Managing Finances

Paper T10

ACCA CERTIFIED ACCOUNTING TECHNICIAN EXAMINATION

ADVANCED LEVEL

WEDNESDAY 14 JUNE 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 Maybay Hospital is a private hospital. Currently, all cleaning is undertaken by staff employed by the hospital. There are 150 cleaning staff in total, of which half work full-time and half work part-time.

Over the last year there has been a serious outbreak of the MRSA bug (a bacterial infection resistant to antibiotics) in the hospital. Cleaning standards have therefore become a key issue. The hospital is currently being sued by a group of patients who are all claiming to have suffered from MRSA following admittance to Maybay. This has caused a significant fall in the number of patient admissions and an increase in the hospital's insurance costs.

The hospital managers are now considering whether they should continue with their existing cleaning staff (Option 1) or contract out the cleaning function to external providers for the next five years (Option 2). The following information has been provided:

1 Full-time cleaning staff work 35 hours a week and are paid £5·70 per hour.
2 Part-time cleaning staff work a 20-hour week and are paid £5·65 per hour.
3 Eight full-time supervisors are also employed, in addition to the cleaning staff, at a salary of £15,000 per annum each.
4 Other staff costs, including pension costs, average £2,625 per annum per full-time employee (including supervisors) and £1,215 per part-time employee.
5 If the cleaning continues to be done by hospital cleaners, it has already been decided that 10 new full-time cleaners will be employed immediately. The hospital will also recruit a further 15 full-time cleaners in one year's time.
6 Total insurance costs for the whole hospital are currently £6·5 million per annum. The hospital estimates that these will fall immediately by 10% if the cleaning is contracted out to an external provider. They will remain the same if the cleaning is NOT contracted out.
7 Cleaning materials cost £1·44 million per annum. If an external provider is used in the future, they will provide their own cleaning materials.
8 Independent inspectors inspect hospital hygiene standards every six months. Breaches of standards fall into one of two categories: serious breaches, for which a fine of £10,000 per breach is imposed, and minor breaches, for which a fine of £2,000 per breach is imposed. If the hospital does NOT contract out its cleaning, but the new cleaners are employed, it is estimated that serious breaches can be limited to 22 per year and minor breaches can be limited to 74 per year. The external providers expect to restrict these breaches to 17 and 50 respectively in the first year, falling to 8 and 25 respectively per year thereafter. Even with a contracted out cleaning service, the hospital will continue to be responsible for all payments of fines.
9 The hospital has invested heavily in floor polishing machines over recent years, and currently has 150 in total. The external providers have offered to buy these immediately at a price of £4,000 each, should the contracting out go ahead.
10 Adverse publicity resulting from the MRSA bug is costing the hospital £1·2 million per annum in lost contribution. The external cleaning providers' reputation is such that this amount can be totally eliminated immediately.
11 The external providers have offered to provide cleaning services for a contracted five-year period. The fees will be £4·25 million for each of the first two years, increasing to £4·5 million per annum thereafter.
12 Administration costs are currently £300,000 per annum. They would fall to £270,000 per annum if the cleaning were contracted out.
13 If the hospital decides to contract out the cleaning, it will be with immediate effect. A redundancy package has been put together for current staff. Each full-time employee, including supervisors, will receive an average of £5,000 and each part-time employee will receive an average of £3,000. These amounts will be payable immediately.
14 The hospital managers have spent £60,000 researching and calculating their costs.
15 The hospital's cost of capital is 10% per annum.
16 Assume that all cash flows occur at the end of each year unless told otherwise.

Required:

(a) **Calculate the net present values of the costs of each of the two options above. Recommend whether the hospital should continue with its existing staff (Option 1) or contract out of cleaning for the next five years (Option 2).** (30 marks)

(b) **State four factors, other than cost, that should be taken into account when deciding whether to use the external providers.** (4 marks)

(c) **Explain the main principles used to differentiate between relevant and irrelevant costs for investment appraisal. Include a brief explanation of the treatment of finance costs.** (6 marks)

NOTE: All workings and answers should be in £'000, to the nearest £'000.

