

Diploma in Financial Management

PAPER DA1, INCORPORATING SUBJECT AREAS

- INTERPRETATION OF FINANCIAL STATEMENTS
- PERFORMANCE MANAGEMENT

MONDAY 7 JUNE 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 twenty 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 The published financial statements of most companies include the following:
- (i) Directors' Report
 - (ii) Auditors' Report
 - (iii) Chairman's Report

Which combination of the above is required by the Companies Act?

- A (i) (ii) and (iii)
- B (i) and (ii)
- C (ii) and (iii)
- D (i) and (iii)

- 2 **Which one of the following statements correctly describes the primary role of the International Accounting Standards Board?**

- A Reviewing Financial Reporting Standards for international acceptance
- B Identifying problems in international application of Financial Reporting Standards
- C Issuing accounting standards for international application
- D Converting financial statements from UK GAAP to International GAAP

- 3 A quoted company will normally make a preliminary announcement of results to the Stock Exchange.

What is the reason for a preliminary announcement?

- A To advise the market of the expected results
- B To ensure that the share price is maintained
- C To ensure that press coverage is maximised
- D To communicate the results as quickly as possible

- 4 Aeon Ltd uses the First In First Out (FIFO) method of stock valuation, whilst Baco Ltd uses the weighted average method. Over the last year, the unit cost of items purchased has been falling. There are no other factors to consider regarding the stock turnover ratio derived from the published accounts.

Which of the following statements regarding the stock turnover ratio is correct?

- A Aeon will have a shorter stock turnover period than Baco
- B Baco will have a shorter stock turnover period than Aeon
- C The stock turnover period for both companies will be the same
- D The method of stock valuation will not affect stock turnover

- 5 The balance sheet of Caman Ltd includes the following reserves:

	£000
Retained profit	1,360
Share premium	250
Revaluation reserve	420
General reserve	630

What is the maximum amount which the directors of Caman Ltd may distribute as dividends?

- A £1,360,000
- B £1,990,000
- C £2,410,000
- D £2,660,000

6 During the last three years Harvert Ltd had held 400,000 ordinary shares in Jamee Ltd. The issued share capital of Jamee Ltd is £500,000 in shares of 50p each. The finance director of Harvert Ltd is a director of Jamee Ltd.

How should the investment in Jamee Ltd be treated in the consolidated financial statements of Harvert Ltd?

- A As a fixed asset investment
- B As a current asset investment
- C As an associated undertaking
- D As a subsidiary

7 The draft accounts of Dalot Ltd report current assets of £275,000 and current liabilities of £210,000. The chief accountant has noted that when the draft accounts were prepared, the deferred tax provision was incorrectly calculated using the partial provision basis. The correct calculation using the full provision basis requires an increase in the deferred tax provision of £75,000.

What is the company's current ratio, following the required adjustment to the deferred tax provision?

- A 0.96:1
- B 1.31:1
- C 1.67:1
- D 2.00:1

8 The finance director of Optune Ltd has calculated that the corporation tax liability on the profits for the year to 31 May 2004 is £275,800. The provision reported on the balance sheet at 31 May 2003 was £216,900. When the liability was agreed, there was an under-provision of £7,860. The required payment was made in January 2004.

What amount should be reported in Optune's Cash Flow Statement for the year to 31 May 2004 for corporation tax?

- A £209,040
- B £224,760
- C £267,940
- D £283,660

9 **Which of the following statements is correct?**

- A Profit is the amount by which the value of assets has increased during the year
- B Profit is the amount by which the value of liabilities has increased during the year
- C Profit is not related to changes in the value of assets and liabilities
- D Profit is the amount by which the increase in the value of assets exceeds the increase in the value of liabilities during the year.

10 Holmbron Ltd currently has £3.25 million of debentures in issue. The directors plan to redeem £1.1 million of the debentures at par at the year end by issuing 1 million ordinary shares of £1 each at a premium of 10p per share. The finance director has estimated that by the year end the total value of equity, before the proposed issue of shares, will be £10.22 million, resulting in a gearing ratio of 31.8%.

How will the company's gearing ratio be affected by the proposed issue of shares?

