

# Diploma in Financial Management

PAPER DA1, INCORPORATING SUBJECT AREAS

- INTERPRETATION OF FINANCIAL STATEMENTS
- PERFORMANCE MANAGEMENT

MONDAY 6 DECEMBER 2004

## QUESTION PAPER

Time allowed **3 hours**

**This paper is divided into three sections**

**Section A** ALL 20 questions are compulsory and MUST be answered

**Section B** THREE questions in total to be answered.

**and** Candidates MUST answer ONE question from

**Section C** Section B, ONE question from Section C and ONE further question from either Section B or Section C.

**Do not open this paper until instructed by the supervisor**

**This question paper must not be removed from the examination hall**

The Association of Chartered Certified Accountants

# Module A



**Section A – All 20 questions are compulsory and MUST be attempted.**

Each question in this Section is worth 2 marks.

Please use the Candidate Registration Sheet provided to indicate your chosen answer to each multiple choice question.

**1 Which one of the following best describes the role of the external auditor?**

- A to calculate the profit for the period
- B to provide information to the stock market
- C to express an opinion on the financial statements
- D to confirm that the financial statements are accurate

**2 Consider the following statement:**

‘a reduction in the monetary value of economic benefits which the entity has received in the last accounting period.’

**Which one of the following is described by the statement?**

- A an asset
- B a liability
- C a gain
- D a loss

**3 When reviewing the draft financial statements, the Finance Director of Harlequinne Ltd discovered that no provision had been made for consultancy fees incurred in respect of a proposed investment.**

**How will the profit and net assets reported in the financial statements be affected when the provision is made?**

|   | <b>Profit</b> | <b>Net assets</b> |
|---|---------------|-------------------|
| A | increase      | increase          |
| B | increase      | decrease          |
| C | decrease      | increase          |
| D | decrease      | decrease          |

**4 The directors of Clonadde plc wish to report a profit on the sale of a machine and also an increase in the value of a building.**

**Which one of the following is correct?**

- A both are recognised gains
- B both are realised gains
- C only the sale of the machine is a recognised gain
- D only the increase in value of the building is a recognised gain

**5 The draft profit and loss account of Thermin Ltd for the year ended 30 November 2004 shows an operating profit of £325,800. This includes:**

- a restructuring charge of £85,000; and
- an adjustment of £42,000 to correct the value of opening stock. An error at the previous year end had led to the stock being over-valued.

**What is the correct operating profit for the year ended 30 November 2004?**

- A £282,800
- B £325,800
- C £368,800
- D £452,800

- 6 In the year to 31 October 2003 Cyanne Ltd acquired a fixed asset which cost £88,000. The company's policy is to depreciate fixed assets at a rate of 25%, on the reducing balance basis.

When preparing the financial statements for the year to 31 October 2004, the accountant calculated the depreciation charge on the straight line basis using a nil residual value.

**How will the reported profit for the year to 31 October 2004 be affected when the depreciation charge is corrected?**

- A reduced by £5,500
- B increased by £5,500
- C reduced by £16,500
- D increased by £16,500

- 7 The price of a raw material used by Diska Ltd is volatile. At the close of business on 30 November 2004, the company had 430 kg of the material in stock. At 1 November there had been none of the material in stock. The movements in November were:

| Date   | Receipts             | Issues |
|--------|----------------------|--------|
| 4 Nov  | 800 kg at £45 per kg |        |
| 12 Nov |                      | 650 kg |
| 19 Nov | 700 kg at £52 per kg |        |
| 23 Nov |                      | 720 kg |
| 28 Nov | 300 kg at £60 per kg |        |

**Using the first in first out (FIFO) method of stock valuation, what is the value of the stock of the material at 30 November 2004?**

- A £21,596
- B £23,850
- C £24,760
- D £25,800

- 8 On 7 November 2004 there was a fire in the storeroom of Yorkfab Ltd, in which stock valued at £120,000 was destroyed. This represented 30% of the company's stock. Due to a clause in the insurance contract, the insurance company has stated that it will only pay out the first £30,000 of the claim.

**How should this be reported in the financial statements for the year to 31 October 2004?**

- A nothing needs to be reported in the financial statements for the year to 31 October 2004
- B no charge in the profit and loss account and a note disclosing a loss of £90,000
- C no charge in the profit and loss account and a note disclosing a loss of £30,000
- D charge of £90,000 to the profit and loss account

- 9 At 30 November 2004 the net book value of the fixed assets of Reynard Ltd was £3,570,000 and the tax written down value was £2,450,000. The provision for deferred tax brought forward was £250,000.

