

Diploma in Financial Management

PAPER DA1, INCORPORATING SUBJECT AREAS

- INTERPRETATION OF FINANCIAL STATEMENTS
- PERFORMANCE MANAGEMENT

MONDAY 4 DECEMBER 2006

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 financial statements of most limited liability companies are subjected to an external (statutory) audit.

What is the function of the external (statutory) audit?

- A to verify that no fraud has been committed
- B to confirm that the financial statements are correct
- C to express an opinion on the financial statements
- D to ensure that all taxes have been paid

- 2 **Which of the following bodies is responsible for issuing International Financial Reporting Standards?**

- A International Federation of Accounting Committees
- B International Accounting Standards Committee Foundation
- C International Professional Accounting Bodies
- D International Accounting Standards Board

- 3 The assistant accountant of Exior Co prepared the first draft of the company's year-end accounts. When the accountant reviewed the draft accounts, the calculation of an accrued expense was revised, leading to an increase in the expenses charged in the income statement.

Which of the following statements correctly describes the effect of the revision on the balance sheet?

- A liabilities have decreased
- B assets have increased
- C assets and liabilities are unaffected
- D net assets have decreased

- 4 In the year to 30 November 2006, Neum Co has recorded the following:

- (i) an increase of \$55,000 in the market value of the head office building;
- (ii) the receipt of a dividend of \$4,800 in respect of shares held as an investment; and
- (iii) an increase in the value of the shares held as an investment.

Which of the above are UNREALISED gains?

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

The following information relates to questions 5 and 6:

The financial statements of Smickers Co report a carrying value of \$1,756,500 for non-current assets. Using this value you have calculated the non-current asset turnover ratio to be 2.88. You have decided that the ratio should be re-calculated using the current valuation of the non-current assets, which is \$317,746 greater than the carrying value.

5 What is the revised non-current assets turnover ratio?

- A 15.92
- B 5.53
- C 2.44
- D 1.92

6 What is the MOST valid reason for using the current valuation of non-current assets?

- A because 2.88 was greater than the industry average
- B to allow comparison with competitors who have re-valued non-current assets
- C because assets should always be reported at current value
- D because you were unsure if the company's depreciation policy is appropriate

7 Which of the following statements is/are correct?

- (i) all intangible assets should be reported on the balance sheet
- (ii) only externally purchased intangible assets should be reported on the balance sheet
- (iii) goodwill should be amortised over its useful economic life

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

8 At the balance sheet date, future obligations to transfer economic benefits are classified as being either:

- (i) liabilities;
- (ii) provisions; or
- (iii) contingent liabilities.

Which of the above are reported on the balance sheet?

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

9 Which of the following statements regarding group accounting is/are correct?

- (i) only the group's share of the assets of a subsidiary is reflected on the consolidated balance sheet
- (ii) only the group's share of the net assets of an associate is reflected on the consolidated balance sheet
- (iii) the value of share capital on a consolidated balance sheet will include the share capital of both the investor and the investee

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

10 At 1 December 2005 the taxation liability of Elfati Co was \$143,700. At 30 November 2006 the liability was \$126,800. The taxation charge in the income statement for the year was \$119,400.

What is the outflow in respect of taxation to be reported in the company's cash flow statement?

- A** \$102,500
- B** \$119,400
- C** \$126,800
- D** \$136,300

11 Trubadur Co is about to launch a new product. The planned selling price is \$28.75 per unit and the total cost is \$19.50 per unit, including a fixed cost of \$4.20. The potential sales volume in the first year of sale will be affected by whether or not a competitor is successful in bringing a similar product to market. Trubadur estimates that there is a 30% probability that the competitor will succeed. In that case the sales volume will be 230,000 units. If the competitor is unsuccessful, the sales volume will be 60% higher.

Using the expected value criterion, what is the expected contribution of the product?

- A** \$2,510,450
- B** \$3,021,050
- C** \$3,650,330
- D** \$4,392,770

12 Which of the following statements regarding transfer pricing is/are correct?

- (i) negotiated transfer prices will always maximise total profit
- (ii) market based transfer prices will always encourage internal transfers

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

The following information relates to questions 13 and 14:

A division of Medriatic Co has reported a profit before tax of \$478,000 and total assets of \$2,756,000. The company's cost of capital is 11% and the economic value of net assets is \$3,150,000. The net operating profit after tax is \$447,000.

