**Exam 3 Answers**

**Question 1**

1. An audit is **an independent examination** of the financial statements to establish that they show a **true and fair view**

of the financial performance (profit)

and position (value/worth) of the company. An audit will not guarantee that the financial statements are correct just true and fair. The scope of the audit does not cover all the information in the annual report, much of the narrative is unaudited.

**6 points maximum 5 marks**

This statement of financial position shows the worth of a company. It shows: the assets which are resources that are controlled by an entity that are expected to bring economic benefits, (generate profits). Example: land and building, inventory the liabilities which are obligations of an entity arising from a past event the settlement of which involves the transfer of resources, (an amount owing by the business). Example loans, trade payables and Equity which represents ”the residual interest in the assets of the entity after deducting all the liabilities” Equity belongs to the owners of the company who are the shareholders

**7 marks** The income statement details the profit that a company has made over the year. It provides information on the financial performance of the company. It highlights gross profit which indicates how well the core business is performing as it compares sales revenue with the manufacturing costs of producing the product. It then highlights operating profit which deducts costs of administration and distribution from gross profit. Final deduction being for tax **7 marks**

(b)

The business has been set up as a limited company. A limited company is a separate legal entity. It is responsible for its own debts. If a limited company cannot pay its debts when they become due it is the company that is bankrupt. The creditors of the company have no recourse to the owners of the business the shareholders.

If the company takes out a bank loan the suppliers of the business may look to see if the company can afford the annual interest payments and whether the company will be able to repay the loan when it is repayable.

If the suppliers have any doubts over the company’s ability to pay debts they will perhaps only supply goods on cash terms or limited credit period **7 marks**

C

ROCE is the key ratio which is operating profit/Equity + Non current Liabilities

It can be compared to any other business/investment. A return on capital employed of 21% is very good. This shows that for every £1 invested in the business 21p is returned.

The ROCE = Asset turnover X operating profit margin

Asset Turnover = Turnover/ Equity + Non current Liabilities

This shows how efficiently the business is operating/how well the business is utilising the assets. The higher the figure the more value the company is getting out of the resources at their disposal. An asset turnover of 1.5 is okay but could be better.

The asset turnover is likely to be depressed when a business starts up or expands. It is on start up or expansion that new assets are purchased. The new assets are at current prices and have had only had 1 year depreciation. The denominator is therefore at a high value. On set up or expansion it takes time for the new assets to generate revenue, there is a time lag between purchasing the new assets and generating revenue so the numerator is low.

Therefore a new business will expect to have a low asset turnover.

Profitability

The gross profit margin is very good at 28%. The core business is performing well with the company able to easily cover profits.

The operating profit margin is half the gross profit margin. The costs that are deducted from gross profit to arrive at operating profits are administration costs and distribution costs. A well managed company would seek to keep these costs as low as possible to achieve high margins.

This company has not done this it needs to look at why these costs are so high. Are there some one off costs that have been included at the start of the business which are not expected to re-occur.

Generally the excellent ROCE is down to high profit margins

**12 marks**

((d) Profits do not equate to cash.

Profits of a business are calculated on the accruals principle

Revenues and costs are recognised when they occur and not when cash flows into or out of the business

When a sale is made it is recognised in revenue even if cash has not been received from a customer

Cost of sales matches the quantity sold with the same quantity. When more stock has been bought than sold the excess is carried forward to the next accounting period as closing stock.

When a business first starts to trade it will have to purchase a lot of stock which may not all be sold plus plant and machinery etc. Therefore there will be a lot of expenditure and a negative cash balance.

The purchase of items of plant and machinery are regarded as assets and so will not go into the income statement. The only charge in the income statement for these items is depreciation.