The tax rate is 22%.

**What should be reported in the profit and loss account in respect of deferred tax?**

(You may ignore discounting)

- A a credit of £3,600
- B a charge of £3,600
- C a credit of £246,400
- D a charge of £246,400

- 10** On 20 November 2004, Clifdan Ltd received a letter from a customer about damage caused by one of Clifdan's products, and claiming £250,000 in compensation. The company secretary of Clifdan wrote to the customer accepting liability and offering £100,000 as compensation. The customer refused this offer and has issued a writ against Clifdan. Clifdan's legal advisors have stated that the case is unlikely to come to court for at least nine months. The legal representatives have also stated that the court is likely to award total compensation of £150,000.

**What amount should be provided for the claim in the financial statements of Clifdan for the year to 31 December 2004?**

- A** nil
- B** £100,000
- C** £150,000
- D** £250,000

- 11** Benown Ltd manufactures a single product which has a variable cost of £17 and currently sells for £30. The budgeted sales volume is 25,000 units per month and the budgeted fixed costs are £250,000 per month. The divisional manager is considering reducing the price to £27 to stimulate sales. He also wishes to increase the monthly profit by 10%.

**What volume of sales is required at the new selling price to increase profit by 10%?**

- A** 19,559
- B** 32,250
- C** 33,250
- D** 43,250

- 12** Clobber Ltd uses a scarce material in its manufacturing process. There are currently 200 metres of the material in stock, which cost £20 per metre. All of this will be used to meet ongoing production requirements. Each metre used in production will generate a contribution of £23. Further supplies can be obtained at a cost of £25 per metre. Clobber has received a one-off order which would require 120 metres of the material, and a customer has asked if Clobber would be willing to sell 150 metres at a price of £22 per metre.

**What price per metre should be used to calculate the cost of the one-off order?**

- A** £20
- B** £22
- C** £23
- D** £25

- 13** Which one of the following is most likely to be the reason for a favourable labour efficiency variance?

- A** an ideal standard was used as part of a quality improvement programme
- B** a shortage of skilled staff meant that more trainees had been recruited
- C** lower grade material was purchased
- D** staff have recently been trained in material handling techniques

- 14** The plastics division of Ladmar plc has just reported a divisional return on capital employed of 30% for the last twelve months. The capital employed in the plastics division is £1,200,000. The company's overall return on capital employed is 18%, and the overall cost of capital is 14%. The plastics division's cost of capital is 13%.

**What is the plastic division's residual income?**

- A** £144,000
- B** £192,000
- C** £204,000
- D** £360,000

- 15** Consider the following statements about Activity Based Management (ABM):
- (i) Activity Based Costing is a necessary prerequisite for ABM.
  - (ii) The primary aim of ABM is a reduction in direct costs.

**Which of the following combinations (true/false) is correct?**

|          | Statement (i) | Statement (ii) |
|----------|---------------|----------------|
| <b>A</b> | True          | False          |
| <b>B</b> | False         | True           |
| <b>C</b> | True          | True           |
| <b>D</b> | False         | False          |

- 16** Eamon Attwood must choose between four mutually exclusive projects, all of which require the same initial investment. He has prepared the following payoff matrix:

|           | Annual Contribution if market demand is: |                  |                |
|-----------|--|------------------|----------------|
|           | Weak<br>£000                             | Moderate<br>£000 | Strong<br>£000 |
| Project A | 32                                       | 48               | 61             |
| Project B | 41                                       | 54               | 70             |
| Project C | 47                                       | 57               | 68             |
| Project D | 25                                       | 36               | 41             |

**If Eamon uses the maximin decision rule, which project will he choose?**

- A** Project A
- B** Project B
- C** Project C
- D** Project D

- 17 Which one of the following statements is correct?**

- A** Manufacturing Resource Planning provides no motivation for managers to eliminate bottlenecks in production
- B** A key objective of Optimised Production Technology is to maximise throughput, while minimising stock holding
- C** Manufacturing Resource Planning and Optimised Production Technology are essentially the same
- D** Optimised Production Technology does not take account of known constraints within the production process

- 18** Consider the following statements about pricing policies:

- (i) a pricing policy which is appropriate when the price sensitivity of demand is unknown
- (ii) a pricing policy which is likely to discourage competitors from entering the market
- (iii) a pricing policy which is likely to encourage competitors to enter the market

**Which of the following combinations of the statements can apply to market skimming?**

- A** (i) and (ii)
- B** (i) and (iii)
- C** (i) only
- D** none of the statements

- 19 The calculation of Economic Value Added (EVA®) is based on an assessment of net operating profit after tax (NOPAT). The accounting policy of Balhay Ltd is to write off all expenditure on R&D in the period in which it was incurred, and to charge operating lease rentals against profit.

