FINANCE AND MANAGEMENT CASE STUDY

Final Test of Professional Competence examination
16 June 2005

TUTORIAL GUIDE

It is important that candidates answer all the questions as set.

Where illustrative figures or information are asked for in a question, or their use is implied in the data, then they must be shown in the candidate's answer.

Evasion of the terms of the question on the grounds that the situation depicted in the Case Study is unlikely to have arisen or occurred, or is improbable in concept, should be penalised.

Working papers submitted with answers should be scrutinised and used to test the candidates' line of argument in unfinished work and as a guide to the method by which the candidates have utilised their acquired knowledge to deal with the various aspects of the case study.

Detailed calculations are set out in the appropriate attached appendices. It must be emphasised that these are not 'model answer' figures but are based upon what are judged to be the 'best' assumptions made in answering the question. Candidates should not therefore be judged on whether they got the figures 'right', but on how they reached their figures and how reasonable are their assumptions and arguments.

CIPFA

CIPFA PROFESSIONAL EXAMINATION 3
FINANCE AND MANAGEMENT CASE STUDY EXAMINATION JUNE 2005

ACADEMIA COLLEGE

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Synopsis of Case

Academia is the largest of the ten islands making up the independent state of Fehe, part of the European Union. Its capital, Universe City, is also the State capital and the location of Academia College, the State's major further and higher education centre. Academia Central Theatre (ACT) was established in 1986 on the Academia College site and, for teaching purposes, forms part of the Faculty of Arts and Media. The primary aim was always to create a professionally operated Arts Complex, although it was agreed that ACT facilities and professional staff should also be used for teaching purposes. ACT has its own constitution, is financially independent and operates through a Board of Governors (BoG). Historically, funding has been through a partnership between three bodies – Academia County Council, Academia College and the Government-funded Fehe Arts Council (FAC). However, as a result of Local Government Reorganisation (LGR) in Fehe, Academia CC was replaced from 1 April 2003 by three unitary Authorities, two of which are now reluctant to fund ACT.

The ACT also has a new Chief Executive (CE), who is responsible for both artistic product within the theatre and overall management of the theatre's resources. Historically, the CE has also been the theatre's artistic director, responsible for devising the artistic programme, casting, production planning, managing the theatre's professional company of actors and personally directing a number of plays each year. The new CE's first season of plays has received critical acclaim, but has impacted adversely on the ACT net production budget as a result of poor box office receipts and higher than planned expenditure. The BoG is also eager to progress a long-held plan to develop a piece of land adjacent to the ACT as an extension of the current facilities and consultants have been employed to produce project "Options" for consideration.

Candidates take on the role of Special Projects Manager within the Finance and Audit arm of the College's Resources Directorate and are given responsibility for carrying out a financial appraisal of the project "Options" and, in the light of concerns raised by the BoG, an independent review of ACT's current and future budgetary positions.

The case material also gives candidates full opportunity to demonstrate their understanding of the case material, their ability to apply management knowledge and their skill at communicating relevant information clearly and tactfully.

Question 1 **Page**

Aims

(a) To test candidates' understanding of the case material and particularly the issues raised by the ACT Chief Executive's (CE's) e-mail/letter to all staff and Governors;
(b) To test their ability to evaluate the ACT CE's proposals and his estimate of the likely savings from the staffing and operational changes suggested;
(c) To test their ability to identify the errors of judgement made by the ACT CE in his approach, the lessons to be learnt for the future and the letter's potential impact on ACT stakeholders;
(d) To test their competence in suggesting a broad approach to tackle and defuse the current situation and to implement the changes required to address the deficit situation;
(e) To test candidates' ability under severe time pressure to prepare a well-structured briefing note for the Vice-Chancellor covering all these issues.