Present value table (extract)

Periods (n)	Discount rate (r)
	10%
1	0·909
2	0·826
3	0·751
4	0·683
5	0·621

Annuity factor table (extract)

Periods (n)	Discount rate (r)
	10%
1	0·909
2	1·736
3	2·487
4	3·170
5	3·791

(40 marks)

2 You have been provided with the following financial information relating to Health Foods Ltd.

Forecast Profit and Loss Account for the year ending 30 June 2007

	£'000
Turnover	20,350
Operating costs	(12,265)
Operating profit	8,085
Interest payable	(785)
Profit before tax	7,300
Tax payable	(2,230)
Profit after tax	5,070
Dividends payable	(2,270)
Retained profit	2,800

Extract from Historical Balance Sheet as at 30 June 2006 (Actual figures)

	£'000	£'000	£'000
Fixed assets			8,000
Current assets			
Stock		2,167	
Debtors		2,543	
Cash		1,264	
		5,974	
Current liabilities			
Trade creditors	1,737		
Tax payable	1,895		
Dividends payable	1,542		
		(5,174)	
Net current assets			800
Net assets			8,800

Extract from Forecast Balance Sheet as at 30 June 2007

	£'000	£'000	£'000
Fixed assets			8,300
Current assets			
Stock		3,245	
Debtors		3,318	
Cash		2,984	
		9,547	
Current liabilities			
Trade creditors	1,723		
Tax payable	2,289		
Dividends payable	2,235		
		(6,247)	
Net current assets			3,300
Net assets			11,600

Additional information

1. Operating costs include depreciation of £200,000.
2. The company does not plan to sell any fixed assets over the next year.
3. Fixed assets are all tangible (physical) assets.
4. All finance costs are paid in the year in which they are incurred.

Required:

(a) Prepare a forecast cash flow statement for Health Foods Ltd for the year ending 30 June 2007 identifying the net cash flow for the business.
Note: Accounting standards format is not required. (16 marks)

(b) Briefly describe the drawbacks of the Baumol (EOQ) cash management model. (4 marks)

(20 marks)

3 You are an accounting technician working at Shoes for You Ltd, a company that manufactures and distributes a range of fashion shoes. All shoes are made at the company's factory in the country of Bushai, where materials and labour have historically been very cheap. The shoes are then exported to the UK where they are sold to a number of retail outlets.

All costs are incurred in Bushai's unit of currency. All materials are paid for in cash at the time of purchase. Production staff are paid their wages daily in cash. They have not had a pay increase in the last year. All other overheads, production and sales, are on credit.

All sales are to UK customers and are on credit. They are, therefore, invoiced (and amounts are received) in £ sterling. Any finance needed for the business is also obtained from the UK.

You have estimated the figures below for the coming year. Sterling has been used for all figures so as to avoid any distortion caused by high inflation in Bushai.

Sales	£2,500,000
Average debtors	£410,000
Materials purchases	£630,000
Production staff wages	£450,000
Other production overheads	£350,000
Sales overheads	£320,000
Net profit margin	30%
Average stocks:	
Finished goods	£325,000
Work in progress (65% complete)	£195,000
Raw materials	£133,000
Average creditors	£73,000

The economy in Bushai has recently become unstable. This has led to a rapid increase in inflation levels over the last year, from 10% at the beginning of the year to 25% at the end of the year. Interest rates are controlled by Bushai's central bank. Inflation in the UK has remained stable at about 4% per annum.

Required:

(a) Calculate the cash operating cycle. (10 marks)

(b) The raw material holding period has doubled over the last year.

State the main financial advantage and main financial disadvantage of this happening, paying attention to the fact that inflation has increased over the year. (4 marks)

(c) Discuss BRIEFLY the general problems associated with inflation as listed below and consider how each problem affects Shoes for You Ltd.

(i) Redistribution of income and wealth; (2 marks)

(ii) The balance of trade (Do NOT discuss exchange rates); (2 marks)

(iii) Higher interest rates. (2 marks)

(20 marks)

4 Financial analysts will use ratios to compare performance of companies in the same industry.

Lenders will frequently use ratio analysis to help them decide whether to lend to an individual in the first place and whether to continue their financial support. Business owners and managers also use ratios to assess the financial performance of their business. Such ratios may include earnings per share, interest cover, gearing and net profit margin.

Required:

(a) Outline FOUR sources of finance (short and/or long-term) available to small and medium-sized businesses. Ignore government grants, leasing and factoring. (12 marks)

(b) Discuss four limitations of ratio analysis. (8 marks)

(20 marks)

End of Question Paper