13 What is the division's residual income?

- A** \$100,500
- B** \$131,500
- C** \$143,840
- D** \$174,840

14 What is the division's Economic Value Added (EVA ®)?

- A** \$100,500
- B** \$131,500
- C** \$143,840
- D** \$174,840

15 Which of the following is/are required if just-in-time procedures are to be effective?

- (i) a commitment to continuous improvement
- (ii) reliable suppliers
- (iii) a production process which is free from bottlenecks

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

16 Which of the following statements regarding optimised production technology (OPT) is correct?

- A** OPT seeks to eliminate bottlenecks
- B** OPT seeks to minimise bottlenecks
- C** just-in-time must be implemented alongside OPT
- D** materials requirements planning and OPT are complementary

17 Which of the following statements about programme planning and budgeting is correct?

- A** the objective of programme planning and budgeting is to minimise the input resources
- B** programme planning and budgeting seeks to allocate resources to programmes on the basis of anticipated profitability
- C** programme planning and budgeting may measure outputs using non-financial measures
- D** programme planning and budgeting is usually carried out over a short time frame

18 The directors of Tarman Co are seeking to maximise the company's market share. It is proposed to introduce an incentive scheme to assist in achieving this objective.

Which of the following incentive schemes is most likely to contribute to achieving the company's objective?

- A** a company wide scheme based on annual profits
- B** a scheme which provides shares to all employees
- C** a scheme which pays commission based on sales volume
- D** a scheme based on the company's share price

19 Which of the following is MOST likely to be the reason for a favourable material usage variance?

- A** a favourable movement in exchange rates leading to a fall in material prices
- B** a change in working practices which has reduced production times
- C** completion of a materials handling training programme for production staff
- D** a coordinated purchasing programme which has maximised discounts

20 Celsor manufactures high performance sports cars. The directors are seeking to reduce costs and wish to identify non-value-added costs.

Which of the following is a non-value-added cost for Celsor?

- A** machine set up cost
- B** the cost of an improved fuel injection component
- C** the cost of tyres
- D** cost of the in-car entertainment system

(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 Delcon Co has just completed its first year of trading. You are the company’s general manager, and the company accountant has prepared draft year-end accounts which have been circulated to the board members.

One of the directors has asked you to contact him to confirm that inventory has been correctly treated in the accounts. The accountant has provided you with the following observations:

- (i) There are two categories of inventory – parts and construction contracts;
- (ii) All inventory has been valued at cost to avoid anticipating profit;
- (iii) Parts and work in progress have been valued on the FIFO basis as this will improve reported profit;
- (iv) ‘Cost’ has been calculated to include a proportion of the company’s overheads;
- (v) The accountant has commented that he will consider replacing FIFO as the inventory valuation method in future years if this will lead to a higher profit;
- (vi) The company is carrying out two construction contracts. Details of these are:

Contract YRE 744

The contract value is \$600,800 and costs of \$289,900 have been incurred to date. It is expected that further costs of \$156,100 will be required to complete the contract.

Contract TGR 311

The contract value is \$400,000 and costs of \$180,000 have been incurred to date. It is expected that further costs of \$256,000 will be required to complete the contract.

(As noted in (ii) above, these have been valued at cost.)

Required:

Draft briefing notes which you will use when discussing the stock valuation with the director, which:

- (a) Explain the correct approach to the valuation of parts and indicate whether the accountant has applied the correct approach;** (6 marks)
- (b) Explain the FIFO method of inventory valuation, ONE alternative method of inventory valuation and comment on the suggestion that the method of inventory valuation may be changed in the future;** (7 marks)
- (c) Explain why the valuation of the construction contracts at cost is incorrect; and** (3 marks)
- (d) Calculate the effect on profit of valuing the construction contracts correctly.** (4 marks)

(20 marks)

- 2** You are the operations director of Tinerage, a limited liability company. The company's draft financial statements have recently been circulated to the board members and a non-executive director (NED) has contacted you asking for clarification of certain expenses included in the draft financial statements.

The draft financial statements currently report an operating profit of \$205,500. The operating profit also represents the company's earnings for the period, leading to a reported earnings per share (EPS) of 27·4c.

The NED has noted that one of the company's key objectives is to maximise reported EPS and has suggested that, where possible, expenses should be separately disclosed and thus excluded from the calculation of EPS.

The NED has enquired if the expenses noted below have been correctly treated, and whether EPS can be improved by separate disclosure of these expenses.