Assessment

(a) Brief background and evaluation of the potential for cost savings in the ACT CE's proposals, in the context of the ACT Finance Manager's revised 2005/06 budget.
(7 marks – C3, A4)

- Brief background to the current financial situation being faced by the theatre in terms of the 2004/05 deficit situation and the need to recoup at least part of this in 2005/06.
- A note that the announcements made by the CE are in response to –
  - the recent College Management Team meeting attended by the CE where he was encouraged to take "drastic action" to address the deficit situation; 6
  - and subsequent undocumented consultation with the Dean of Art and Media.
- Comment that the discussions with the Dean appear to have been general rather than specific, but have been interpreted by the CE as giving him power to act. 24
- Comment upon the various detailed proposals put forward to achieve savings. 24
- On the administrative staff savings proposed - 24
  - calculation of the specific staff savings proposed;
  - comment that these are likely to save £20,000, not "over £30,000" ;
  - a note that the ACT Finance Manager has already taken account of savings of £20,000 in the revised 2005/06 budget.
- On the production staff savings proposed - 24
  - breakdown of production staff costs into base pay, oncosts and overtime; 6,9,17
  - calculation of the impact of switching all production staff from COSTS to STAGE conditions of service;
  - a statement that the <u>maximum</u> savings possible are £61,200, not £150,000;
  - a note that the ACT Finance Manager has already taken account of savings of £35,000 in the budget proposed for 2005/06 and this looks high.
- Comment that the "cost savings" from the proposed reduction in teaching contact hours are largely notional, since the freed staff and facilities time will be "redirected to the theatre's own artistic product" (this might result in some marginal overtime savings). 24 6,12,16 (viii),24
- On the proposed cut in amateur productions, a note that the production costs of these shows are recouped against box office income to achieve a net nil cost position.
- Comment that touring is funded specifically by the FAC and any reduction in this area would almost certainly be matched by a reduction in FAC grant. (viii)
- Conclusion that the CE's proposals are likely to have little real impact on the ACT's current financial position. (viii)

<u>NOTE</u> For suggested calculations see Appendix 1A

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(b) Identification of, and comment upon, the errors of judgement made by the ACT CE in issuing the letter to all staff and Governors and the lessons to be learnt for the future, together with an evaluation of the potential impact of the letter on ACT stakeholders. **(8 marks – A8)**

- Lack of planning – a comment that the proposals to make changes have been left to the last minute.
- Lack of consultation with all parties.
- Timing -
  - letter e-mailed to all staff late in the day;
  - letter sent out by post to all Governors;
  - staff meeting late in the day.
- Autocratic approach – 24
  - changes must be made – "inevitable";
  - the purpose of the staff meeting is not really consultation – "any questions".
- No real consideration of the consequences suffered by the CE's previous theatre when similar changes were made, except that most were negative –
  - it was painful; 24
  - it took a long time;
  - it hurt relationships.
- A note that he left after just three years and a query about whether the changes made, in fact, have proved to be worthwhile. 4,16
- Misinterpretation of a broad directive given by the College Management Team and the Dean of Arts and Media to take unilateral action.
- No consideration of the effect of change upon any of the ACT stakeholders –
  - Governors – the changes proposed affect policy, not merely administration and the ACT CE has effectively overridden their powers in issuing the letter; 4,16
  - Students – the ACT CE sees education as very much secondary to the artistic product at a time when student numbers for such courses are increasing and commitments have already been made re course provision;
  - Theatre employees – implied criticism of their commitment and customer focus coupled with the threat to their conditions of service (particularly pensions) and even their continuing employment; (iii) (viii)
  - College – the ACT permanent staff are technically College employees and any dispute situation could escalate to affect other College operations;
  - FAC – touring is a key objective, particularly as part of the resource allocation review and the need to increase artistic product at more remote venues; 24
  - National Lottery – has provided additional "Arts for All" funding and will be concerned about a "Theatre cash crisis"; (vii), 16
  - Amateur Companies – reducing use of the theatre by such companies would potentially alienate groups who are probably regular theatre-goers and supporters of the professional products, as well as upsetting Lerningshire County Council, a keen supporter of amateur groups and a major ACT funding partner; (viii),1 (vi), 18
  - Theatre–going public – clearly did not support the CE's product very well in 2005/06 and are unlikely to be encouraged to return by talk of production cut-backs, deficits, disputes and possible strike action.
- No consideration of media involvement and the potential bad publicity for most of the main stakeholders.
- No consideration of the response from the Unions.
- The potential threat to ACT funding as a result of the proposals and the CE's approach to implementing these.
- Query whether the CE's actions are deliberately extreme to provoke reaction and deflect attention off theatre programming and programme budgeting – the real issues.

