation of profit
 - instead the gain is credited to a reserve (the revaluation reserve)
 - as a recognised gain, the gain will be reported in the statement of total recognised gains and losses
 - following the revaluation, depreciation should be based on the new valuation and the estimated remaining useful life of the asset
 - if an asset has fallen in value, the fall in value should be charged to the profit and loss account
- Therefore, it is permissible to reflect the increase in value of the buildings, but the loss in value of the third building must also be recognised.
- It is worth noting that the company is not required to recognise the increase in valuation, but is required to recognise the loss in value.

No depreciation charge

- This suggestion is based on a commonly held misconception about the nature of depreciation
- Depreciation is not a way of ensuring that fixed assets are reported at their current value
- FRS 15 describes depreciation as a measure of the cost of the economic benefits of the fixed asset that have been consumed during the period
- Therefore depreciation is based on the basic accounting principle of matching (or accruals), and seeks to match the cost of the economic benefits with the revenue which has been earned
- This means that any fixed asset which is consumed or has a finite useful life must be depreciated
- From this it follows that freehold land, which normally is not consumed (consumption may arise due to mining for example) need not be depreciated
- It may be possible to reduce the annual depreciation charge if there is evidence that the useful life of a property is longer than had originally been foreseen
- Another exemption from depreciation is permitted by SSAP 19 which deals with investment properties.
- An investment property is one which is held for its investment potential, rather than for use by the investing company
- Investment properties are carried at current value, with any increase being credited to an investment revaluation reserve and not to the profit and loss account
- It should be noted however that if there is a permanent diminution in the value of the investment property, the fall in value must be charged to the profit and loss account

Effect on financial statements

- Assuming that it is decided to recognise the increase in valuation, the financial statements will be affected as follows:
 - in respect of the properties which have increased in value:
 - the value of fixed assets will increase
 - a revaluation reserve will be created (equal to the difference between the total valuations and the depreciated historical cost of the two buildings)
 - future depreciation will be based on the revised valuations and estimated remaining useful life of all three of the buildings
 - whilst the total balance sheet value of the company will increase (provided the fall in value is outweighed by the increase in the other two buildings), and in that sense the balance sheet will be 'strengthened' the overall effect is likely to be a fall in return on capital employed (due to the increased depreciation charges, combined with the higher capital employed)
 - in respect of the property which has fallen in value:
 - as the directors are not obliged to recognise the increase in value, but are required to recognise the fall in value, there will certainly be a charge to the profit and loss account to reflect the fall in value
 - the value of fixed assets and therefore the total balance sheet value will also fall by the same amount
 - future ongoing depreciation charges will be reduced to reflect the reduction in value of one of the properties

Allocation of marks:

1 mark for each valid point, subject to the following maximums:

Discussion of revaluation issues	8
Discussion of depreciation issues	8
Effect on financial statements	4
Total	<u>20</u>

- 3 (a) (i)** FRS 9 states that an Associate is an entity - other than a subsidiary - in which the investor: has a participating interest and over whose operating and financial policies the investor exercises a significant influence
- The FRS goes on to state that: a participating interest is an interest in the shares which is held – on a long term basis and with a view to obtaining a contribution to the activities of the investor
- significant influence arises when the investor is actively involved in the operating and financial policy decisions and the board of directors
- where the investor holds 20% or more of the voting rights, it is presumed that it can exercise significant influence, but this presumption can be set aside if it can be demonstrated that significant influence is not exercised
- (ii) the equity method of accounting is applied to associates, which means that: in the balance sheet of the investor, the investment is treated as a fixed asset investment and is normally shown at cost while the consolidated balance sheet will include the investor's share of the net assets of the associate, plus the unamortised value of any goodwill on acquisition
- (iii) as your client has acquired 1.25m out of the 5m shares in issue, we can see that they have a 25% holding. As there are no indications that there is any difference between the number of shares held and the voting rights, it would appear that this investment is correctly treated as an associate

Allocation of marks

1 mark per valid point, subject to	
MAXIMUMS of:	
definition of associate	4
accounting treatment	2
decision on status	2
Total	<u>8</u>

(b) Net assets at date of acquisition:

	£000	
Ordinary share capital	5,000	
Share premium	1,000	
Reserves	<u>700</u>	(31.3.03 £900 less retained for year £200)
	6,700	
of which 25% =	1,675	group share of net assets at acquisition
Cost	<u>1,915</u>	
Difference	240	goodwill on acquisition
Amortised over 8 years =	<u>30</u>	per annum
Thus unamortised after 1 year	<u>210</u>	
Net assets at balance sheet date:		
	£000	
Ordinary share capital	5,000	
Share premium	1,000	
Reserves	<u>900</u>	
	6,900	
x 25% =	1,725	(group share of net assets at 31.3.03)
+ unamortised goodwill	<u>210</u>	
= consolidated value	<u>1,935</u>	

