
Answers

Section A

1 B	6 C	11 D	16 D
2 D	7 D	12 D	17 C
3 B	8 A	13 A	18 B
4 D	9 B	14 A	19 B
5 A	10 C	15 D	20 D

Workings:

4 The net book value of non-current assets is reported as \$2,562,500. This is after deduction of the accumulated depreciation of \$1,475,400. Thus the cost of the non-current assets is \$4,037,900 (\$2,562,500 + \$1,475,400). Depreciation on the straight-line basis means that the 20% rate is applied to the cost. Depreciation is therefore \$807,580.

5 A provision is required when a past event gives rise to a reasonable certainty that a transfer of economic benefits will occur, but either the amount which will be transferred or the timing of the transfer is uncertain. In this case, Equib has accepted liability, and there is reasonable certainty that an outflow will be required although Equib does not agree that this should be \$750,000. Based on legal advice, the amount (\$45,000) can be estimated with reasonable accuracy, but there is less clarity about when the transfer will take place.

(A contingent liability arises when there is less certainty about either the value of economic benefits which will be transferred or whether a transfer of economic benefits will be required at all. The lack of certainty is because the obligation to transfer economic benefits will be determined in the future by events which the firm is not able to control.)

6 Earnings =	Retained profit	\$689,424
	+ Ordinary dividend	\$65,000
		<u>\$754,424</u>
Number of shares =	65,000 ÷ 0.1	650,000
Thus EPS =	(754,424 × 100) ÷ 60,000 =	116 cents

7 As Orius has not acquired sufficient shares to control the voting at any meeting of members, but has a representative on the board of directors, it is in a position to exercise significant influence over, but not to control, Eerus. This means that Eerus is an associate of Orius.

The correct accounting treatment of an associate is equity accounting (consolidation accounting is applied to subsidiaries).

11 If variable costs are 70% of sales, contribution is 30%	
Thus contribution is	\$726,000 × 30% = \$217,800
less Fixed costs (balancing figure)	\$145,800
= Profit	\$72,000

In next year:		
Required profit	\$81,000	
Fixed costs	\$153,090	= %145,800 + 5%
Contribution	\$234,090	= 25%
Sales	\$936,360	= 100%

12 Operating profit	\$586,900	
Imputed interest	\$359,772	(\$2,569,800 × 14%)
Residual income	\$227,128	

13 NOPAT	\$491,300	(\$586,900 – \$95,600)
Economic return	\$445,200	(\$3,180,000 × 14%)
EVA®	\$46,100	

14 As the material currently in inventory has no alternative use and has no salvage value (i.e. no opportunity cost as a result of being used), the relevant cost of using the existing inventory is nil. The cost of the additional 160 units is the replacement cost of \$28·00. Thus the contract cost is: 160 units at \$28·00 = \$4,480.

16 Observation (i) is incorrect as some costs will be fixed in the short term. For such costs, it will only be possible to achieve a reduction in the long term.

Observation (ii) is incorrect as ABC will provide a greater insight into the causes of costs. This will allow managers to exercise greater control of costs by focusing attention on managing the causes of costs.

17 Standard output:

11 staff x 30 productive hours per week x 4 weeks x 2 per hour =	2,640
Actual output	2,850
Variance	210

As the actual output is greater than standard, this is a favourable variance

Standard cost per question is \$11·38 per query

Variance of 210 queries at \$11·38 =	\$2,389·80
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18 The total cost is analysed into two cost pools, as follows:

Cost pool	Cost driver	cpu of cost driver
Transport	km travelled	\$1·76 (\$2,631,200 ÷ 1,495,000)
Processing	orders processed	\$4·84 (\$1,573,000 ÷ 325,000)

Thus the cost to be quoted is:

per order	Transport	122 km at \$1·76 per km =	\$214·72
	Processing		\$4·84
	Total		\$219·56

For 138 orders, the cost is \$30,299·28

20 Specialised training on a specific task is incompatible with cellular manufacturing, as the initiative requires the use of multi-skilled staff, capable of completing a range of tasks. A team-based bonus is likely to be successful as it will encourage staff to adopt a team-based approach which should foster the flexibility which is a key element of cellular manufacturing.