- A** Reduced to 18.99%
- B** Reduced to 21.04%
- C** Reduced to 28.71%
- D** Remains at 31.8%

11 Which of the following items should be included in a cash budget?

- (i) loan repayments
- (ii) depreciation charge
- (iii) tax provision
- (iv) wages paid

- A** (i) and (ii)
- B** (i) and (iv)
- C** (ii) and (iii)
- D** (iii) and (iv)

12 Which of the following is/are necessary for the successful operation of a Just in Time purchasing system?

- (i) long-term contracts with suppliers
- (ii) a reliable forecast of the level of demand
- (iii) an effective quality assurance programme

- A** (i) only
- B** (ii) only
- C** (iii) only
- D** (i) (ii) and (iii)

13 Consider the following statements:

- (i) outsourcing always leads to short term cost savings
- (ii) outsourcing normally reduces the risk of under-utilisation of resources

Which of the following combinations is correct?

	Statement (i)	Statement (ii)
A	True	False
B	False	True
C	True	True
D	False	False

- 14 The production director of Discology Ltd is seeking to improve:
- (i) time taken to respond to customer orders
 - (ii) utilisation of raw materials

Which of the objectives will be met through supply chain management?

- A (i) only
- B (ii) only
- C (i) and (ii)
- D neither (i) nor (ii)

The following information is relevant to questions 15 and 16:

The management team of Hillcrest Ltd uses the 'maximin' decision rule. The following data relates to four mutually exclusive projects, each of which will incur the same level of fixed costs:

	Expected contribution – based on level of demand		
	Low	Moderate	High
	£000	£000	£000
Project 246	720	790	820
Project 123	740	815	870
Project 369	590	645	705
Project 468	400	510	630

A new non-executive director has questioned whether the 'maximin' decision rule is appropriate. He has made the following observations:

- (i) the 'maximin' decision rule is defensive
- (ii) the 'maximin' decision rule ignores opportunities for higher profits
- (iii) the 'maximin' decision rule does not consider the probabilities of each outcome

15 Using the 'maximin' decision rule, which project should be selected?

- A 246
- B 123
- C 369
- D 468

16 Which of the non-executive director's observations are correct?

- A (i) and (ii)
- B (i) and (iii)
- C (ii) and (iii)
- D (i) (ii) and (iii)

17 Amelpa Manufacturing Ltd manufactures a range of industrial products. The budgeted costs of the maintenance section for the current twelve month period have been analysed as follows:

Routine maintenance	£151,000
Production line set up	£ 42,000
Total	£193,000

The budget was prepared on the basis that there will be 720 set ups and that 10,080 machine hours will be worked. The company has received an enquiry for an order which requires three set ups and will take 56 machine hours.

How much (to the nearest £1) should be included in the cost of the order in respect of maintenance costs?

- A £804
- B £1,014
- C £1,072
- D £4,106

18 Which one of the following is most likely to be the explanation for an adverse material usage variance?

- A A major supplier of material has reduced the rate of trade discount
- B Rates of pay have been increased
- C Quality standards have been increased
- D Unforeseen material price rises have been incurred

19 Cornaur Products uses a scarce material in the manufacture of four products.

Data per unit of each product is shown below:

	Y	W	S	E
Selling price	£38.72	£29.86	£41.17	£31.25
Variable cost	£30.58	£25.56	£34.19	£20.53
Material input	1.7kg	1.5kg	1.9kg	1.6kg

In the next period, insufficient material will be available to manufacture all four products and therefore one product must be discontinued.

In order to maximise short-term profit, which product should be discontinued?

- A Y
- B W
- C S
- D E

20 The accounts of Arban Ltd for the three month period to 31 May 2004 show a profit after tax of £726,580. The managing director wishes to assess performance using Economic Value Added (EVA (®)). The finance director has provided the following data:

Value of assets employed:	Net book value	£4,759,600
	Economic value	£5,200,000
Cost of capital		11% per annum

What is the EVA (®) for the three month period to 31 May 2004?

- A £154,580
- B £203,024
- C £583,580
- D £595,691

(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 Fasset Ltd, a recently established company. The directors are due to meet to agree on the company’s accounting policies. At the last meeting, the Board agreed that the key areas on which decisions will be made are:

- Research and development expenditure
- Depreciation of fixed assets
- Revaluation of fixed assets

The directors agreed on two main objectives for the company’s financial reporting. These are:

- 1 the information in the financial statements should be presented in a manner that ensures it will be useful to users
- 2 consistent with the first objective, where there is a degree of choice open to the directors, the accounting policy will be chosen in order to maximise reported profit.

You have decided to present a written submission on these points to the directors at the next Board meeting.