**How should Balhay Ltd treat R&D and operating lease rentals to calculate NOPAT?**

|          | <b>Expenditure on R&amp;D</b>     | <b>Operating lease rentals</b>    |
|----------|-----------------------------------|-----------------------------------|
| <b>A</b> | add to operating profit           | add to operating profit           |
| <b>B</b> | add to operating profit           | no adjustment to operating profit |
| <b>C</b> | no adjustment to operating profit | add to operating profit           |
| <b>D</b> | no adjustment to operating profit | no adjustment to operating profit |

- 20 The manufacturing process of Rowl Ltd involves two stages, each of which is carried out in a separate profit centre. All output from the machining profit centre is transferred immediately to the assembly profit centre, and the production flow is balanced. The budgeted sales volume is 120,000 units at a price of £26 per unit. Budgeted costs are:

|                | <b>Machining</b> | <b>Assembly</b> |
|----------------|------------------|-----------------|
| Variable costs | £6 per unit      | £4 per unit     |
| Fixed costs    | £525,000         | £350,000        |

The transfer price is set at variable cost, plus 150%.

**What is the budgeted profit for each profit centre?**

|          | <b>Machining</b> | <b>Assembly</b> |
|----------|------------------|-----------------|
| <b>A</b> | £487,500         | £2,050,000      |
| <b>B</b> | £522,500         | £522,500        |
| <b>C</b> | £555,000         | £490,000        |
| <b>D</b> | £555,000         | £2,290,000      |

**(40 marks)**

**Section B – Candidates MUST attempt ONE question from Section B, ONE question from Section C and ONE further question from either Section B or Section C.**

- 1** You are the Financial Director of a company which is listed on the Stock Exchange. The Board of Directors is due to meet shortly to consider the first set of financial statements since the listing. The Commercial Director has noted that the financial statements now include both an Operating and Financial Review (OFR) and a Five Year Summary. As these were not included in the previous financial statements, he has questioned their usefulness.

You have been asked to draft a report to the Commercial Director in advance of the Board meeting.

**Required:**

**Draft a brief report to the Commercial Director, which:**

- (a) describes the main features of the OFR, and indicates how these features are likely to provide benefits to the users of financial statements;** (12 marks)
- (b) discusses the usefulness of the Five Year Summary, and suggests one improvement which would make it more useful to the users of financial statements;** (4 marks)
- (c) discusses whether the OFR and Five Year Summary should be a requirement for all companies.** (4 marks)

**(20 marks)**

- 2 As the newly appointed Company Accountant of Flowline Ltd, you have been asked to report to the Board of Directors on the company's cash situation. The Directors are concerned that, although generating cash was one of the key objectives of the last year, the company has actually consumed cash. You have prepared the balance sheet at 30 November 2004 and this is shown below together with the comparative figures for 2003 along with information extracted from the profit and loss account for the year to 30 November 2004:

|  | 2004    |             | 2003    |             |
|--|---------|-------------|---------|-------------|
|  | £       | £           | £       | £           |
| Fixed Assets   |         | 849,162     |         | 853,962     |
| Current Assets   |         |             |         |             |
| Stock  | 97,593  |             | 84,829  |             |
| Debtors  | 176,041 |             | 157,494 |             |
| Cash at Bank   | —       | 273,634     | 5,480   | 247,803     |
|  | <hr/>   | <hr/>       | <hr/>   | <hr/>       |
| Creditors: amounts falling due within one year           |         |             |         |             |
| Creditors  | 137,065 |             | 128,569 |             |
| Interest   | 3,000   |             | 3,000   |             |
| Tax  | 9,000   |             | 25,700  |             |
| Dividends  | 5,000   |             | 9,000   |             |
| Bank overdraft   | 11,464  | 165,529     | —       | 166,269     |
|  | <hr/>   | <hr/>       | <hr/>   | <hr/>       |
| Net Current Assets                                       |         | 108,105     |         | 81,534      |
| 4% Debentures  |         | 150,000     |         | 150,000     |
|  |         | <hr/>       |         | <hr/>       |
|  |         | 807,267     |         | 785,496     |
|  |         | <hr/> <hr/> |         | <hr/> <hr/> |
| <i>Financed by:</i>                                      |         |             |         |             |
| Ordinary shares of £1 each                               |         | 400,000     |         | 400,000     |
| Share Premium  |         | 40,000      |         | 40,000      |
| Profit and Loss Account                                  |         | 367,267     |         | 345,496     |
|  |         | <hr/>       |         | <hr/>       |
|  |         | 807,267     |         | 785,496     |
|  |         | <hr/> <hr/> |         | <hr/> <hr/> |
| Profit and Loss Extracts:                                |         | £           |         |             |
| Depreciation Charge                                      |         | 15,800      |         |             |
| (NB there were no disposals of fixed assets in the year) |         |             |         |             |
| Tax charge   |         | 9,000       |         |             |
| Interest charge  |         | 6,000       |         |             |
| Dividends declared                                       |         | 5,000       |         |             |