(c) Suggestions as regards a broad approach to tackle and defuse the current situation. **(3 marks – R3)**

- ❑ Acknowledgement that the ACT does have a serious financial problem which must be addressed and that there is a need to consider all options.
- ❑ A note that there is a clear need to defuse the current situation through -
  - some toning down of the "decisions" made by the CE;
  - an explanation that the CE's proposals have not yet been considered in detail by the ACT Board of Governors, the College Management Team or the Dean of Arts and Media;
  - a note, however, that no options can be ruled out until they have all been properly evaluated.
- ❑ A note of the need for a joint press statement from interested parties to minimise further bad publicity.
- ❑ A statement that there is a need to bring together all key parties to discuss the main issues and problems.
- ❑ On some issues, there may be a need to consult the theatre-going public and/or carry out market research.
- ❑ A note that, through these consultations and approaches, there is a need to identify and evaluate all possible options, not just those proposed by the CE.
- ❑ A comment that the current artistic programme proposed for 2005/06 is not "sacrosanct" in this respect as the CE suggests, but will need to be considered along with all other options.
- ❑ A note that, whilst such consultation is essential and hopefully agreement on a way forward can be reached, the Board of Governors is required by its own constitution to take action to address the current financial position.
- ❑ A comment that, in the search for an agreed solution, it might be necessary to involve an independent third party as negotiator/arbitrator.
- ❑ A comment that ultimately, therefore, an action plan and timetable need to be produced for recovery of the deficit and implementation of any changes agreed to achieve this.
- ❑ A note of the need to notify and inform all people affected by these changes and to offer such support as may be required.
- ❑ A note that the action plan then needs to be implemented.
- ❑ Comment that the implementation needs to be carefully monitored and if necessary adjustments made, but only after consultation.

(d) Presentation, format, tact and general readability. **(2 marks – P2)**

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Question 2

Aims

(a) To test candidates' ability to adjust, analyse and evaluate budgetary information relating to the ACT;
(b) To test their ability to evaluate the ACT's funding problems and their implications;
(c) To test their ability to update the 2004/05 projected outturn and 2005/06 revised budget;
(d) To test candidates' ability to quantify the likely overspend position in 2004/05 and analyse the reasons for this;
(e) To test candidates' ability critically to appraise the 2005/06 budget proposed by the ACT CE and particularly the planned artistic programme;
(f) To test candidates' ability to draw conclusions about the ACT's overall financial position and make recommendations about the treatment of the deficit position;
(g) To test candidates' ability to produce a well-structured report for the Director of Resources for presentation at the next ACT GP Committee.

Assessment

(a) Brief background to the report, its purpose and an evaluation of the current funding problems. **(6 marks – C3, A3)**

- General background to the note and identification of the main objectives – 11
  - Realistic consideration of the likely funding level in 2004/05;
  - Determination of an updated projected outturn for 2004/05 and budget for 2005/06;
  - Identification of the likely 2004/05 budget variance and the reasons for this;
  - A critical appraisal of the updated 2005/06 budget and particularly the proposed 2005/06 production budget.
- A comment that the closing of the 2004/05 accounts and the setting of the 2005/06 budget must be on the basis of firm funding commitments and not aspirations.
- An evaluation of the current funding problems and the determination of realistic funding bases for 2004/05 and 2005/06 -
  - a note that Academia College has now agreed an increase of £30,000 in 2005/06, producing a contribution of £460,000 rather than £430,000; 25
  - a note that Lerningshire has allowed 3% for inflation on its 2004/05 budget, in addition to the £25,000 base increase – a total of £602,000 rather than £585,000; 23
  - a comment that it appears certain that Studiland and Teechingham will not contribute in either year; 21,23
  - a note that lottery funding at £380,000 in 2004/05 and £170,000 in 2005/06 has been confirmed; 18
  - a note that the FAC has –
    - cash limited its block grant at the 2004/05 level - £510,000; 4
    - denied making any commitment as regards the match-funding of £400,000 (£175,000 in 2004/05 and £225,000 in 2005/06). 1,4,21
  - A note that sponsorship only achieved £85,000 in 2004/05 rather than £100,000. 9
- A comment that these adjustments reduce income from Grants, Subsidies and Sponsorship by £300,000 in 2004/05, and £78,000 in 2005/06.
- Conclusion that, for 2004/05, this will increase the already substantial deficit shown in the ATC Finance Manager's projections for the last BoG meeting.
- Conclusion that, for 2005/06, this means finding compensating savings on operational activities or some adjustment to the artistic programme.

