Managing Finances

Paper T10

ACCA CERTIFIED ACCOUNTING TECHNICIAN EXAMINATION

ADVANCED LEVEL

WEDNESDAY 16 JUNE 2004

QUESTION PAPER

Time allowed **3 hours**

ALL FOUR questions are compulsory and MUST be answered

The Association of Chartered Certified Accountants

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1 Paradise Ltd is a large company specialising in luxury holidays for the rich and famous. It has recently purchased an uninhabited island, close to the popular resort of Luca, at a cost of £2 million. The company has already spent £1·5 million on preparing the land for construction work. Over the next year it plans to develop the island extensively, with the aim of making it one of the most exclusive holiday locations in the region.

An offer has just been made to buy the land for £5 million. Paradise Ltd has therefore decided to reappraise the project in order to decide whether they should still proceed with the project, or should instead accept the offer. If they decide to accept the offer, the sale will take place immediately, incurring legal fees of £20,000. If they reject the offer, development will continue and accommodation will be available for rent in one year's time.

The company's project accountant has provided estimates of costs and revenues for the next five years as set out below.

1. Total construction costs for the seven hotels on the island are £37 million. Of the total, £2 million has already been spent in the form of down payments to several construction firms. These down payments are irrecoverable.
2. Total construction costs for the forty luxury self-catering lodges that will be attached to the hotels are £24 million. A down payment of £4 million is required immediately.
3. The cost of furnishing the hotels and lodges is estimated at £3·2 million.
4. Each lodge will have its own private swimming pool. The cost of each pool is expected to be £12,000.
5. Six restaurants will be built on the island at a cost of £15 million. Paradise Ltd has already had to commit to £3 million of these costs in order to attract the chefs it requires. Although these monies have not yet been paid over, Paradise Ltd is contractually bound to pay them, irrespective of whether the project now proceeds.
6. A small parade of shops will be developed at a cost of £4 million.
7. Annual cash overheads are expected to be £2 million for the hotels. Revenues for the hotels are estimated at £13 million per annum.
8. Maintenance costs for each of the lodges will be £7,000 per annum, compared to rental income of £390,000 per annum, per lodge.
9. Depreciation totalling £1·5 million per annum will be charged in Paradise Ltd's accounts for the hotels, lodges, restaurants and shops.
10. The restaurant and shops are expected to generate net income of £4·73 million per annum, in total.
11. Interest on money borrowed to finance the project will be £2·5 million per annum.

All the set-up costs will occur within the next year, before the resort is open. The annual revenues and overheads relate to the four years following this. Assume that all cash flows occur at the end of each year, unless otherwise stated, and that there are no terminal values to consider at the end of the four years.

The company's cost of capital is 10% per annum.

Required:

(a) **Explain the main principles used to differentiate between relevant and irrelevant costs for investment appraisal, using the information in the question to illustrate your points.** (8 marks)

(b) **Calculate the project's net present value (NPV) at the company's required rate of return. Conclude as to whether the company should accept the offer or continue with the project, giving a reason for your conclusion.** (16 marks)

(c) **Calculate the internal rate of return (IRR) for the project, using the discount rates in the tables provided.** (4 marks)

(d) **State three advantages and three disadvantages of using the IRR as a method of project appraisal.** (6 marks)

(e) **Briefly outline each of the following stages involved in evaluating capital projects:**

(i) **Initial investigation of the proposal;**

(ii) **Detailed evaluation;**

(iii) **Authorisation;**

(iv) **Implementation;**

(v) **Project monitoring;**

(vi) **Post-completion audit.** (6 marks)

(40 marks)

(Workings should be in £'000, to the nearest £'000.)

Present Value Table (extract)

	Discount Rates (r)	
Periods (n)	10%	20%
1	0·909	0·833
2	0·826	0·694
3	0·751	0·579
4	0·683	0·482
5	0·621	0·402

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Question 2 begins on page 5.

2 Chocoholics Ltd sells high quality Belgian chocolates that it buys in ready-made. Its main attraction to customers is that it gift wraps the items and delivers them to an address of the customer's choice. The company has just expanded its product range to include flowers.

You are an accounting technician and have been asked to prepare a cash budget for the next six months, incorporating the sales of the new products. You have been provided with the following table of estimated revenues and their relative costs. Other costs are also included in the notes below.