**Required:**

- (a) Prepare Flowline's Cash Flow Statement for the year to 30 November 2004 (15 marks)
- (b) Identify the main issues which are apparent from the Cash Flow Statement and suggest actions the company might take to improve cash flow. (5 marks)

**(20 marks)**



- 3** You are a non-executive director of Harbinger plc. The company agreed to acquire 30% of the ordinary share capital of Ameer Ltd at a cost of £290,000 on 1 December 2004. The goodwill arising on the acquisition is to be amortised over five years.

Under the terms of the acquisition, Harbinger will treat Ameer as an associated undertaking, and as such, the Managing Director of Harbinger has become a director of Ameer. You have been asked to advise the directors of Harbinger on the effect of the acquisition on the financial statements.

For the purpose of the acquisition, the balance sheet of Ameer at 1 December 2004 has been agreed as follows:

|                            | <b>£000</b> |
|----------------------------|-------------|
| Fixed assets               | 890         |
| Net current assets         | 140         |
| Long-term liabilities      | (280)       |
|                            | —           |
|                            | 750         |
|                            | ====        |
| Ordinary shares of £1 each | 500         |
| Share premium              | 25          |
| Retained profit            | 225         |
|                            | —           |
|                            | 750         |
|                            | ====        |

Harbinger's year end is 30 November. It is estimated that in the year to 30 November 2005, Ameer will report a retained profit of £80,000, and that there will be no other changes to the capital and reserves of the company.

**Required:**

**(a) Calculate:**

- (i) the goodwill arising on the acquisition of the shares in Ameer; and (2 marks)
- (ii) the unamortised value of the goodwill at 30 November 2005. (2 marks)

**(b) Calculate how the net assets and capital and reserves reported on the Balance Sheet will be affected by the need to include the investment in:**

- (i) Harbinger's financial statements for the year to 30 November 2005; and (2 marks)
- (ii) the consolidated financial statements for the year to 30 November 2005. (6 marks)

**(c) Describe how the accounting treatment would differ if the investment gave rise to control. (8 marks)**

**(20 marks)**

**Section C – Candidates MUST attempt ONE question from Section B, ONE question from Section C and ONE further question from either Section B or Section C.**

**4** You are a member of the management team of Oxbrary Ltd. The company employs 475 people operating call centres on five sites. Each site has a specific list of clients. The company’s business is divided into two divisions – Outbound and Inbound, each of which is overseen by a Divisional Director. Both divisions operate from each site.

The Outbound Division ‘cold calls’ customers and potential customers on behalf of clients. Depending on the nature of the client’s business, the section’s objective is to produce either a list of appointments for follow up by the client’s sales team, or to complete the sale.

The Inbound Division receives calls from customers and acts as the ‘Customer Services’ department for clients. The calls are mainly of a technical nature – for example: solving problems in the operation of computer, hi-fi and home entertainment products; processing of insurance claims; arranging deliveries.

The directors have decided in principle to introduce incentive schemes throughout the company. The management team is considering how this may be done in the most effective manner, and a profit based bonus has been suggested.

In particular, there is uncertainty as to whether the resulting bonus should be based solely on the company’s reported profit or whether other variables should be included in the calculation. You have agreed to prepare a briefing paper for consideration at the next meeting of the management team.