Allocation of marks

calculation of goodwill on acquisition	5
calculation of unamortised goodwill	2
calculation of consolidated value	5
	<u>12</u>
Total for question	20

Section C

4 (a) Supply chain management

- recognises that the customer's 'buying experience' includes a number of elements, some of which are internal while some are external
- attempts to manage all of the elements
- therefore the relationship with suppliers and delivery firms becomes more collaborative
- may be regarded as a new paradigm in which external providers of goods and services are no longer regarded as external
- thus the provision of goods and services is viewed holistically with improvements being developed together
- price is not seen as the dominant issue in the relationship
- relationships are developed with a smaller number of key suppliers
- all of this will improve the quality experienced by the customer

1 mark per valid point, to a MAXIMUM of

6

(b) Just-in-time purchasing

- traditional approaches to stock management use a buffer stock to ensure that items are available when required by customers
- just in time seeks to bring items into stock as required
- and therefore reduce stock levels and associated costs
- as resources are freed from the task of stock management, improvements in quality can be achieved
- this will involve more deliveries, each of lower volume
- effective supply chain management is an important element in just in time
- there are a number of potential difficulties:
 - any interruption to the supply chain will be critical as stock may not be available
 - we must be able to predict demand with a reasonable degree of accuracy
 - we will be much more reliant on our suppliers
 - effective and speedy communication with suppliers will be essential
 - suppliers may seek to obtain a premium price for low volume deliveries
 - however this may be offset by the cost saving possible through appropriate use of IT (see below)

1 mark per valid point, to a MAXIMUM of

8

(c) Information technology

- computerising the purchasing process is often referred to as e-procurement
- ordering of products can be automated, so that the order is triggered without the need for staff action
- this can be developed to the stage that our IT system can link directly to the system of the appropriate supplier (this is referred to as Electronic Data Interchange – EDI)
- in this way orders can be sent and confirmation received via a network link, or the internet
- this would also allow us to track the physical location of stock in transit in response to customer enquiries
- such a system can be tailored to ensure that the style and type of product is appropriate to the customers of each individual store
- the form and medium for data transfer must be agreed with the suppliers
- alternatively, we could avail of the services of a specialist in this area
- this should help to reduce order processing costs, both for ourselves and our suppliers
- this will help with the integration of our suppliers as discussed above

Overall, these three elements are interdependent and will help to improve the quality of the service we deliver to our customers. This will also help us to expand our customer base. A further element in this is the ability to offer a customer loyalty card and associated customer incentives.

1 mark per valid point, to a MAXIMUM of

6

Total

20

				£	
5 (a)	Materials	WZ954	3g at £4.74 =	14.22	
		RT429	5g at £6.12 =	30.60	
		Other materials		5.01	
				49.83	1
	Opportunity cost of using WZ954	(W1)		11.25	2
	Labour		1.5 hrs at £21 =	31.50	1/2
	Overheads		1.5 hrs at £29 =	43.50	1/2
	Development Costs	(W2)		20.42	1
	Total cost			156.50	1
	Plus Profit (25% margin = 1/3 of cost)			52.17	1
Selling price			208.67	1	
				8	

Working 1

Opportunity cost of WZ954		
Contribution per unit of other product		£15
Each unit produced requires 4g		
∴ Contribution per g =	£15 ÷ 4	£3.75
Each unit of Autolong uses 3g	∴	£11.25

Working 2

Development costs	
Total of development costs	£3,675,000

NB WZ954 is in short supply
Maximum supply of 180,000g is sufficient for 60,000 units

On maximum sales of 60,000 p.a. for three years, the impact of development costs is £3,675,000 ÷ 180,000 = £20.42 per unit

(b) To: Managing Director
From: Management Consultant
Ref: Pricing of Autolong
Date: 5 June 2003

Introduction

This report considers the options available to the company with regard to the initial pricing of Autolong. The report is based on the information provided by the company and the Market Report.

Pricing Policy

There are a number of strategies which the company could adopt in respect of pricing. Two of these (market skimming and market penetration) have been specifically referred to by a Non Executive Director, while the company currently operates a policy of cost plus pricing. Before considering these in detail, it may be useful to provide an overview of the alternatives referred to by the Non Executive Director.

