Paper T10

Managing Finances

ACCA CERTIFIED ACCOUNTING TECHNICIAN EXAMINATION

ADVANCED LEVEL

WEDNESDAY 13 DECEMBER 2006

QUESTION PAPER

Time allowed **3 hours**

ALL FOUR questions are compulsory and MUST be answered

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

ALL FOUR questions are compulsory and MUST be attempted

1 Morello Landscapes is a small business established several years ago. The owner, Mr Morello, designs and landscapes gardens for a range of clients using his team of five employees. The firm works on one job at a time. Mr Morello has just signed a contract with a local building firm to landscape the gardens on a development of thirty executive houses. His designs have already been accepted and he has agreed to complete the work within a six-month period, starting on 1 January 2007. Should he fail to complete the work on time, he will have to pay a penalty. Should the work be completed early, workers can begin working on the next project.

Mr Morello understands the importance of careful cash budgeting and wants to prepare the cash budget for the next six months, from January to June 2007.

The following information has been obtained:

(i) Opening debtors are forecast to be £2,400, all of which will be received in January.

(ii) A price of £400,000 has been agreed for the contract. The amount will be paid in instalments as follows:

January	5%
February	15%
March	10%
April	10%
May	10%
June	50%

(iii) Opening creditors, which will be paid in January, are forecast to be as follows:

Materials	£6,600
Miscellaneous	£2,570

(iv) Five diggers will be hired at the start of the job in January to level the land. They will be hired for the whole month at a cost of £1,200 each. The fee is payable in full on the first day of hire. A deposit of £500 per digger is also payable at this point but this amount is refunded in full on the return of the vehicles on the first day of February.

(v) Various materials are needed to complete the work and these will be purchased at different times over the six months. Ace Ltd supplies all the soil and turf and Hardcastle Ltd supplies the sand, cement and bricks/stones. Shrubs and 'other materials' are bought from several different companies. Materials have to be kept on the driveways of the properties during the landscaping process. Since space is restricted, the following schedule of purchases has been drawn up:

Materials	Month Purchased	Amount	Credit terms
Soil	January	£12,600	None
Sand	February	£2,200	One month
Cement	February	£3,100	One month
Bricks/stones	March	£85,000	Two months
Turf	May	£48,000	One month
Shrubs	May	£16,700	None
Other materials	Every month	£2,000 per month	None

The two key suppliers do charge delivery costs but these are already included in the above amounts. Both key suppliers also give a 10% bulk order discount on any individual order that exceeds £40,000 in any given month. Mr Morello has not taken any bulk discounts into account when calculating the above figures.

(vi) A waste disposal company has agreed to remove waste throughout the six months at a total cost of £8,500. This must be paid in January.

(vii) Each of Mr Morello's five employees is paid a salary of £21,600 per annum. They are all paid on the last working day of each month for that month's work. Mr Morello has also agreed to give each worker a bonus of £1,500 in June for completion of the contract within the six-month period.

(viii) The firm uses three vans, which the five workers share. These are leased at an annual cost of £3,960 each, payable in equal monthly instalments on the first day of each month.

(ix) Mr Morello himself uses a business car that has already been fully paid for. He plans to sell the car in April for £3,000 cash, giving rise to an anticipated profit on disposal of £600. His replacement car, to be bought and paid for in the same month, is expected to cost £18,500. He charges depreciation of £300 each month in his accounts for the existing car and will charge £385 per month for the new car. Depreciation is charged in full in the month of acquisition but not at all in the month of disposal.

(x) Mr Morello's business account is expected to be overdrawn by £14,200 at the beginning of January.

(xi) The bank charges interest of 1% per month on an overdrawn balance, calculated on the closing bank balance each month, and payable the following month. No interest is credited on positive balances.

Required:

(a) Prepare a monthly cash budget for each of the six months to 30 June 2007, showing the cash balance at the end of each month. Assume that the contract is completed on time. (24 marks)

In the past, Mr Morello has had problems with Hardcastle Ltd delivering the wrong materials or delivering the materials late. Its prices are so good that he does not want to buy from anybody else. However, it has been such a problem that he is considering making all of these purchases at the beginning of January. He feels that it would also be useful to have a basic understanding of the essential elements of a contract so that he knows his position when dealing with problems with suppliers.