Section B

1 (a) (i) Thank you for your enquiry about the references to taxation in the financial statements you have been reviewing.

I hope the information below will be helpful.

While it is the case that the taxation liability which arises in one year will be paid in the following year, the charge in the income statement and the liability on the balance sheet will be different for two reasons.

The first reason is that the charge will include an amount in respect of deferred taxation. However, the liability for deferred taxation is reported under the heading 'Provision for liabilities and charges' on the balance sheet.

The second is that the charge in the income statement is an estimate of the liability arising on the current year's profit. It is almost certain that the final liability agreed with the tax authorities will be different to the estimate. Any under-estimate or over-estimate in one year will lead to an adjustment to the charge in the following year.

Mark allocation:

1 mark for each valid point, for example:

Liability does not include deferred taxation

Deferred taxation reported as 'Provision for liabilities and charges'

Current year charge is estimated

Adjustment in following year

to a maximum of

4

(ii) Deferred taxation arises because a company's accounting profit and taxable profit will be different. The reasons for the difference can be classified as either permanent differences or timing differences.

A permanent difference occurs when an item is treated differently for accounting purposes and taxation purposes. Examples of this would be entertaining expenses and fines. While these may be charged in the income statement, they are usually not allowable expenses when calculating the taxation charge. If these were the only differences, the taxable profit would be higher than the accounting profit by the total amount of such charges.

Timing differences arise due to items which are included in both accounting profit and taxable profit, but in different periods. Therefore an item may reduce taxable profit in the current period, but will not give rise to a charge in the income statement until a later accounting period. Such differences arise due to specific tax legislation. However, examples might include:

Development expenditure which is an allowable tax charge in the year in which it was incurred, but will be charged against accounting profits over a number of years;

Accelerated capital allowances, which will result in capital expenditure being an allowable tax charge over a shorter period than the useful economic life of the asset.

Mark allocation:

Accounting and taxable profit are different

1

Differences may be permanent differences or timing differences

1

Explanation of

permanent differences

up to 2

timing differences

up to 2

Deferred tax arises on timing differences only

1

to a maximum of

4

(iii) Deferred tax will affect the financial statements as follows:

As discussed above, the taxation charge in the income statement may include an amount for deferred tax. If the overall liability for deferred tax has increased, this will lead to a charge, and if the overall liability has decreased, this will lead to a credit.

The balance sheet will be affected as any liability for deferred tax will need to be included.

It should also be noted that earnings per share, as reported on the face of the income statement, will also be affected by any movement in the liability for deferred tax. Any charge for deferred tax will reduce 'earnings' and therefore earnings per share, while any credit for deferred tax will increase earnings per share.

Deferred tax included in

income statement

1

balance sheet

1

earnings per share

1

Explanation of effect on

income statement

1

earnings per share

1

to a maximum of

3

(b)			\$000	
Current assets	Inventory	W1	1,050·0	3
	Receivables	W2	2,240·0	1
	Prepayments	per q	96·5	
	Total		<u>3,386·5</u>	1 (for correct composition)
Current liabilities	Payables	W3	2,025·0	1
	Current tax		290·0	1
	Bank overdraft		120·0	
	Accrued expenses		131·0	
	Total		<u>2,566·0</u>	1 (for correct composition)
Thus, current ratio = $3,386·5 \div 2,566·0 = 1·32$				<u>1</u> <u>9</u>
				20

W1		\$000	\$000	
	Opening inventory (per q)		825	1/2
	Purchases to 31 March 2008		3,375	1/2
	Sales to 31 March 2008	4,200		
	Cost of sales (75%)		3,150	1
	Thus Closing inventory		1,050	1
W2	1·6 months = \$1,400,000 x 1·6 =	\$2,240,000		
W3	1·8 months = \$1,125,000 x 1·8 =	\$2,025,000		

2 (a) (i) Matsup Co

The key question regarding this arrangement is whether the inventory on site is owned by the supplier or the company.

This is an example of the accounting principle of substance over form, which states that transactions should be accounted for according to their commercial substance, rather than their legal form. One of the key issues is that if the supplier can demand the return of items, and is likely to do so, then the supplier retains title. This would mean that the items will continue to be reported as part of the stock of the supplier.

