Level 3 CMA (Theory 20 Marks)

Working Capital

Q: Describe the actions management could take to improve the working capital ratios
A: The rate of inventory turnover needs to increase (1) by promotions, discounts, marketing campaigns (1).
Trade receivables need to pay quicker (1) the company needs to improve its credit control (1).
Trade payables may need to be paid quicker (1) if the company improves the first two factors it should have the necessary working capital to do this (1).

Q: Explain what is meant by the term **working capital management** and why this is important to company.
A: Working capital management involves the careful control of inventory levels (1) with the aim of not carrying too much, too little, or obsolete inventory. (1)

Aiming to keep the trade receivables payment period at a low level by seeking prompt payment. (1)

Aiming to delay the payment of trade payables (without incurring any penalties). (1)

Efficient working capital management will ensure that a company has sufficient cash to meet its day-to-day operational needs (1) with the overall aim of minimising the risk of insolvency/illiquidity. (1)

Budget

Q: State 3 benefits that a business would expect to gain from the use of budgetary planning.
A: 1. Provides a basis for <u>control</u>. (Progress can be measured against plan.) (1)
2. Provides <u>motivation</u> for managers and workforce. (Provided managers have participated in the initial budgeting process for their department.)(1)
3. Provides <u>coordination</u> between departments. (Each department is part of the overall budget.)(1)

Q: Describe **three** benefits that the company might obtain from preparing budgets.
A: Budgeting provides a means of <u>communicating</u> management's plans throughout the organisation (1) so that various levels of the workforce are informed of the company's intentions. (1)
Budgeting forces managers to think about and <u>plan for the future</u> (1). In the absence of the necessity to prepare a budget, managers might spend their time dealing with daily issues (1).
The budgeting process provides a means of <u>allocating resources</u> (1) to those parts of the organisation where they have been proved to be required and can be used most effectively. (1)
Budgeting <u>co-ordinates the activities</u> of the organisation (1) by integrating the plans of the various departments / thus helping to ensure that everyone is pulling in the same direction. (1)
Budgets define goals and objectives (1) that can serve as benchmarks for evaluating subsequent performance (1).

The actual results can be compared with the budget (1) which might allow for corrective action to be undertaken / variance analysis (1).

Q: Identify **two** factors that might influence the company's choice of **budget period**.
A: The size of the company might dictate shorter budget periods
The complexity of the company - many departments or offices/factories
The requirement of external agencies, like a bank Government requirements - tax rules

Q: Describe **two** uses of a cash budget.
A: 🎬 Cash shortages revealed early (1) and arrangements can be made for overdraft on best terms.(1)
🎬 Cash surpluses revealed (1) and can be invested. (1)
🎬 Can highlight difficulties e.g. paying suppliers (1) and take appropriate action e.g. liaise with suppliers (1).

Q: Explain why prepares a flexible cost budget.
A: To allow costs to be predicted for the actual level of activity that occurs (1) This will give a meaningful comparison of actual costs with (flexed) budgets(1)

Q: Explain what is meant by the term **principal budget factor** using an example that might apply to Diamonde Limited.
A: The principal budget factor is the factor that determines or limits (1) the budget or activity level of all other factors (1). The supply or demand of a factor determines if it is the principal budget factor (1).
If a company is limited to producing 1,000 units a month because of the available labour force(1) that will be the principal budget factor limiting all the other factors, e.g. sales levels and material requirement (1)

Q: Explain 1 difference between a fixed and a flexible budget.
A: A fixed budget is based on one level of activity (1). Unlike a flexible budget which has all its variable costs and revenues adjusted for different levels of activity (1).
A fixed budget may be used for planning (1) where as a flexible budget may be used as a tool of control.(1)

Q: Explain 1 advantage of preparing a flexible budget.
A: Flexible budgets recognise how costs behave and allow costs to be predicted/adjusted for a range of activity levels (1). This allows for a more meaningful comparison of actual costs with budgeted costs (1).

Process Costing
Q: Explain the meaning of joint products & by-products
A: Joint products - Two or more products separated in processing (1), each having a sufficiently high saleable value to merit recognition as a main product (1).

By-products - A product that is not the main product for which the production process is intended (1) but has a commercial value (1).

Q: State 3 methods, other than net sales value, for the apportioning of process costs to joint products.
A: 1. Sales revenue (1) 2. Units produced (1) 3. Product weight (1)

Inventory

Q: Identify **four** benefits of inventory management and control.
A: Maintains planned levels of inventory (1)
Keeps total inventory investment to a minimum (1)
May keep inventory holding costs to a minimum (1)
Reduces the risk of running out of inventory (1)
May keep inventory ordering costs to a minimum (1)

Q: Explain the meaning of (i) opportunity cost (ii) relevant cost (iii) avoidable cost

A: Opportunity costs relate to the benefit that could have been earned but have been given up (1) by choosing one option instead of another/an alternative option. (1)

A relevant cost is a future cash outflow/expenditure (1) arising as a direct consequence of a decision being made. (1)

Avoidable costs are defined as "the specific costs of an activity (or sector) of a business which would be avoided if that activity did not exist". (1) These are the costs that would be affected if a business or activity was 'shut down' or discontinued (1)

Overheads
Q: Explain the following terms, giving **one** example of each:
(i) allocated overheads
(ii) apportioned overheads.
A: Allocation is the charging of the whole overhead item to one cost centre.(1) Examples include:

- specific rent and insurance (1)
- indirect labour (1)
- indirect material.(1)

Apportionment is the sharing of overheads between two or more cost centres. (1) Examples include:

- non-specific rent (1)
- rates (1)
- insurance (1)
- electricity (1)
- depreciation.(1)

Q: State **one** example of an ordering cost.
A: Ordering cost – telephone, mail, transportation costs, person placing the order's time (maximum 1)

Q: State **two** examples of holding costs.
A: Holding costs – warehouse rental, heating and lighting, stores salaries, security, waste, theft (maximum 2 x 1)

Investment Appraisal

Q: Explain the meaning of the terms: (i) net present value & (ii) Internal rate of return
A: Net present value: An investment appraisal technique that converts future cash flows into present-day values (1) and states if there is a discounted net cash inflow or outflow.(1)

Internal rate of return: An investment appraisal technique that estimates the interest rate (cost of capital) (1) at which there is no inflow or outflow of cash.(1)

Q: State **two** advantages and **two** disadvantages of the net present value investment appraisal technique.
A: Advantages
- It takes into account all future cash flows. (1)
- It takes into account the 'time value' of money. (1)
- Helps show if the investment meets the target rate.(1)

Disadvantages
- It assumes that the interest rate/cost of capital remains constant through the life of the investment. (1)
- It is difficult to accurately predict future costs and revenues. (1)

Q: Advise the company why it might have been more appropriate to calculate the **discounted payback period**, as opposed to the **traditional payback method**, when evaluating this investment proposal.
A: Using a discounted payback approach takes into account the time value of money **(1).** This overcomes the weakness of the traditional payback method as a means of appraising an investment **(1)**

If the discounted method had been used it would have clearly shown that the discounted cash flows did not result in the investment making a positive payback at the end of four years **(1)**

Accounting System

Q: Describe what is meant by: (i) an integrated accounting system & (ii) a non-integrated accounting system.
A: Integrated accounts are a set of accounting records that provide **both** financial and cost accounts **(1)** using a **common input of data (1)**

Non-integrated accounts are a system where the cost accounts are distinct from the financial accounts **(1).** The two sets of accounts are kept in agreement by the use of controls accounts **(1)**

Absorption Costing (AC) & Marginal Costing (MC) & Activity Based Costing (ABC)

Q: Evaluate which of the two methods of costing (absorption or activity based) would be the most appropriate
A: Not all costs are able to be related to e.g. labour activity **(1)** so the use of absorption costing may not be appropriate (1).
With ABC costs are allocated on a discreet usage basis**.** Products that use more of an activity are charged a higher proportion of the overall cost.
Products made in smaller batches cause an increase in costs **(1)** and should therefore be charged more (pro rata) using ABC, than those made in larger batches **(1)**

Q: Advantages of ABC
A: Activity- based costing builds up a more realistic allocation of costs (1) an advantage of which could be, e.g., that a more accurate selling price can be calculated for specific products (1)

Q: State what is meant by:
(i) allocation of production overheads
(ii) apportionment of production overheads
(iii) absorption of production overheads
(iv) under absorption of production overheads.
A: Allocation is the charging of a whole item of cost to a cost centre (1)
Apportionment is the sharing of overheads between two or more cost centres (1)
Absorption is a method of charging overheads to a product or service (1)
Under absorption is when insufficient overheads are charged to a product or service (1)

Q: Explain, including an example, why the notional rent charge is shown in the cost accounts.
A: A notional charge is a hypothetical cost, which is necessary in order to account for a benefit enjoyed, even though no actual cost has been incurred **(1)**
It is important to include these notional costs in the cost of the production in order to calculate the correct cost for pricing purposes **(1)**
An example of a notional charge would be the business owner not paying rent on the property **(1)** but it would be thought correct to make a notional charge to the overheads equivalent to the rental charge liable for similar properties **(1)**

Liquidity & Cashflow

Q: Explain **two** reasons why liquidity and cash flow management are important for the successful operation of the business.
A: It will avoid the need to take out a short-term bank loan/organise an overdraft facility **(1)** which will incur interest **(1).**
Supplier confidence might be undermined if the business is unable to pay for its purchases when requested **(1)** subsequently they may refuse to supply products/further credit **(1).**
Regular payments for utilities etc avoid the risk of eg electricity being cut off **(1)** which would bring production to a halt **(1)**
Cash may need to be available on a weekly basis to pay wages **(1)** otherwise staff will leave and production will stop **(1).**

Variance

Q: Explain the following terms:

(i) standard cost

A standard cost is a predetermined **unit** cost (1). It is a target cost that should be achievable under normal efficient operating conditions (1).

(ii) standard hour

The standard hour is the **quantity** of work achievable under expected operating conditions levels in an hour (1). It is a measure of performance and not time spent (1).

(iii) Explain **one** reason why the investigation of variances is important in a standard costing system.

Investigation of variances is important: Two marks for one answer:

To take advantage of favourable situations (1) or to attempt to correct adverse ones. (1) To determine what external factors might cause the variance (1) for example seasonal/economic factors. (1)

To determine if the variance is caused by internal factors (1) and to pinpoint who or what is responsible for the variance. (1) To enable standards to be revised where necessary (1) and to promote good working practice. (1)