Additionally as stated above only the cost of stock that has actually been sold will be included in the income statement and not all the expenditure. Therefore it is possible that a new business can show a healthy profit while still having an overdraft. **(9 marks**)

**Total 50 marks**

**Question 2**

***Direct costs*** of a cost object are those that are related to a given cost object (product, department, etc.) and *that can be traced to it in an economically feasible way.*

**Indirect costs** are related to the particular cost object but cannot be traced to it in an economically feasible way.

Any example

***Product costs*** are those costs that are attached to the products and therefore included in the inventory (stock) valuation. The product cost will be:

Direct Materials X Direct Labour X Other Direct Expenses X Prime cost X Indirect production costs (overheads) X Product cost X **8 marks**

**(b)**

|  |  |  |  |
| --- | --- | --- | --- |
|  | Cushions | Bean bags | Service |
| Direct material | 3metresX £6.50x8,000 units  **156,000** | 3.2metres x £5.60 x 6,500units  **116,480** |  |
| Direct expenses | £6 x 8,000 units  **48,000** | £7.50 x 6,500units  **48,750** |  |
| Direct labour | 1.5hrs X£11x8,000units  **132,000** | 2hrs x£11x6,500units  **143,000** |  |
| **Prime cost** | **336,000** | **308,230** |  |
| Rent and business rates | £30 x 1,500  **45,000** | £30 x 1,300  **39,000** | £30x200  **6,000** |
| Utility | 0.28x80,000  **22,400** | 0.28x60,000  **16,800** | 0.28x10,000  **2,800** |
| Department costs | **403,400** | **364,030** | **8,800** |
| Re-apportion service cost | £4 x 1,200  **4,800** | £4 x 1,000  **4,000** | **(8,800)** |
|  | **408,200** | **368,030** |  |
| Number of units | 8,000 | 6,500 |  |
| PRODUCT COST | **51.03** | **56.62** |  |

Rent and business rates absorbed on basis of area 90,000/3,000sq.metres = £3 per sq metre

Utility bills absorbed on the value of plant 42,000/150,000 = 0.28 per £

Service centre split on call outs 8,800/2,200=£4 per call out

Prime cost 336,000/8000 = £42 308,230/6,500 = £47.42 **7 marks**

Product cost £51.03 £56.62 **15 marks**

(C) Any suggestion above product cost.

Need to cover any period costs such as administration and distribution

Need to add a mark up that provides the business with an acceptable level of profit

Need to look at the market as would tend to be a price taker as a large number of buyers and seller. Were demand and supply would be market price. If the products are priced any higher may not sell

If can may be able to distinguish product or company to obtain a small price increase through premium pricing.

If you could find a single customer- large retail outlet/department store willing to take large quantities may reduce price as will have less selling and admin costs.

**1-2 marks per point depending on quality of explanation maximum 10 marks**

***(D) Determine the organisation objective*** Collect information on market, suppliers, finance and competition

***Identify different strategies to achieve the organisation objective C***ollect information on availability of resources (land, labour and capital), collect accurate cost information and obtain information on different markets and revenue streams. Although uncertainty will exist in making future decision the information needs to be relevant and reliable if appropriate choices are to be made on the alternative courses of action.

***Prepare detailed plans for the selected courses of action to achieve the organisation goal*** Plans need to be prepared on an organisation level but also broken down for individual departments. They need to be properly communicated to those responsible for carrying out the relevant activities.

***The plans need to be monitored throughout*** ***the process to ensure they are being adhered to***

***Review of organisation achievement***. At appropriate time periods there needs to be a comparison of the planned organisation activity with the actual activity. Any divergence from the planned outcome, good or bad, needs to be explained and understood. Individuals need to take responsibility for the meeting of planned performance.

***Organisations goals and strategies may need to be reviewed and revised* 9 marks**

**(Total 50 marks)**

**Question 3**

1. The break-even point is where total costs = total revenue

Sales Revenue – Variable Costs – Fixed costs = 0

BEP (units) = Fixed costs/contribution

Margin of safety is the excess number of units sold over break-even point.

Break-even point is important for a business- need to know how many units you need to sell to be profitable.

If just starting or expanding to a new product line particularly important.

If a business expect to be able to produce or sell the required number of units then should not proceed.