<u>**NOTE**</u> For suggested calculations see Appendix 2A.

(b) Updating of the 2004/05 projected outturn and the 2005/06 budget, and determination of the likely deficits carried forward in each year. **(8 marks – C8)**

- Adjustment of grants and subsidies, as detailed above.
- Reduction of the catering income in line with the letter from Kate Herring Ltd. 6,10
- Adjustment of other earned income in line with the information provided by the Theatre Manager - 6,9
  - adjustment of the net bookshop position for the stock write-off in 2004/05 and the saving from reduced opening hours in 2005/06;
  - reduction in the front of house sales figures to reflect lower audience figures and the reduced 2005/06 programme;
  - adjustment of facilities hire income for the improved 2004/05 position and the restrictions on hire in 2005/06.
- Adjustment of the net company productions budget for the year-end shows. 14,15,17
- Adjustment of the budgets on other artistic activities in line with the information provided by the ACT Finance Manager - 6,13
  - adjustment of the projected 2004/05 outturn to reflect the worsening position on visiting professional companies;
  - adjustment of the film figures to reflect the latest projections.
- A summary of the updated 2004/05 projected outturn figures and the updated 2005/06 budget figures and calculation of the deficits in each year.
- Adjustment for the equipment increase. 17
- A statement of the cumulative projected deficit position at 31 July 2006. (iv),(v)

<u>NOTE</u> For suggested points see Appendix 2B.

(c) Analysis of the reasons for the 2004/05 deficit, with particular emphasis on the net company production overspend. **(7 marks – C4, A3)**

- A note that the total overspend against budget in 2004/05 is projected to be £704,500.
- Comment that £350,000 is accounted for by the shortfall on Grants, Subsidies and Sponsorship.
- A note that the net company production budget accounts for a further £334,000.
- Comment that the balance is made up of smaller variations on earned income heads (£46,000) and other artistic activities (£11,000) offset by the contingency (£50,000) and an overspend on overheads (£13,500).
- A statement analysing the net company production account between the Main Theatre (MT) and Studio Theatre (ST), and between income and expenditure. 14,15
- Comment that –
  - contrary to the ACT Chief Executive's statements, poor control over expenditure has not been the main cause of the overspend; 4
  - the shortfall in box office income was the largest contributor, accounting for almost £229,000 of near £334,000 overspend;
  - a note that this was almost entirely on MT productions;
  - a note that almost all overspending also occurred on MT productions;
  - a comment that the first five MT shows all have significant net variances and more than account for the total variance;
  - a note that the adverse variances on expenditure were primarily related to the busy pre-Christmas shows and were probably caused by poor production planning. 13

<u>NOTE</u> For suggested calculations see Appendix 2C.

(d) A critical appraisal of the updated 2005/06 budget and the identification of any areas of risk or concern on the overall budget, together with suggestions to minimise these risks. **(4 marks – A4)**

- A note of the potential risks in the overall 2005/06 updated budget –
  - FAC Block Grant – Has the FAC seen the proposed company production programme for 2005/06 in terms of its artistic content and its reduced number of performances (down from 372 to 288)? (viii),14,15
  - Sponsorship – Only £85,000 was achieved in 2004/05 and there is a reduced artistic programme in 2005/06. Is £100,000 realistic? Commitments only £40,000 so far. 9
  - Catering Franchise Income – Only £45,000 was earned in 2004/05 and the Theatre Manager has reduced his Front of House sales figure by 25% in 2005/06. Is the £50,000 achievable? 10
  - Contingency – There is no contingency provision built in for 2005/06 – surely a high-risk strategy on the basis of 2004/05 variances. (vii),6
  - Production Staffing – Is the cut of £35,000 realistic in view of the comments by the Head of Human Resources? 16
  - Equipment – There is no budget provision. What happens if breakdowns/breakages occur (as happened recently with the lighting control board)? 17
  - Publicity & Marketing – Is the cut of £120,000 sensible when the theatre is seeking to build its audience base? What happens if advance bookings are low? 9
- A comment that the revised budget made no provision for the payback of deficit and the updated budget is itself in deficit.
- Comment that –
  - Views on the 2005/06 net company production programme need to be sought urgently from the FAC;
  - It might be worth approaching the FAC in a positive (non-aggressive) way about the deficit and about the possibility of additional one-off funding towards it; 1,4
  - If there is no contingency, company production budgets need to be very conservative (see below);
  - An equipment budget must be added;
  - There need to be specific plans and very careful monitoring to ensure that the other at-risk budgets are achieved.