On the other hand, if the inventory is seldom returned, and the possibility that it may be returned is low, the items will be part of the stock of the customer.

On balance, this arrangement seems to be an arrangement chosen by the supplier in order to encourage sales, by helping the customer to avoid stock-outs.

This means that title to the items does not pass to the company until they are drawn down, and therefore they will not be included in Suform's inventory.

Mark allocation:

1 mark for each valid point, for example:

Matsup

Consider who owns inventory/when is legal title transferred

Can supplier demand return

Does this happen often

If seldom returned, requirement is of little consequence

Appears to be a commercial arrangement, thus supplier owns inventory

Ture

Monthly charge for usage – as Matsup

Inventory will increase to reflect holding of one month's inventory as Suform will have acquired title.

to a maximum of

6

(ii) The accounting treatment will depend on whether the company has acquired an asset and an associated liability.

In considering this, the key question is whether the risks and rewards of ownership have been substantially transferred.

The following would normally be considered:

Is the company legally obliged to make payments which have a present value of 90% or more of the fair value of the asset?

Is the asset to be used by the company for a period which is roughly equal to its estimated useful life?

Is the company responsible for the insurance and upkeep of the asset?

Leasing option A

As the answers to these questions are 'no', this would appear to be an operating lease.

Leasing option B

In this case:

The payments exceed the cost by a significant amount, and the insurance and repairs are the responsibility of the company.

These facts suggest that this is a finance lease, and that consequently, the company would acquire an asset and an associated liability.

Mark allocation:

1 mark for each valid point, for example:

- Are risks and rewards transferred
- Do payments exceed 90% of FV
- Period of use compared to UEL
- Responsibility for insurance/maintenance
- Conclusion – A appears to be an operating lease
- B appears to be a finance lease

To a maximum of

4

(b) Payments due under the lease:	48 × \$16,500 =	\$792,000		
	plus Final payment	<u>\$50,000</u>		
		\$842,000		
Fair value of machine		<u>\$700,000</u>		
Thus total finance charge		<u>\$142,000</u>	1	
Thus annual charge	\$142,000 ÷ 4	\$35,500		
Depreciation:				
Cost \$700,000	=	\$175,000 p.a.	1	
Thus:				
Profit before interest and tax				
22·6%, on capital employed of \$9,475,000 =	\$2,141,350		1	
Less Depreciation	\$175,000		1	
=		\$1,966,350		
Capital employed				
Estimated	\$9,475,000		1	
Carrying value of asset	\$700,000			
Less Depn.	<u>\$175,000</u>	\$525,000	1	
Reduction due to payments	\$16,500 × 12	(198,000)	1	
Current liability:				
12 payments	\$198,000			
Less interest element	<u>\$35,500</u>	(\$162,500)	1	
Non-current liability	two years	(\$325,000)	1/2	
	Final payment	<u>(\$50,000)</u>	1/2	
=		\$9,264,500		
Thus ROCE =	$\frac{\$1,966,350}{\$9,264,500} \times 100 = 21\cdot22$		1	10
			<u>1</u>	20

- 3 (a) Cash flow statements provide important information to users of financial statements. Perhaps the most important aspect is that by reporting on how cash is generated and used, a cash flow statement provides information on the resource which is essential for business survival – cash. The fact that a firm generates a profit does not mean that it will generate cash. This is because cash will be used to pay tax, dividends and loans.

For some users, particularly creditors and lenders, the ability of the firm to meet its obligations will be more important than profitability. Reporting cash movements is more objective than reporting income and expenses, as is done in the income statement, and assets and liabilities, as is done in the balance sheet. This means that the information provided in a cash flow statement may be regarded as more reliable than the information in the income statement or balance sheet.

Given that the objective in most management decisions is to generate cash rather than profit, a cash flow statement is of more use to both managers and shareholders. As many users of financial statements may find the accruals concept difficult to understand, the focus on cash provides information which is easier to understand. It is also more difficult to mask the effects of transactions through creative accounting.