**Required:**

**Prepare a briefing paper which:**

- (a) discusses the benefits and drawbacks of using the company’s reported profit as the sole criterion in the bonus calculation, as opposed to including a wider range of variables; and** (8 marks)
- (b) identifies two other types of incentive scheme which might be introduced, and briefly discusses the potential benefits of each; and** (6 marks)
- (c) discusses the potential problems of introducing any incentive scheme and indicates how these can be overcome.** (6 marks)

**(20 marks)**

- 5 Egerton Manufacturing Ltd produces a range of products at seven separate sites. Each site produces a maximum of four products. The directors have decided to introduce Activity Based Costing (ABC) and have asked each site manager to obtain and analyse the relevant data for their site. Product costs are currently calculated using absorption costing, with overheads being absorbed on a machine hour basis. As part of the process of introducing ABC, the directors wish to assess the profitability of individual products, with the possibility that the product range may be reduced. You are the Manager of the Brumley site and you have obtained the following data:

| Product                  | A      | B   | C      |
|--------------------------|--------|-----|--------|
|                          | £      | £   | £      |
| Selling price per unit   | 300    | 530 | 435    |
| Direct material per unit | 55     | 67  | 98     |
| Direct labour per unit   | 41     | 54  | 57     |
| Overheads per unit       | 117·20 | 293 | 117·20 |
| Total cost per unit      | 213·20 | 414 | 272·20 |

|                                  |           |           |           |
|----------------------------------|-----------|-----------|-----------|
| Budgeted production volume       | 600 units | 400 units | 200 units |
| Machine hours per unit           | 0·6       | 1·5       | 0·6       |
| Production runs in period        | 32        | 40        | 25        |
| Number of sales orders           | 19        | 5         | 15        |
| Number of deliveries of material | 8         | 2         | 16        |

The budgeted overheads of the site for the period are:

|                         |         |
|-------------------------|---------|
| Machine running costs   | £78,560 |
| Set up costs            | £82,900 |
| Material handling costs | £49,500 |

Machine hours are limited to 1,140 hours per period.

**Required:**

**(a) Calculate the cost of each product using ABC.** (12 marks)

**(b) Draft a memo to the Managing Director which:**

**(i) using the ABC information, indicates which product(s) should no longer be manufactured and justifies your recommendation;** (4 marks)

**(ii) discusses the other factors which should be considered before a final decision is made.** (4 marks)

**(20 marks)**

**6** You are a Business Consultant with a local enterprise agency. Your role is to provide assistance to both new and established local businesses.

You have been approached by Rodney Short who proposes to establish a tree maintenance business, commencing on 1 February 2005. Rodney has asked for your help in preparing a monthly cash budget in support of an application for a £15,000 bank loan.

In particular, Rodney wants to know if the loan will provide sufficient funds for the first six months of the business, and if there is any action he should take to reduce the total funding required.

From discussion with Rodney you have noted:

- (i) Nine staff will be employed. One of these will be an administrator and the others, along with Rodney, will provide the service to customers.
- (ii) The administrator will be paid £15,000 per annum and the other staff will be paid £8 per hour for a 5 day, 35 hour week. Rodney will be paid a salary of £20,328 per annum.
- (iii) For planning purposes, each calendar month is to be treated as including 22 working days, before holidays.
- (iv) In the first six months of operation, the business will close for the following holidays:
  - Spring – three days in April
  - May – one day
  - Summer – two weeks in JulyStaff will be paid for all of these holidays.
- (v) Employment related costs will be 12% of gross pay.
- (vi) There will be two types of customer: contract and domestic.
- (vii) Rodney has negotiated three contracts which will require an average of 25 man-days in total each month.
- (viii) Domestic customers will pay in cash on completion of the agreed work, while contract customers will be allowed credit. Rodney expects that all contract customers will pay in the second month following the issue of his invoice.
- (ix) Customers will be charged £20 per man hour, with a 10% discount to contract customers.
- (x) Rodney anticipates that staff utilisation will be 70% for the first two months of operation, increasing to 80% in the third and fourth months, and 90% thereafter.
- (xi) The required equipment and lorry will be leased. The leasing rental will be £13,500, paid every three months in advance.
- (xii) Operational costs will be:
  - Rent – £13,000 per annum, payable half yearly in advance;
  - Other overheads – £1,500 per month, paid monthly in arrears.

**Required:**

**(a) Prepare Rodney's cash budget for each of the first six months of his business, showing the cash flows and the opening and closing balance of cash for each month.** (14 marks)

**(b) Draft a letter to Rodney, which advises him:**

- (i) whether or not the proposed loan will provide sufficient funds for the first six months of operation;**
- (ii) what action he could take to reduce the total funding requirement.** (6 marks)

**(20 marks)**

**End of Question Paper**