You have been asked to draft a memo to the NED.

The expenses referred to by the NED are currently included in cost of sales. They are:

Sale of packaging machine

Following a decision to outsource the packaging of the company's products, a machine which is no longer required was sold. As there is a limited market for such machines, the sale resulted in a loss of \$6,200.

Reorganisation costs

As well as outsourcing the packaging of the company's products, the production process was reorganised. Previously the production process was organised on the basis that each of the company's factories produced a single product. As part of a quality improvement programme, the production process was re-organised into a cellular configuration. The cost of this reorganisation was \$35,250.

Warranty provision

During the year it had been discovered that a mathematical error had been made in the calculation of the provision for warranties at the previous year-end. The correction of this error had resulted in a charge of \$28,500.

Required:

Using an appropriate format, draft a memo to the NED which:

- (a) discusses the proposal that EPS can be improved by separately disclosing certain expenses;** (7 marks)
- (b) explains the correct accounting treatment for each of the expenses referred to by the NED; and** (10 marks)
- (c) states the correct figure for the company's reported EPS.** (3 marks)

(20 marks)

- 3 (a) It is generally accepted that the information in financial statements should be useful. Two important elements which contribute to ensuring that the information is useful are relevance and reliability.

Required:

Briefly explain what is meant by financial information which is:

- (i) **relevant; and** (4 marks)
(ii) **reliable.** (4 marks)

- (b) The directors of Nouveau Co, a company which specialises in selling antiques and fine art, are considering the impact of the following matters on the financial statements for the year to 30 November 2006:

- (i) A painting was delivered to a customer on a sale or return basis on 29 September 2006. The painting had an estimated sale value of \$94,000 and had cost Nouveau \$61,000. The customer had agreed that the painting should be displayed in their gallery until it is sold. However, if the painting is unsold after two months, it would be returned to Nouveau.

The customer identified a potential buyer and an agreement for the sale of the painting was concluded on 26 November, but no contract was signed until 3 December. Nouveau will receive \$92,000 from the sale.

One of the directors of Nouveau has suggested that the sale of the painting for \$92,000, and the resulting profit of \$31,000 should be reported in the financial statements for the year to 30 November 2006.

- (ii) In the year to 30 November 2004, Nouveau had bought a computer system for restoring artwork. The system had cost \$80,000 and was expected to have a useful life of four years. Because Nouveau were one of the first buyers of the system, the supplier agreed to provide free updates until July 2006. The system has proved to be successful and by July 2006 a new system with the same features as Nouveau's upgraded system would have cost \$95,000. Since July 2006 some additional features have been released. Nouveau's IT manager has stated that these would increase the value of the system further, but she cannot place a value on these additional features.

Required:

- (i) **Identify the conceptual issues which must be resolved in selecting the appropriate accounting treatment for each of these matters;** (2 marks)
(ii) **Explain how each of the items should be treated in the financial statements in order to comply with generally accepted accounting practice; and** (8 marks)
(iii) **State the value which should be included in the financial statements for the year to 30 November 2006 for both gains (or expenses) and asset value for the painting and the computer system.** (2 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 have recently taken up the post of general manager with Foodie Co, a medium sized food processing company in the South West of England. The company is seeking to achieve market-led growth throughout the EU. The growth is seen as a development of the company's success to date in supplying local retailers with a range of ready-prepared meals. The product range is noted for providing good quality meals at a keen price, and the company has a strong reputation for being responsive to customers' needs.

The company uses only quality approved suppliers of raw materials and by carefully controlling quality it has been successful in avoiding the health scares which have arisen in the industry in recent years. The directors believe that careful promotion of the company's quality management programme will also make it possible to improve margins.

Market research has indicated that demand for the products is strong, and that the success of the expansion will depend on the company's ability to maintain quality standards while increasing the volume of activity, and to create an effective distribution network that will allow retailers to obtain orders at short notice. The need to meet customer orders at short notice has led the directors to decide that the required expansion of the production facility will mean that a number of new factories will be established in key locations which are close to potential customers.

To date the company has adopted a functional organisational structure with quality being the responsibility of the production manager.

You have been invited to the next meeting of the board of directors in order to recommend whether or not the company should develop a mission statement and the changes in organisational structure and management responsibilities that will be required if the proposed expansion is to be successful.