(b) Discuss the costs and benefits, for Mr Morello, of ordering materials early. No additional calculations are required. (8 marks)

(c) Briefly outline two essential elements of a contract. Do not discuss 'form' since most contracts do not have to be in any strict legal form. (4 marks)

(d) The local building firm that Morello Landscapes has entered into the new contract with has only been in business for five years. Mr Morello therefore had to check on the creditworthiness of the firm.

List four *external* sources of information that Mr Morello may have used to provide assurance about the creditworthiness of the local building firm. (4 marks)

(40 marks)

2 ‘Nippers’ is a children’s nursery. It is a profitable business and demand for child places always exceeds supply because of the great shortage of local nurseries. It is owned and managed by a lady called Mrs Dibble. All the staff at the nursery are either relatives or good friends of Mrs Dibble’s and even the shortest-serving member of staff has worked at the nursery for ten years. Mrs Dibble is planning on retiring on her sixtieth birthday in six years’ time, at which point she hopes to sell the business to one or some of the existing staff. She wants to work full-time until then since she enjoys working so much.

She is currently considering whether to extend the building in order to create more space so that she can meet the demand for nursery places. Mrs Dibble’s brother has offered to do the extension, by himself, at a very competitive price. He is currently unemployed and he faces bankruptcy if he does not find work soon. Mrs Dibble estimates that, with the extension, she would be able to sell the business as a going concern for £600,000 in six years’ time. Without the extension, she would expect to sell it for £500,000 in six years’ time.

A local builder has recently approached Mrs Dibble with an unexpected offer to buy the nursery now for £850,000. He hopes to build apartments on the land.

Mrs Dibble needs to decide whether to carry on in business without the extension (Option 1), have the extension built (Option 2), or sell to the developer (Option 3). The following information is available.

1. Mrs Dibble has already obtained preliminary planning permission for the extension at a cost of £1,200.
2. Mrs Dibble’s building costs are estimated to be £85,000. Of this amount, £45,000 relates to materials and must be paid immediately. The balance of the building costs relates to labour and will be paid on completion of the work. The work would take one year to complete. The nursery would still be open as usual during the year so revenue would be unaffected by the building work.
3. The nursery currently generates net cash inflows of £98,000 per annum. With the extension, these would rise to £135,000 once the work is complete. Mrs Dibble pays herself a salary, but this amount has already been deducted before arriving at the £98,000.
4. The nursery’s cost of capital is 10% per annum.
5. Assume that all cash flows occur at the end of each year, unless otherwise stated.

Required:

(a) Using the discount tables provided at the end of the question, calculate the net present value (NPV) of each option at the business’s cost of capital. Based on these calculations, conclude as to which option Mrs Dibble should choose. (16 marks)

(b) Outline four non-financial factors that Mrs Dibble should take into account before finally making a decision. (4 marks)

Discount factor tables at a discount rate of 10%

Time	Factor
1	0·909
2	0·826
3	0·751
4	0·683
5	0·621
6	0·564

Annuity factor tables at a discount rate of 10%

Time	Factor
1	0·909
2	1·736
3	2·487
4	3·170
5	3·791
6	4·355

(20 marks)

3 Noise Ltd makes and sells sound equipment to a range of clients. Its main supplier, Speak Ltd, has never offered discounts for early payment so Noise Ltd has always taken the full 60 days' credit allowed by Speak Ltd.

Speak Ltd has recently been having problems collecting its debts on time. Following this, a decision has been made to offer customers a 2% discount for all invoices paid within two weeks (14 days) of purchase.

Noise Ltd can invest cash to obtain an annual return of 12%.

Required:

(a) Determine whether it is financially viable for Noise Ltd to take advantage of the early payment discount. (7 marks)

(b) From Speak Ltd's point of view, what might be three benefits of offering such settlement discounts to its customers? (3 marks)

(c) Discuss four features of a credit control system that would encourage customers to pay on time. (10 marks)

(20 marks)

4 Zimmer plc is a listed company specialising in the manufacture and distribution of mobility aids, ranging from walking sticks to wheelchairs. The company directors are considering branching out into the manufacture and distribution of stair lifts. Such expansion would require considerable capital investment and the company is therefore considering how it could finance the project.

Required:

Explain:

(a) the advantages and disadvantages, to a company, of debt finance over equity finance; (8 marks)

(b) the reasons why a company may choose to issue preference shares rather than ordinary shares or debt; (4 marks)

(c) four factors that will be taken into account by a bank when deciding whether or not to lend money to a client. (8 marks)

(20 marks)

End of Question Paper