Required:

Prepare your submission to the Board meeting, which should:

(a) explain the qualities of financial information which are necessary if such information is to be useful to users; (8 marks)

(b) indicate, for each of the three key areas on which decisions will be made:

(i) the choices which are available to the directors; and (8 marks)

(ii) the effect of the choices on reported profit. (4 marks)

(20 marks)

- 2** The directors of Lessons Ltd have approved the acquisition of a new machine at a cost of £224,480. The machine will be used to manufacture a new product. A leasing company has agreed to provide finance for the acquisition under a leasing arrangement.

The finance director of Lessons Ltd has been asked to report to the board on how the company's financial statements will be affected by the leasing arrangement. As a member of the finance team, you have been asked to prepare a draft response to the board.

You have the following information:

- the company's policy is to charge depreciation on the straight line basis
- depreciation is calculated monthly
- the new machine is expected to be brought into use on 1 July 2004
- it will have a useful economic life of 5 years with a negligible scrap value
- the first sales of the new product will not take place until November 2004
- running costs are forecast to be £15,000 per month
- the lease terms are:
 - Lease period 4 years
 - Payments £24,000 in advance, followed by 16 payments of £15,500 each. These payments are to be made every three months in arrears.

Lessons Ltd will be responsible for maintaining and insuring the machine.

Notes:

You may ignore taxation.

The finance cost of the lease should be allocated to accounting periods on a straight line basis.

Required:

- (a) Explain the correct accounting treatment for the proposed lease arrangement.** (9 marks)
 - (b) Calculate how the proposed lease arrangement will be reported in Lessons Ltd's:**
 - (i) profit and loss account for the year to 30 September 2004; and** (5 marks)
 - (ii) balance sheet at 30 September 2004.** (6 marks)
- (20 marks)**

3 You are a member of staff in the Corporate Communications Section of a public limited company. The company offers shareholders a question and answer service via the internet.

You have received the following e-mail enquiry from a shareholder:

I have been looking at the company's annual financial statements for last year and find myself overwhelmed by the sheer volume of information.

In particular I find it difficult to understand:

- why the financial statements include both a Profit and Loss Account and a Statement of Total Recognised Gains and Losses;
- what types of items are included in each of these reports;
- the significance of the figure for earnings per share;
- how earnings per share is calculated.

I would be grateful if you could explain these items to me.

You have decided that before replying, it would be a good idea to check the calculation of earnings per share and the preparation of the Statement of Total Recognised Gains and Losses as included in the Financial Statements. You have extracted the following information:

	£m
Profit on ordinary activities before taxation	15.4
Taxation	3.7

Profit on ordinary activities after taxation	11.7
Dividends: Preference	4.0
Ordinary	2.4

Retained profit for the year	5.3

At the beginning of the year, there were 10 million ordinary shares of £1 each in issue. Three months before the year end, a further 2 million £1 shares were issued at a price of £2.75 each.

During the year, the company revalued its properties from £1.2 million to £1.8 million. It was also discovered that an error in the computer system led to stock at the previous year end being over-valued by £1.2 million. The error had been corrected by the year end.

Required:

(a) Draft a reply to the shareholder, which:

- (i) explains why the company is required to prepare both a Profit and Loss Account and a Statement of Total Recognised Gains and Losses, giving TWO examples of items which will be reported in each; and** (8 marks)
- (ii) explains the significance of, and the basis of the calculation of, the figure to be reported for earnings per share.** (4 marks)

(b) Calculate the earnings per share figure which should be reported on the face of the Profit and Loss Account. (3 marks)

(c) Prepare the Statement of Total Recognised Gains and Losses. (5 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 Musent Ltd is a UK based manufacturer of domestic and in-car entertainment systems. The company has developed and patented a new product, the digital media unit (dmu). This product will provide an alternative to multi-changer CD systems by burning the equivalent of up to 60 CDs onto the dmu. The dmu can then be incorporated into either a domestic or in-car sound system for playback.

A new division has been set up to manufacture the dmu. This division will sell to both the domestic and in-car manufacturing divisions within Musent. Because of the competitive advantage Musent will derive from the unique nature of the dmu, there are no plans to sell to external customers.

As a Business Development Manager, you have been given the task of establishing the basis for trading between the dmu manufacturing division and the domestic and in-car manufacturing divisions. As part of this process, you have agreed to circulate a briefing paper highlighting the key issues which must be considered.