Margin of safety give the directors confidence that even if sales or production falls slightly a profit can still be maintained. **(8 marks)**

1. BEP = Fixed costs/contribution SP-VC

BEP = 42,000/165-70-45

BEP = 42,000/50

BEP =840 bikes **3 marks**

Units = Fixed costs + profit/ contribution

Units = 8,000+42,000/50 =1,000 units **3 marks**

Margin of safety

1,000-840/1,000 = 16% or 160 units **2 marks**

**Total for part (b) 8 marks**

(c). Number of units = Fixed costs + profit/contribution (Sales price-variable cost)

100 units + 200uniuts = 1,200units

Fixed costs now 42000 + 12,000 =54,000 profit = 8,000 so numerator = 62,000

1,200 = 62,000/165 – variable cost

1,200(165-variable cost) = 62,000

198,000 – 1,200VC = 62,000

1,200VC = 136,000

VC = 113.3

As variable cost previously were 45+70=115 variable costs need to be reduced by £2

Discounting at the cost of capital to a particular company or project to bring cash flows to their net present value allows factors such as risk, opportunity cost and the time value of money to be taken into consideration.

Recognises £1today is worth more than £1 tomorrow in terms of spending power

Compensates for the fact that a project carries a risk and so must ensure the future cash flows not only compensates for deferred consumptions but that its return is put at risk.

Opportunity cost. If a company has an amount of money to invest there will be alternative options, The project chosen should generate a return equal to or greater than the next best alternative project. The discount factor takes this into account

**3 for each explanation to a maximum of 6 marks**

**(d)**

**Town bikes**

|  |  |  |
| --- | --- | --- |
| **Year** | **Cash flow** | **Cumulative cash flow** |
| **0** | **(180,000)** | **(180,000)** |
| **1** | **80,000** | **(100,000)** |
| **2** | **80,000** | **(20,000)** |
| **3** | **40,000** | **0** |
| **4** |  |  |
| **5** |  |  |
|  |  |  |
|  |  |  |

**Assume even cash flow the 20,000 will be paid back in 6 months**

**Payback period 2 years and 6 months**

**Sherwood Forest**

|  |  |  |
| --- | --- | --- |
| **Year** | **Cash flow** | **Cumulative cash flow** |
| **0** | **(180,000)** | **(180,000)** |
| **1** | **20,000** | **(160,000)** |
| **2** | **50,000** | **(110,000)** |
| **3** | **50,000** | **(60,000)** |
| **4** | **72,000** | **nil** |
| **5** |  |  |
|  |  |  |

Assuming even flow of cash 72,000/12 =6,000 per month

Payback period 3 years 10 months

Town bikes

|  |  |  |  |
| --- | --- | --- | --- |
| Year | Cash flow | Discount factor | Present value |
| 0 | (180,000) | 1 | (180,000) |
| 1 | 80,000 | 0.926 | 74,080 |
| 2 | 80,000 | 0.857 | 68,560 |
| 3 | 40,000 | 0.794 | 31,760 |
| 4 | 20,000 | 0.735 | 14,700 |
| 5 | 20,000 | 0.681 | 13,620 |
|  |  |  | 22,720 |
| Sherwood  Year | Cash flow | Discount factor | Present value |
| 0 | (180,000) | 1 | (180,000) |
| 1 | 20,000 | 0.926 | 18,520 |
| 2 | 50,000 | 0.857 | 42,850 |
| 3 | 50,000 | 0.794 | 39,700 |
| 4 | 72,000 | 0.735 | 52,920 |
| 5 | 80,000 | 0.681 | 54,480 |
|  |  |  | 28,470 |

**Payback 3 marks each 6 marks**

**NPV 5 marks each 10 marks Total 16 marks**

(f) Sherwood longer payback but better NPV

Unless important to recoup investment quickly choose Sherwood as NPV superior technique.

But not much difference in NPV and Sherwood later cash inflows so estimates may not be as accurate. **5 marks**