Different accounting policies will have less impact on the results reported by a cash flow. This means that using cash to compare performance between firms is made easier. Financial statements are intended to provide information on financial performance, financial position, generation of cash and financial adaptability. Clearly a cash flow statement contributes to this objective with regard to generation of cash.

Mark allocation:

1 mark for each valid point, for example:

Cash is essential for survival

Some users are more interested in cash than profitability.

Reporting cash is objective

Information in cash flow statement is more reliable

Cash is easier to understand

Creative accounting is more difficult

Accounting policies have less impact on results reported by a cash flow

Comparison of performance is made easier

Reporting generation of cash is a key objective

To a maximum of

6

(b) (i) Net cash flow from operating activities

		\$000		
Profit before tax	(W1)	43	2	
Depreciation charge		302	1	
Movement in inventories		(24)	1	
receivables		21	1	
payables		15	1	
Cash generated by operating activities		357		
Tax paid	(W2)	(82)	1	7
Net cash flow from operating activities		<u>275</u>		
<u>Working 1</u>		\$000		
Retained profit	2007	201	1	
	2006	186		
Increase (= profit after tax)		15		
Tax charge		28	1	2
Profit before tax		<u>43</u>		
<u>Working 2</u>		\$000		
Tax charge in income statement		28		
less Increase in Deferred Tax Liability		(12)		
		16		
Opening balance		97		
Closing balance		<u>(31)</u>		
Amount paid		<u>82</u>		

(ii) Net cash flow from investing activities

In this case, there have been no disposals of fixed assets. This means that any cash flow in respect of investing activities is the cost of additions to non-current assets.

	\$000		
Non-current assets at 31 October 2006	1,976		
less Depreciation charge	(302)		
Net book value before additions	1,674	1	
Net book value at 31 October 2007	2,168		
Thus additions = outflow	494	<u>1</u>	2

(iii) Net cash flow from financing activities

	2006	2007	Increase		
	\$000	\$000	\$000		
Ordinary share capital	850	900	50	1	
Share premium	32	48	16	1	
Long term borrowings	677	783	106	1	
Short term borrowings	113	197	84	<u>1</u>	4
Total increase = Inflow			<u>256</u>		

(iv) Movement in cash and cash equivalents

In this case there are no items which are classified as 'cash equivalents' and the only balance relating to cash is the balance at the bank.

Thus the movement is the difference between the:

	\$000	
Bank balance at 31 October 2007	51	
Bank balance at 31 October 2006	<u>14</u>	
Increase	<u>37</u>	1

Section C

4 (a) Income:

Chargeable days per annum	180		
Already committed	45		
thus available	135		
× 80% of capacity =	108		
thus days sold = (108 + 45)	153		
Income per consultant:		Senior	Junior
153 × \$900/153 × \$500	\$137,700	\$76,500	
Number of consultants	16	22	
thus total income	\$2,203,200	\$1,683,000 =	\$3,886,200
Costs:		\$	
Salaries – Senior consultant	16 × \$60,000	960,000	
Junior consultant	22 × \$35,000	770,000	
Other staff		160,000	
Employment costs (\$960 + \$770 + \$160) × 10%		189,000	
Training 38 consultants (16 + 22)			
× 2 days each at \$400		30,400	
Administration expenses		830,000	<u>\$2,939,400</u>
Budgeted profit			<u>\$946,800</u>
Mark allocation: Income			2
Consultant salaries			1
Employment costs			1
Other salaries			1
Training			1
Administrative expenses			<u>1</u>

- (b) (i) Chargeable days per annum 180
 Already committed 45
 thus available 135
 × 120% of capacity = 162
 thus days sold = (162 + 45) 207

Additional income for 54 (207 – 153) days:

Senior 54 × \$900 = \$48,600 × 16 consultants	\$777,600
Junior 54 × \$500 = \$27,000 × 22 consultants	\$594,000
	<u>\$1,371,600</u>

Additional costs:

Bonuses for 27 (207 – 180) days:

Senior 27 days at \$900 × 50% = \$12,150 × 16	\$194,400
Junior 27 days at \$500 × 50% = \$6,750 × 22	\$148,500
	<u>\$342,900</u>

Employment costs:

\$342,900 × 10%	\$34,290
	<u>\$377,190</u>

Additional profit \$994,410

Mark allocation:

Additional income based on 54 extra days	1	
Bonuses based on 27 days	1	
Calculation of additional income	2	
Calculation of additional costs	2	6
	<u>2</u>	

- (ii) At 120% of capacity, 27 days per consultant are required.