(e) A critical appraisal of the proposed 2005/06 net company production programme and budget, particularly the assumptions on audience capacity and yield per ticket, together with suggestions to minimise these risks. **(7 marks – C4, R3)**

- A critical appraisal of the base used for audience attendances in the 2005/06 net company production budget – 25
  - Calculation of the budgeted and actual audience percentage attendances for the MT, ST and overall in 2004/05;
  - Calculation of the budgeted audience percentage attendances for the MT, ST and overall in 2005/06;
  - Acknowledgement that on the MT the budgeted percentage has been reduced from 71.6% to 68.5%, but this is still well ahead of the 2004/05 actual;
  - A note that for the ST, the percentage has been increased from 71.8% to 80%, again ahead of the 2004/05 actual;
  - Comment that the 2005/06 budgeted percentages still look optimistic.
- A critical appraisal of the base used for ticket yield in the 2005/06 net company production budget –
  - Calculation of the budgeted and actual yield per ticket for the MT, ST and overall in 2004/05; 14,15
  - Calculation of the budgeted yield per ticket for the MT, ST and overall in 2005/06;
  - Acknowledgement that on both theatres the budgeted yield per ticket has been reduced by 40-45p, but that this is still well ahead of the 2004/05 actual;
  - Comment that the 2005/06 budgeted yield per ticket still looks optimistic.
- Comments upon the detailed programme for 2005/06 and comparison of similar types of shows in terms of attendances and yield per ticket – 14,15
  - English 20th C drama –
    - MT1 (2004/05) – 23% attendance at £7.47 yield per ticket
    - MT4 (2005/06) – budget = 60% at £8.00
  - Academian 19th C drama –
    - MT2 (2004/05) – 31% attendance at £7.50 yield per ticket
    - MT3 (2005/06) – budget = 60% at £8.00
  - Christmas Pantomime –
    - MT3 (2004/05) – 83% attendance at £6.76 yield per ticket
    - MT2 (2005/06) – budget = 90% at £6.80
- A note that these are relatively crude comparisons as shows might differ considerably in popularity, but that again they do reflect optimistic rather than safe budgeting;
- Comment that in 2005/06 –
  - ST2 seems very high cost for just 15 performances (cut back significantly from 2004/05); 15
  - ST3 is relatively costly for 23 performances; 15
  - ST4, the Academian premiere, looks high risk and is relatively costly; 15
- Possible suggestion that amendments are made to the current programme to bring in more popular productions, such as ST1 in 2004/05 (produced surplus), in place of these high cost/high risk shows. 14

NOTE For suggested points see Appendix 2D.

(f) Presentation, format, readability and general logic of approach and argument **(3 marks – P3).**

Question 3

(a) To test candidates' ability to apply statistical and investment appraisal techniques in the context of various proposals for extending the existing facilities at the ACT;
(b) To test their ability to produce net costs for the various proposals and, from these, to calculate the expected monetary values (EMVs) for each of the options;
(c) To test their competence in explaining the decision tree methodology to a non-financial person;
(d) To test their competence in marshalling, arranging and analysing complex financial data and probability figures relating to these proposals through the use of the decision tree approach;
(e) To test their ability critically to appraise and interpret the results of the exercise and to make recommendations based upon these results and the broader financial and non-financial factors relevant to the various proposals;
(f) To examine candidates' competence in drafting a short report for the Head of Finance & Audit for initial discussion with the ACT CE, the Vice-Chancellor and the Dean of Arts and Media.