Market Skimming

Essentially this strategy is used to achieve high unit profits in the early stages of a product's life cycle. This is done by charging a high price on entry to the market and stimulating demand through advertising and promotion. As the product enters later stages of its life cycle, the price will be reduced. There are many examples of products which have been brought to market in this way. (Laptop computers, digital cameras, DVD players). The approach essentially 'skims' the profit in the early stages of the life cycle before increased competition leads to lower prices.

Market Penetration

This strategy is based on charging lower prices in order to achieve a high level of penetration into the market and so build market share. This allows economies of scale to be built rapidly so that unit costs can be reduced.

Application to Autodes

Using the company's current policy, the price of the Autolong would be £209. There are two important points to note about this price. The first is that it is well below the upper price limit of £225 referred to in the market report. The second is that it is based on a significant assumption regarding the recovery of development costs.

Development Costs

The company has a policy that development costs should be recovered within the first three years of a product's life cycle. In the case of the Autolog, the fact that the supply of one of the materials (WZ954) is limited, places an upper limit of 60,000 units on the market penetration for the product. As it will be two years before our competitors bring their products to market, we could consider a shorter recovery period.

The indications are that we will be able to sell the full production capacity of 60,000 units in each of the first two years. The impact of this shorter recovery period would be that the costs of £3,675,000 would be recovered over 120,000 units. This would increase the cost of the Autolog by £10.21 to £167. When the profit margin is added the selling price will be increased by almost £14 to £223.

Recommendation

We have a two year window during which we are probably able to sell the full production volume of the product, and also achieve full recovery of the development costs at a price of £223. Market research indicates that the maximum price we can achieve is £225 per unit.

I would recommend a market skimming approach using a price of £223. This will give us the opportunity to reduce our price by around £40 or 18% in order to respond to the entry of our competitors to the market.

Allocation of marks		
Explanation of market skimming		2
Explanation of market penetration		2
Reference to use of cost plus		1
Development costs:		
Discussion of recovery period (2/3 yrs)		2
Calculation of increase if 2 years applied		1
Full recovery, allowing future price decrease		1
Two year window before competition		1
Limitation on production capacity		1
Likely to be able to sell full production		1
Clear recommendation		2
Justification of recommendation		2
Available		<u>16</u>
Maximum		<u>12</u>
Total		20

6 (a)	Localcab	Budget for Year 1 of proposed business model		
	Revenue	(working)	£	
			4,898,208	3
	Costs			
	Drivers' wages	100 drivers at £500 pw x 52 weeks	2,600,000	1
	Payroll Costs	10% of wages	260,000	1/2
	Admin./Advertising	£120,000 + 18%	141,600	1/2
	Contract hire	100 vehicles at £400 pm x 12 mths	480,000	1
	Repairs	100 vehicles at £50 pm x 12 mths	60,000	1/2
	Depreciation	100 vehicles at £2,500 pa	250,000	1/2
	Fuel	£15,563 pw x 48 weeks	747,024	4
	Total Costs	(working)	<u>4,538,624</u>	1
	Profit		<u>359,584</u>	1
				<u>13</u>

(b) Current Profit

	£	
Revenue generated per week 26,880 journeys at £3.70	99,456	
Localcab share at 10%	9,945.60	
x 48 weeks	477,389	
Less Administration/Advertising	120,000	
=	357,389	1
Target profit £357,389 + 20%	428,867	1/2
Budgeted profit	359,584	1/2
Shortfall	69,283	1
Thus profits must increase by £69,283 ÷ 100 per driver p.a. =	£692.83	1
Thus reduction in each driver's wage is:		
(£692.83p.a. x 10/11) ÷ 52 weeks	= £12.11	2
Thus maximum wage payable = £500 - £12.11	= £487.89	1
		<hr/> 7
		<hr/> 20

WORKINGS

Driver by volume category:

	Current		Revised
High	42	+5	47
Low	58	-5	53
	<hr/> 100		<hr/> 100

Number of journeys per week

High	350
Low	210

Driver journeys per week

	Journeys pw	x Number of drivers =		
		Current	Revised	
High	350	14,700	16,450	
Low	210	12,180	11,130	
		<hr/> 26,880	<hr/> 27,580	1

Fuel costs per week:

27,580 journeys at 5 miles each	=	137,900 miles	
at 7 miles per litre	=	19,700 litres	1
at 79p per litre	=	£15,563	1
NB 4th mark is for x by 48 weeks not 52			<hr/> 1
			4

Revenue generated by drivers as employees:

Journeys per week	x	Average fare	= Revenue per week	
27,580		£3.70	£102,046	1
Revenue per week	x	No of weeks	= Revenue per annum	
£102,046		48	£4,898,208	<hr/> 2
				3