Thus, senior consultant days = 27 × 16 = 432

Junior consultant days = 27 × 22 = 594

At 180 contracted days per consultant, this equates to employing:

Senior consultant 432 ÷ 180 = 2.4 i.e. 3 consultants

Junior consultant 594 ÷ 180 = 3.3 i.e. 4 consultants

Employing additional consultants would lead to:

Savings: Bonus and employment cost (per (i)) \$377,190

Costs: Salaries: 3 senior at \$60,000 =	\$180,000
4 junior at \$35,000 =	<u>\$140,000</u>
	\$320,000
Employment costs (10%)	\$32,000
Training 7 staff × 2 days at \$400	\$5,600
	<u>\$357,600</u>

Net saving \$19,590

Mark allocation Savings	1/2	
Costs salaries	1/2	
employment costs	1/2	
training	1/2	2
	<u>1/2</u>	<u>8</u>

NB Marks were also awarded for other valid interpretations of the data.

(c) To Managing partner
 From Administration manager
 Re Consultant capacity
 Date 4 December 2007

I have assessed the costs and revenues which will arise in the event of our commitments reaching 120% of remaining consultant capacity.

This assessment indicates that there would be a net saving of \$19,590 if we employed additional consultants, as opposed to paying bonuses to existing consultants. I would suggest that, as well as the financial implications, we also need to consider other factors, such as:

- Employing additional consultants will give us both greater flexibility to respond to customer demand, as well as increased capacity to offer additional services. This could lead to further growth.
- By employing additional consultants and maintaining the workload at the contracted level, there will be less pressure on individual consultants. This should help to maintain our high levels of service.
- If capacity reaches 120% of remaining capacity, and we do not employ additional consultants, the demands on consultants will be considerable. This could lead to a fall in the quality of our service, or consultants resigning. If sustained, it may lead to health problems for consultants. This would contravene our obligation to provide a safe and healthy working environment.
- If we cannot obtain sufficient work, this will have a detrimental effect on performance.
- Indeed, as we must make this decision in advance of obtaining contracts, we may create surplus capacity in the short term.
- Of course, we can only recruit if there are potential recruits available. We would need to be sure that staff with the appropriate skills and experience are available.

Taking all of the above into account, any final decision is likely to be most heavily influenced by our assessment of the market. If we are to believe that the 120% capacity level can be achieved – and maintained – the analysis above suggests that the financial benefit is enhanced by the non-financial benefits. However, if we have doubts about whether the 120% level can be achieved, it may be preferable to consider using a combination of existing and additional consultants, perhaps by employing fewer than required (for example 1 or 2 senior and 2 or 3 junior). Another alternative is to use freelance or part-time consultants.

Mark allocation

1 mark for each valid point considered, to a maximum of	4	
For financial conclusion, up to	2	
Memo format	1	
Available	7	
Maximum	5	20

5 (a) The overall purpose of performance measurement is to contribute to the managerial tasks of planning, making decisions and controlling. It is therefore an essential part of the control process, and seeks to assess the extent to which targets have been achieved and plans fulfilled. As such, it follows that before performance may be measured, a plan must have been prepared and targets must have been set and, in most situations, agreed with the manager who will be responsible for achieving the targets.

The purpose of performance measurement is to improve organisational performance. This should be achieved by a cycle of activities which commences with setting overall objectives and identifying the outcomes that will arise if these objectives are achieved. It is these outcomes which should be measured, and which therefore become the performance measures for the organisation. It goes without saying that to ensure that the performance measurement system is effective, the underlying reasons why certain outcomes were achieved and others were not achieved should be investigated. The results of such investigation should form the basis of both future targets and future operational plans.