Required:

Draft a briefing paper which:

- (a) **describes three bases which could be used to calculate the transfer price of the dmu from the dmu division to the domestic and in-car divisions;** (7 marks)
 - (b) **identifies three problems which Musent may encounter in establishing and using a transfer price;** (6 marks)
 - (c) **assesses the extent to which each of the bases you have identified in part (a) is likely to be suitable for Musent.** (7 marks)
- (20 marks)**

- 5 You are part of a project team working on the development of an improved design for the warning system for a passenger ferry. This project has been given the code PF201. An impending change in legislation means that a modification to the fire warning system is required. This modification will add £2.4m to the development costs and will also require an engineering team to be transferred from another project (BR156) which is close to completion. The engineering team will be required to work on the ferry project for four weeks at cost of £112,500 per week. The transfer of the team will delay the completion of project BR156, reducing the number of units which will be sold. Data relating to the two projects is given below:

Project	Note	PF201	BR156
Cost to date	1	£3.35m	£32.86m
Costs to complete	2	£31.14m	£0.75m
Expected sales volumes (units):			
Year 1	3	40	25
Year 2		55	30
Year 3		50	20
Selling price per unit		£1.43m	£2.86m
Variable cost per unit		£1.12m	£1.96m
Standard hours per unit	4	700	1,100

Note 1 It is the company's policy to recover development costs over the first three years of a project's life. If the project is abandoned, costs incurred to date cannot be recovered and must be written off against profit in the accounting period in which the project is abandoned.

Note 2 The costs relating to Project PF201 are before the transfer of the engineering team.

Note 3 Expected sales volumes do not take into account the effect of the transfer of the engineering team. The delay resulting from the transfer of the engineering team is expected to lead to a loss of the sale of three units of Project BR156 in the first year. The sale of these units will not be recovered in subsequent periods.

Note 4 The company absorbs fixed costs on the basis of standard hours at a rate of £100 per standard hour.

The project manager has shown you a memo from the Managing Director which includes the following comments:

'You will be aware that the company requires all projects to generate a profit over the first three years in which sales are made. The calculation of profit should include the full write off of development costs. When external factors lead to a major change in the resources required for a project, a revised assessment should be carried out. This is to establish if the profit objective is still likely to be achieved. Such an assessment should take full account of sunk costs and opportunity costs. If the revised assessment indicates that the project will not generate a profit over the first three years, it should not be continued.'

Please let me have your assessment of Project PF201, based on these criteria.'

The project manager does not know what is meant by the terms 'sunk costs' and 'opportunity costs'. He has asked you to explain these terms and to prepare the revised assessment.

Required:

(a) Define, and in relation to Project PF201, give an example of:

- (i) **sunk cost** (3 marks)
- (ii) **opportunity cost** (2 marks)
- (iii) **relevant cost** (2 marks)

(b) Prepare the revised assessment of Project PF201, and indicate whether or not it should be continued.

(13 marks)

(20 marks)

6 Ballyskeagh Fabricated Products (BFP) manufactures a wide range of internally designed products. Sales, which are difficult to forecast, are made to trade customers through the company's website and catalogues. Updated catalogues are mailed to customers every three months. The company has a wide customer base, mainly due to its promise that all orders will be filled within two weeks.

BFP has been invited to submit proposals which, if accepted, would lead to the company becoming the preferred supplier to a major customer. This proposal would lead to BFP's design team working closely with the customer's design team to agree product specifications. At a recent staff briefing, the Board of Directors indicated their intention to achieve preferred supplier status, and to reduce the number of products sold to existing customers. They expect this to provide a number of benefits, including:

- greater certainty with regard to sales levels;
- a reduction in stock levels;
- improved cash flow.

The directors also indicated that the ability to forecast sales and cash flow would enable them to offer a long term wages agreement, providing guaranteed increases in wages over a four year period. They pointed out that the proposal would lead to a fundamental shift in the production process from the current model in which stocks are maintained at a level which ensures that the 'two week promise' can be met, to a just in time model. They have asked for suggestions as to how this might be achieved.

You are the finance member of the project group which has been set up to manage the change in production. A brainstorming session resulted in a number of suggestions including: Materials Requirements Planning, Manufacturing Resource Planning and Optimised Production Technology. You have agreed to summarise the issues to enable the group to consider the implications of these suggestions at the next meeting.

Required:

In preparation for the next project group meeting, draft brief notes which:

- (a) explain:**
 - (i) materials requirements planning;** (4 marks)
 - (ii) manufacturing resource planning;** (4 marks)
 - (iii) optimised production technology; and** (4 marks)
 - (b) differentiate between these techniques; and** (2 marks)
 - (c) outline the problems which BFP may encounter in achieving preferred supplier status.** (6 marks)
- (20 marks)**

End of Question Paper