Assessment

(a) Brief introduction, a note of the main options, main constraints and assumptions, and production of net income figures for each of the proposals. **(7 marks – C5, A2)**

- ❑ Brief introduction and identification of the proposals which need to be analysed -
  - Option A1 – The building of a concert room (seating 250) for jazz, folk and other such small-scale events, incorporating a bar area, a small film theatre and a large storage room for sets and props; 8,19,20
  - Option A2 – As for A1, but with a storage room much reduced in size in order to incorporate a snack bar, small kitchen and food servery area into the proposal;
  - Option B - The building of a medium-sized concert hall and conference centre (seating 1,000), incorporating a bar, snack bar, small kitchen and food servery plus a rehearsal room;
  - Option C1 – The building of a large-sized concert hall and conference centre, (seating 1,500), incorporating a bar, snack bar, small kitchen and food servery plus two rehearsal rooms;
  - Option C2 – As for C1, but with one rehearsal room instead of two in order to incorporate a restaurant into the proposal.
- ❑ A note of the FAC's requirement that the proposals must produce a positive expected monetary value after the meeting of capital costs over the ten-year appraisal period. 7
- ❑ A note of the assumptions used in the analysis for all Options -
  - Net earned income projections are based upon three levels of usage – high, medium and low with probabilities attached of 0.4, 0.3 and 0.3 respectively; 7,8
  - All revenue income and expenditure projections are based upon a ten-year period (2006/07 to 2015/16) discounted back to 2005/06;
  - Capital costs are incurred in 2005/06. 7
- ❑ A note of the assumptions used for the additional Options, A2 and C2 -
  - Net earned income projections are based upon two levels of usage – high and moderate with probabilities attached of 0.4 and 0.6 respectively; 20
  - All net earned income projections are based upon a ten-year period (2006/07 to 2015/16) discounted back to 2005/06; 7,8,20
  - Capital costs are incurred in 2005/06; 20
- ❑ Calculation of projected overall net income figures for each of the Options.

NOTE For suggested calculations see Appendix 3A.

(b) Explanation of the decision tree methodology and its limitations. **(3 marks – A3)**

- A simple explanation of the decision tree methodology –
  - A decision tree is a diagram that illustrates the choices and possible outcomes of a decision;
  - All possible choices that can be made are shown as the branches of a tree and all the possible outcomes of each choice are also shown as subsidiary branches;
  - Decision trees are normally from left to right and symbols are used to distinguish between points where decisions must be made and points at which the outcome is uncertain;
  - The evaluation of a decision tree is carried out by "rolling back" from right to left calculating the average expected value at each outcome point by computing a weighted average of the ascribed value of each possible outcome at that point weighted by their probabilities;
  - At decision points, the best alternative in terms of expected value is taken and that decision's payoff used in prior (further left) outcomes;
  - This process continues until the far left of the decision tree is reached and the best alternative in terms of expected value net of one-off capital costs is identified.
- A note of the methodology's limitations –
  - It merely considers the alternatives put forward – there may be other viable options not evaluated;
  - It is purely a numerically driven approach and takes little account of broader non-financial issues such as the availability of funds, stakeholder views, the organisation's strategic objectives, risk, etc.;
  - The methodology produces "average" results based upon probability weightings (which may be highly subjective), not one specific outcome, and indeed the average expectation may not represent an actual possible outcome;
  - It takes no account of the decision takers, and their level of risk aversion.

(c) Drawing of the decision tree for the Options, calculation of the net EMVs for each of the Options being considered and the netting of the EMV of each of the Options A1, A2, B, C1 and C2 against capital costs. **(10 marks – C4, A4, R2)**

- Drawing of the decision tree to incorporate all the proposals being considered.
- For the two additional complex Options (A2 and C2) –
  - Calculation of the A2 and C2 EMVs for each of the high, medium and low scenarios after extra running costs and the open/not open decision;
  - Calculation of the net position for each scenario after taking account of capital costs pertaining to Options A2 and C2;
  - Determination of which scenarios, if any, produce a positive contribution;
  - Conclusion that the range of possible outcomes from the various scenarios is highly variable, ranging from £555,000 surplus (Option A2 high usage) to £620,000 deficit (Option C2 low usage);
- Calculation of the individual EMVs of the five Options for each of the high, medium and low scenarios, after taking account of the above additional contributions arising from the further decisions on A2 and C2.
- Calculation of the combined EMVs on the basis of the high, medium and low probabilities of 0.4, 0.3 and 0.3 respectively for the five Options to arrive at an average total net income position for each Option.
- Calculation of the EMV of each of the Options, net of capital costs.