2004	July	August	September	October	November	December
	£'000	£'000	£'000	£'000	£'000	£'000
Sales	250	266	282	306	320	330
Purchases of chocolates and flowers	125	133	141	153	160	165
Administration expenses	55	60	62	65	68	70
Packaging costs	2	3	3	3	4	4
Miscellaneous expenses	6	6	7	7	8	8
Loan repayments	50	–	–	–	50	–

Notes:

1. Opening stocks of chocolates and flowers will amount to £250,000 at 1 July 2004. Closing stocks at 31 December 2004 are estimated at £170,000.
2. Suppliers allow one month's credit. Purchases in June will total £60,000.
3. 30% of sales are paid for by cash but the remaining 70% take advantage of the company's offer of 'Buy now, pay in one month'. June 2004 sales are expected to be £140,000.
4. Delivery costs are 1% of sales revenue each month, and are paid in the month in which they are incurred. Administration and miscellaneous expenses are also paid as they are incurred.
5. Packaging expenses are paid two months after they are incurred. These costs were £1,000 in May and will be the same in June.
6. The bank charges interest of 1% per month for the overdraft, calculated on the closing bank balance each month, and payable the following month.
7. The bank overdraft at 1 July 2004 is expected to be £155,000.
8. The loan repayments above refer to an interest free loan obtained by the company when they moved their business to a new bank.
9. The business has no depreciable fixed assets.

Required:

(a) Prepare a monthly cash budget for EACH of the six months to 31 December 2004, showing the cash balance at the end of each month. (13 marks)

(b) Prepare a budgeted Profit and Loss account for the six month period ending 31 December 2004. (7 marks)

Note: All workings should be shown clearly in order to score maximum marks. Please show workings in £'000, to the nearest £'000.

(20 marks)

3 Rant Ltd manufactures and distributes plasma screen televisions to a number of electrical retailers. Due to the increased popularity of these products, growth has been rapid and the Financial Director (FD) of the company is concerned that the company is overtrading. Turnover has increased by 250% over the last year, and fixed assets have increased by 75%. The bank overdraft limit of £3 million has been exceeded on five occasions in the last year, culminating in a recent threat by the bank to withdraw the facility altogether.

Rant Ltd is a largely family-owned company, with twelve shareholders in total. Whilst the long-term plan involves making a rights issue in two years' time, none of the current shareholders are in a position to inject new capital into the company at present. Neither do they wish to issue new shares outside the current group of shareholders, as they do not want to lose their collective control of the company.

Some preliminary analysis has revealed that debtors are increasing rapidly and raw material stock days have gone up from 30 days to 55 days. The FD is concerned that these stock levels are so high. He has asked you, an accounting technician, to assist him in reviewing them.

One of the key costs of making a plasma television is the screen. These screens are bought in ready-made at a cost of £250 per unit. It costs £150 to place an order for these screens, irrespective of the number of units ordered. At current sales levels, which are expected to stabilise now, 150,000 screens are needed per annum. The cost of holding one screen in stock for one year is £15.

Required

(a) Define the terms 'over-capitalisation' and 'overtrading'. (2 marks)

(b) Briefly describe the symptoms of overtrading. Conclude whether Rant Ltd is overtrading, giving reasons for your conclusion. (6 marks)

(c) Explain the four main types of costs associated with stock management. (4 marks)

(d) Explain how the economic order quantity (EOQ) model can assist in reducing stock costs, AND the assumptions it is based upon. (4 marks)

(e) Calculate the EOQ for screens AND the number of orders to be placed per annum, using the data contained in the question. (4 marks)

(20 marks)

Note: The formula for EOQ is $\sqrt{\frac{2\ Co\ D}{Ch}}$

(where Co represents fixed cost of placing one order;
D represents annual demand in terms of units;
Ch represents cost of holding one unit of stock per annum.)

4 Clean Lens Ltd is a contact lens manufacturer and distributor producing an extensive range of contact lenses that are distributed direct to customers via the Internet. It is a small company with five shareholders, all of whom are involved in the running of the company.

The company is in the preliminary stages of developing a new type of contact lens, made of a unique material that moulds to the shape of the eye, providing revolutionary comfort for the lens wearer. The company's projections show that profits of £1·3 million per annum are expected over the first five years, once sales commence.

In order to proceed with the project, further finance of £1·5 million is required. Clean Lens Ltd expects to fund the project through a mix of debt and equity finance, and is considering approaching venture capital organisations.

Required:

(a) Briefly explain five factors that Clean Lens Ltd should take into account when deciding on the mix of debt and equity finance. (10 marks)

(b) Identify and discuss five factors that a venture capital organisation should take into account when deciding whether or not to invest in Clean Lens Ltd. (10 marks)

(20 marks)

End of Question Paper