The targets which an organisation seeks to achieve might be expressed in financial terms or non-financial terms. While financial performance measures are important, such measures cannot provide a comprehensive picture of performance. One of the main reasons for this is that such measures are often reported some time after the activity which they measure has taken place. Non-financial performance measures can often be reported a very short time after the actual performance, which provides managers with an opportunity to take corrective action. In addition, many financial measures are available externally (via the annual financial statements) while only those non-financial performance measures which an organisation's management decide to publish are available to those outside the organisation. While financial measures can be used to assess the performance of specific sectors of an organisation, in the main they are 'high level' measures, reporting on the outcome of a combination of activities. Non-financial measures, on the other hand can provide an overview of the performance of quite specific activities – for example the output of a specific machine for a specific shift.

Non-financial performance measures may be either quantitative (e.g. number of repeat customers) or qualitative (the level of satisfaction experienced by customers), but financial measures, by their nature, can only be quantitative.

For these reasons, an effective performance management system will invariably make use of both financial and non-financial measures of performance.

Mark allocation 1 mark per valid point to a maximum of

6

For example:

Part of control process

Improve organisational performance

Outcomes measured

Reasons investigated

Influences future targets and plans

Financial not comprehensive

Non financial are often immediate

Financial are usually available externally/non-financial internal

Non-financial more detailed

Non-financial may be both quantitative and qualitative

Marks were also awarded for other valid points

- (b) The fact that effective performance measurement will combine both financial and non-financial measures is often overlooked and leads to what is perhaps the most significant problem of performance measurement – the fact that it is possible to set too many targets. While this problem has long been recognised, it has become more acute in recent years due to the sheer volume of information that is available to most organisations. It is all too easy to measure and report what *can* be measured, and to neglect what *should* be measured. This has meant that the performance measurement system in many organisations does not actually contribute to improved performance, as managers find that it is difficult to identify the actions which will affect specific performance measures.

A key task for managers is therefore to distinguish between those actions which will have a direct effect on performance and those which will have less influence. The former are often referred to as ‘critical success factors’ (CSFs). There will usually be a relatively small number of CSFs in any organisation.

The importance of these is that they provide the focus which helps to avoid the problem discussed in the paragraph above.

Having identified the CSFs, it is important that managers consider how they will know if these are being achieved. The targets and measures which will report the extent to which CSFs are being achieved should form the basis of the performance measurement and reporting process. These targets and measures are usually referred to as key performance indicators (KPIs) and they will be a mixture of financial and non-financial measures.

Because CSFs are derived directly from the organisational objectives, and they are measured by the use of KPIs they contribute to the effectiveness of the performance measurement process by establishing a link between actions and performance.

Mark allocation

Identification of problem(s) up to 2 marks

Explanation of nature and contribution of

CSFs up to 2 marks

KPIs up to 2 marks

6

- (c) In the case of a local government authority, non-financial measures will have particular significance as the overall organisational objective is not expressed in financial terms. Although financial measures cannot be totally ignored, it will be more important that the overall goal (increasing the number of tourists remaining in the region for two days or more) is achieved over the long term. It is therefore more important that the actions which are taken will contribute to this than it is to achieve short term financial goals, as we are not constrained to the same extent as commercial organisations by the need to report short term profits.

The following CSFs and KPIs are suggested:

CSF	KPI		
Increase awareness of tourism resources	– Number of hits on website – Number of tour guide entries		
Develop hospitality facilities in area	– Number of bed-nights available – Number of all weather facilities		
Create integrated transport links	– Total travel time between arrival at port and arrival at accommodation – Road miles served by public transport as % of road miles in area		
Visitor satisfaction	– Number of return visitors – % of visitor experiences in 'satisfied' category or above		
Mark allocation			
For explanation of importance of NFPIs, up to 1 mark for each valid CSF and KPI identified to a maximum of		3 <u>8</u>	
Available		11	
Maximum			<u>8</u> 20

NB Marks were awarded for other valid CSFs and KPIs not included above.

- 6 (a) Although it is correct to say that the transfer price will represent income to one division and a cost to the other, and that the income and cost will cancel one another out, it is not correct to say that this will have no effect on profit. An effective transfer pricing system will encourage divisional managers to take appropriate decisions which will lead to overall company profit being maximised.