NOTE For suggested calculations see Appendix 3B.

(d) A critical interpretation and evaluation of the results achieved, together with recommendations based upon these results and the broader financial and non-financial factors relevant to the various proposals. **(6 marks – C2, R4)**

- Conclusion that Option B produces a negative net result and does not therefore satisfy the key criterion set by the FAC. 7
- A comment that both Options A1, A2, C1 and C2 produce positive net EMVs but that all the expected surpluses are relatively small, the best being option A2 at £99,000.
- A comment that, in terms of the financial decision, much depends upon the views of the various stakeholders and the degree of risk aversion of the decision takers. 8,19
- Academia College favours one of the two smaller schemes in order to retain land for student accommodation and prefers the original proposal A1 with the larger store room in order to free space currently being used by the ACT within the college building.
- Lerningshire County Council is primarily concerned about the deficit situation and believes that any decision must be driven by financial considerations. 23
- In terms of prestige, the FAC makes it clear that it would prefer Option C2 as this involves inclusion of the restaurant at the expense of a rehearsal room, but on the best financial terms in view of the ACT revenue deficit position. 4
- The ACT Chief Executive clearly favours Option C1, as this gives him the rehearsal space required and he has doubts about the viability of restaurants in theatres. 4,17
- A note that, whilst Option A2 produces the highest net EMV, this is the average based upon three different outcomes and relies heavily upon the most optimistic (high) outcome.
- Option C2 would involve not opening the restaurant in order to minimise losses after incurring extra capital costs of £120,000 if usage is low which would be a public embarrassment.
- A comment that Option A2 at the medium and low usage levels produces negative net EMVs of £33,000 (medium usage) and £377,000 (low usage).
- A note that Options C1 and C2 produce the widest variation in possible results and therefore expose the ACT to the greatest level of risk.
- The decision is relatively close between the Options with a positive EMV (A2, A1, C2 and C1 ranked by size of positive EMV) on financial grounds.
- The financial risk involved in Options C1 and C2 is likely to be unacceptable to all the main funding partners.
- Option A1 has the lowest negative worst case at £320,000, but this is material to the ACT and would make the whole operation more financially unstable if low usage were to be encountered.
- The level of financial risk is unacceptable on all the Options as a low usage outcome would result in unacceptable levels of deficit and there is a substantial (30%) probability of this.
- The best option on financial grounds is Option A2, but the ACT could only proceed with this option if one or more of the funding partners were prepared to underwrite the significant deficit that would arise if usage of the Concert Room turns out to be low.
- Given their inability to increase funding much further for current activities, it is unlikely that any of the partners could underwrite a further substantial deficit.
- It would therefore be more prudent not to proceed with any of the proposals.

NOTE For suggested calculations see Appendix 3C.

(e) Presentation, format, tact and general readability. **(2 marks – P2)**

Question 4

Aims

(a) To test candidates' understanding of the case material and particularly the issues raised by the ACT CE in his recent letter;
(b) To test their ability to analyse the College's actual and notional contributions to the ACT in order to refute the statements made by the ACT CE;
(c) To test their ability to consider and determine appropriate treatment of the invoices raised in respect of contribution income from Studiland and Teechingham in response to the ACT CE's proposals;
(d) To test their ability to consider and determine appropriate treatment of the NI windfall in response to the ACT CE's proposals;
(e) To test candidates' ability to produce a balanced, tactful and well-structured draft letter addressing all relevant issues.

Assessment

(a) Brief introduction and responses to the funding issues raised by the ACT CE.
(7 marks – C3, A4)