Required:

In preparation for your meeting with the directors of Foodie, prepare a briefing paper which:

- (a) **discusses the purpose of a company mission statement, and the benefits and problems which the company may experience if a mission statement is developed;** (7 marks)
- (b) **recommends and justifies an appropriate organisational structure, as well as the types of responsibility centres which the company should use; and** (8 marks)
- (c) **indicates why a more structured approach to performance measurement is likely to contribute to the company's success.** (5 marks)

(20 marks)

- 5 Recco, a limited liability company, makes three products which are sold to manufacturers of luxury cars. The company's profitability has been declining recently and the directors are considering a number of possible options.

The following product data has been collected:

Product	Robin	Eagle	Hawk
Selling price per unit	\$400.00	\$470.00	\$320.00
Material cost per unit	\$92.60	\$83.20	\$57.90
Labour hours per unit	1.2	0.9	1.4
Machine hours per unit	4.0	5.5	2.5

The labour cost is \$54.50 per labour hour. Variable overheads are incorporated into product cost on a machine hour basis at a pre-determined rate of \$34.70 per hour.

At present, capacity is 44,000 machine hours per annum.

Fixed costs are \$680,000 per annum.

Three possible options to halt the decline in profitability have been suggested:

(1) Increase production capacity

An investment of \$1,400,000 would provide an additional 11,200 machine hours per annum. The investment would have a useful life of three years.

The marketing director estimates that if the selling price of each product is maintained at the present level, annual sales volumes will be:

Robin – 5,200 units; Eagle – 3,100 units; Hawk – 6,700 units.

(2) Improve product quality

A change in the production process would increase the machine hours for each unit produced by:

Robin – 0.2 hours; Eagle – 0.3 hours; Hawk – 0.1 hours.

This would improve product quality, and would allow sales prices to be increased by 5%. To ensure that customers are aware of the improved quality, a marketing campaign would be required. This campaign will cost \$875,000 in the next year, and \$640,000 per annum for each of the next two years.

The anticipated annual sales volumes would be:

Robin – 5,800 units; Eagle – 4,400 units; Hawk – 7,900 units.

(3) Preferred supplier contract

The marketing director is aware that one of Recco's customers would be interested in entering into a 'preferred supplier' contract. It would be a term of the contract that Recco would not sell the same product to any other manufacturer.

The customer has indicated that they would contract to purchase 5,200 Eagle units per annum, and as many units of either Robin or Hawk as Recco can produce.

Required:

(a) Calculate the profit which would be generated by each of the three options under consideration.

(Note: marks are equally divided across each option. The time value of money should be ignored.)

(18 marks)

(b) Briefly indicate the action the directors should take, based on the available information.

(2 marks)

(20 marks)

- 6 (a)** Delphinium Co produces building materials. The company has developed a new material which will reduce the construction time for building high density houses. It is hoped that the resulting fall in costs will make the product attractive to large developers. However initial customer trials have indicated that customers are concerned that the product's effective life will be shorter than that of the traditional products which it is intended to replace.

One potential customer has agreed to use the product for a trial period. This customer will not pay more than \$36.50 per kg, and requires 10,000 kg per month. It has been agreed that this will be ordered in batches of 200 kg.

Delphinium uses a variable cost-plus approach to pricing, and adds 50% to variable cost to calculate selling price. Activity based costing is used to calculate overheads.

It has been suggested that the company should use a target cost approach to pricing for this product.

You have been asked to consider the company's options and to report back to the management team.

The following information has been collated:

Product Costs:

Materials	\$7.90 per kg produced
Labour	\$8.60 per kg produced

You have estimated that each 100 kg produced will require four deliveries of raw materials, and eight machine hours.

Company Overheads:

Machine running	\$276,250 per month
Materials handling	\$118,500 per month
Order processing	\$390,000 per month

Activity levels (for the company)

Machine hours	5,000 per month
Materials deliveries	2,000 per month
Customer orders	3,000 per month

Required:

- (i) Compare and contrast variable cost-plus pricing and target pricing, and indicate the circumstances in which each might be appropriate.** (8 marks)
- (ii) Indicate whether the customer's maximum price is consistent with the company's pricing policy.** (6 marks)
- (b)** Assume that further tests have confirmed the product's useful life, and that Delphinium Co wishes to maximise profits by reducing costs.

Required:

Indicate techniques which could be used to achieve a reduction in the product cost. (6 marks)

(20 marks)

End of Question Paper