On the other hand an ineffective transfer pricing system will lead to divisional managers taking decisions which will maximise the profit for their own division, but will not maximise overall company profit.

This can arise because the basic premise of divisionalisation is that each division is autonomous. This basic premise will encourage managers to seek the best result for their division, irrespective of the effect on the rest of the company.

This means that an effective transfer pricing system is likely to be designed (and may even be imposed) by head office. As a result, the concept of divisional autonomy is somewhat undermined. There is therefore a tension between the concept of divisional autonomy and head office control.

The extent to which managers will be satisfied with a transfer pricing system, and therefore managerial behaviour, is likely to be influenced by two factors. One of these will be the extent to which divisional managers perceive that their decisions are constrained by head office involvement (more involvement = less autonomy = less satisfaction). The second will be the extent to which managers feel that the transfer price provides adequate reward for the effort and resources which have been utilised.

Consequently, the transfer pricing system will have a significant influence on the motivation of divisional managers and therefore divisional and corporate performance. The greater the extent to which the transfer pricing system can achieve a balance between maximising overall company profits and maintaining divisional autonomy, the more successful it will be.

The transfer price should:

- provide an adequate reward to the supplying division to compensate for the resources used;
- provide the receiving division with access to resources at a reasonable cost;
- allow divisional performance to be assessed on a basis which is commercial;
- motivate divisional managers to achieve corporate goals;
- maximise overall company profits.

Mark allocation:

1 mark for each valid point, for example:

- Can affect overall profit
- Key objective is to maximise overall profit
- Self interest will influence decisions
- Need for HO involvement will reduce divisional autonomy
- Managers satisfaction will influence behaviour

TP should provide adequate reward
 supply resources at reasonable cost
 facilitate performance measurement
 to a maximum of 5

(b) Market-based

per unit	\$	\$	
Selling price of final product		78·00	
less: Margin (25%)	19·50		
Processing cost	<u>12·50</u>	<u>32·00</u>	
Selling price/Transfer price		<u>46·00</u>	1

Capacity 450,000 hours ÷ 2½ = 180,000 units 1

Revenue	\$000	\$000	
180,000 units at \$46·00		8,280	1

Costs			
Variable cost 180,000 units at \$26·80	4,824		
Fixed costs	<u>2,700</u>	<u>7,524</u>	1
Profit		756	
Target profit \$8,280,000 × 5%		<u>414</u>	1
Excess		342	

Bonus at 4% = \$13,680 1

Cost-based

per unit	\$		
Variable cost	26·80		
Mark up 70%	<u>18·76</u>		
Transfer price	<u>45·56</u>		1

Revenue	\$000	\$000	
External sales 60,000 units at \$46·00	2,760·0		
Transfers 120,000 units at \$45·56	<u>5,467·2</u>	8,227·20	1

Costs (as market-based)		<u>7,524·00</u>	1
Profit		703·20	
Target profit \$8,227,200 × 5%		<u>411·36</u>	1
Excess		291·84	

Bonus at 4% = \$11,673·60, say \$11,674 1

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(c) Recommended basis

The fact that an external customer is the catalyst for establishing divisions and therefore transfer pricing means that the transfer price should be based on market price. The emergence of the partner creates a market where it appears none previously existed. As the market price will be based on negotiations with an external partner, it will provide a degree of objectivity. This will mean that the transfer price will be perceived as equitable.

In market based systems, the transfer price may be set below the external sales price. This is to reflect the fact that certain costs (e.g. advertising, packaging, distribution) are not incurred on internal transfers.

Marydown has been approached by the partner, so it can be argued that most of the possible savings considered above in respect of market based transfer prices do not apply. For example, as there has not been any external market for the component in the past, there will not be any advertising costs associated with the component. If there will be any packaging and distribution costs to be incurred in connection with sales to the partner, it should be possible to ensure that the price negotiated is calculated to take account of such costs. In that way, it will be possible to arrive at a final price for the component itself. This should be the transfer price, as it will be an objective, market based price, and will exclude those elements which typically need to be 'stripped out' from the market price to arrive at the transfer price.

Mark allocation:

1 mark for each valid point to a maximum of 4

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