- Brief introduction and a note that -
  - the building of the ACT was primarily driven by Academia County Council; (iii)
  - as a result, Academia County Council was the main funding partner, providing about two thirds of the external finance; (v)
  - Academia College had always been the junior partner, providing about 15% of funding in 2002/03. (v)
- Comment that the increased pension fund employers' contributions and job evaluation costs have not been imposed arbitrarily, but are a consequence of the conditions of service of the permanent ACT staff, including the CE. 3,16
- A note that the ACT is financially independent through its constitution and cannot therefore be treated as a faculty of the College. (iii)
- A calculation to show the notional "budget" that would have been given to the ACT if it had been a faculty of the College.
- Conclusion that the ACT has been treated favourably by Academia College -
  - receiving £19,500 more than the notional "budget" in 2003/04;
  - receiving £40,000 more than the notional "budget" in 2004/05, meaning that the additional pension fund employers' costs were more than covered;
  - receiving £50,000 more than the notional "budget" in 2005/06, meaning that the additional job evaluation costs were more than covered.
- An acknowledgement that the FAC did provide a one-off survival grant in 2003/04, but a note that the FAC is only providing £510,000 in 2004/05, not £775,000. (v),(vi),1
- Comment that Lottery money, whilst applied for through the FAC, is not FAC funding. 18
- Calculation and comment that the FAC has, in fact, reduced its block grant in real terms since 2003/04 because of its resource reallocation exercise.
- A note that the FAC grant would have been £546,400 if the 2003/04 base had been fully inflation-proofed and that £36,400 of funding has been "lost" as a result.
- A statement that Lerningshire County Council has more than met its LGR pro-rata funding level. (i),(v),(vi), 23
- A note that, in addition to its stated contribution, Academia College also covers central support and cash flow costs of £185,000 relating to the ACT. 25
- Comment that this makes Academia College the main funding partner, not the junior.

<u>NOTE</u> For suggested calculations see Appendix 4A

(b) Consideration of the issues raised by the ACT CE's proposals to write off the other local authority income against a bad debts provision and an explanation of the appropriate treatment of this in the ACT budget and accounts. **(4 marks – R4)**

- Acknowledgement that Studiland and Teechingham County Councils met their agreed contributions in 2003/04. (v),(vi)
- Acceptance that invoices were raised and sent to Studiland and Teechingham County Councils early in 2004/05 in respect of their expected 2004/05 contributions. 2
- Agreement that the ACT accounts had been credited with this "income", when the invoices were processed.
- An explanation of the debtors ledger system and a note that -
  - When an invoice is issued and processed, the college department is credited immediately with the invoice amount and the debtors ledger is debited;
  - When the income is received, the debtors ledger is credited.
- A note that, in the case of the 2004/05 invoices sent to Studiland and Teechingham -
  - It later became clear that there had never been any agreement that the two local authorities would contribute in 2004/05; 2,21,23
  - The invoices had been returned by both Authorities with letters to this effect;
  - The invoices should never have been raised by the ACT.
- A comment that there is a difference between the write off of "bad debts" and the cancellation of invoices which have been raised incorrectly –
  - The write-off of true "bad debts" generates a debit to the bad debts provision and a credit to the debtors ledger;
  - The cancellation of invoices necessitates reversing the original entries, namely a debit to the department originating the invoice and a credit to the debtors ledger.
- A conclusion that, as regards the invoices raised by the ACT in respect of Studiland and Teechingham County Councils, cancellation was clearly the correct accounting practice, with any other approach certain to be challenged at audit.

(c) Consideration of the issues raised by the ACT CE's proposals in respect of the refund of NI contributions received and determination of an appropriate treatment of this in the ACT budget and accounts. **(4 marks – R4)**

- Acknowledgement that the ACT is correct in stating that the FAC must be consulted as regards the disposal of any surpluses. (vi)
- A tactful statement that the NI receipt is not a surplus, but rather windfall income for the ACT as a result of a refund of specific past payments. 2,17
- A comment that, in these circumstances, the income ought not to be used in 2005/06 to enhance the net production budget, as the ACT Chief Executive suggests.
- A note that the Director of Resources, as a professional accountant is required to comply with Generally Accepted Accounting Practice (GAAP).
- A note that the College's external auditors –
  - Review the accounts annually to ensure compliance with GAAP as defined in National Financial Reporting Standards;
  - Have already commented specifically upon the ACT's projected deficit position and are looking for this to be addressed. 17
- A statement of the correct accounting treatment, namely that -
  - As the NI income has been received in 2004/05 and relates to prior, not future years, it must be brought into the 2004/05 accounts as income;
  - This windfall income will reduce the 2004/05 projected deficit.
- If any other treatment were possible, it would require Board of Governors approval anyway. (iii)

(d) Presentation, format, tact and general readability. **(2 marks – P2)**