Oxford Cambridge and RSA

Friday 16 June 2017 - Morning

Level 4 Certificate in Management Consulting 10331

UNIT 2 Analysing financial statements and reports

MARK SCHEME

Duration: 1 hour 30 minutes

MAXIMUM MARK 60

Mark Schemes have been issued on the basis of **one** copy per Assistant examiner and **two** copies per Team Leader.

Question	Answer	Marks	Guidance	Levels of Response
1(a)(i)	Gross profit margin £886000-£526000=£360000 $\frac{£360000}{£886000}$ = 40.63% **[1]**	**1**		
1(a)(ii)	Net profit margin £886000-£526000-£247000-£15000=£98000 $\frac{£98000}{£886000}$ =11.06% **[1]**	**1**		
1(a)(iii)	Mark-up $\frac{£360000}{£526000}$ =68.44% **[1]**	**1**		
1(a)(iv)	Operating expenses as a percentage to revenue $\frac{£247000}{£886000}$ =27.88%	**1**		
1(a)(v)	Return on capital employed $\frac{£98000 + £15000}{£600000 + £150000}$ =15.07% **[1]**	**1**		

Question	Answer	Marks	Guidance	Levels of Response
1(a)(vi)	Return on equity $\frac{£98000}{£600000}$ =16.33% **[1]**	**1**		
1(a)(vii)	Interest cover $\frac{£98000 + £15000}{£15000}$ =7.53 **[1]**	**1**		
1(a)(viii)	Gearing ratio $\frac{£150000}{£600000 + £150000}$ =20% **[1]**	**1**		

Question	Answer	Marks	Guidance	Levels of Response
1(b)		**8**		Level 4**[7 - 8 marks]** Candidate evaluates whether to invest in Waves Ltd or lend to Waves Ltd. Level 3**[5 - 6 marks]** Candidate analyses whether to invest in Waves Ltd or lend to Waves Ltd. Level 2**[3 - 4 marks]** Candidate explains whether to invest in Waves Ltd or lend to Waves Ltd. Level 1**[1 - 2 marks]** Candidate identifies the return to shareholders and loan provider.

Question	Answer	Marks	Guidance	Levels of Response
	Indicative content: • fixed interest rate • return on equity • return on capital employed • interest cover • gearing • profitability in the long run • dividend policy • share price. **Exemplar response:** At present the return to loan provider is 10% (interest rate) and the return to shareholders is 16.33% (return on equity) **[L1]**. It should be noted that the interest rate is fixed throughout the loan period but the net profit fluctuates, resulting in an unstable return to shareholders.**[L2]** In 2016, Waves Ltd has a return on capital employed of 15.07%, which is higher than the interest rate which is fixed at 10%. The shareholders will benefit as the profit after paying the interest is attributable to the shareholders. This will raise the return on equity. **[L3]** Although in 2016, return to shareholders is higher than return to loan provider, Leon should also consider the risk. The gearing ratio of Waves Ltd in 2016 is only 20% which is regarded as low. The interest cover of 7.53 means that the ability to cover interest is strong. It appears that the risk of investing in Waves Ltd as			

Question	Answer	Marks	Guidance	Levels of Response
	loan provider is very low. However, the interest rate is fixed at 10% and at the end of the loan period, Leon will get back only the principal. To be a shareholder, Leon has to take the risk of uncertainty in profitability. In 2016, the ROCE is higher than the interest rate. But it is uncertain whether Waves Ltd will achieve the same result in the coming years. If Waves Ltd keeps on maintaining a high profitability, Leon will receive greater return (by receiving dividend) and capital gain (by increasing share value). However, the profitability of Waves Ltd may decrease. As Leon is a risk-averse investor, it is advised that he should invest in Waves Ltd as loan provider. **[L4]**			

Question	Answer	Marks	Guidance	Levels of Response
1(c)		**8**		Level 4**[7 - 8 marks]** Candidate assesses the performance of both years. Level 3**[5 - 6 marks]** Candidate analyses the performance of both years. Level 2**[3 - 4 marks]** Candidate explains the performance of both years. Level 1**[1 - 2 marks]** Candidate identifies the performance of both years.

Question	Answer	Marks	Guidance	Levels of Response
	Indicative content: • gross profit margin • net profit margin • expenses • profitability • selling price • efficiency in controlling expenses. **Exemplar response:** The gross profit margin 40.63% in 2016 is lower than 45% in 2015. However the net profit margin 11.06% in 2016 is higher than 10% in 2015. **[L1]** The decrease in gross profit margin is due to the decrease in selling price. In order to increase the sales, Waves Ltd had reduced its selling price. The sales had increased from £794000 in 2015 to £886000 in 2016, an increase of 11.59%. **[L2].** Although there is a decrease in gross profit margin, the net profit margin in 2016 increases from 10% to 11.06%. This is mainly due to the increase in gross profit and decrease in operating expenses. In real terms, gross profit has increased from £357300 (£794000x45%) in 2015 to £360000 in 2016. Operating expenses as a percentage to revenue in 2015 and 2016 is 33.11% and 27.88% respectively. Although there is an increase in sales, but there is no corresponding increase in expenses; on the contrary, the operating expenses decreased from £262893 (£794000x33.11%) in 2015 to £247000 in 2016. Waves Ltd may have streamlined some operations to			

Question	Answer	Marks	Guidance	Levels of Response
	reduce the operating expenses. **[L3]** In terms of profitability, the performance of Waves Ltd in 2016 is better than 2015. In real terms, the net profit has increased from £79400 (£794000x10%) in 2015 to £98000 in 2016. Apart from sales increase which leads to increase in gross profit, Waves Ltd is efficient in controlling its operating expenses. **[L4]**			
				[Total: 24]

Question	Answer	Marks	Guidance	Levels of Response
2(a)(i)	Current ratio 2015 $\dfrac{£72000 + £83000 + £3000}{£62800}$ = 2.52 : 1 **[1]**	**1**		
	Current ratio 2016 $\dfrac{£108000 + £115000}{£92500 + £28000}$ = 1.85 : 1 **[1]**	**1**		
2(a)(ii)	Quick (acid) ratio 2015 $\dfrac{£83000 + £3000}{£62800}$ = 1.37 : 1 **[1]**	**1**		

Question	Answer	Marks	Guidance	Levels of Response
	Quick (acid) ratio 2016 $\frac{£115000}{£92500 + £28000}$ = 0.95 : 1 **[1]**	**1**		
2(a)(iii)	Stock (inventory) turnover (in number of days) 2015 $\frac{1/2(£68000 + £72000)x365}{£397000}$ = 64.36 days **[1]**	**1**		
	Stock (inventory) turnover (in number of days) 2016 $\frac{1/2(£72000+£108000)x365}{£465000}$ = 70.65 days **[1]**	**1**		

Question	Answer	Marks	Guidance	Levels of Response
2(a)(iv)	Debtor turnover (in number of days) 2015 $\frac{£83000 \times 365}{£668000}$ = 45.35 days **[1]**	**1**		
	Debtor turnover (in number of days) 2016 $\frac{£115000 \times 365}{£754000}$ = 55.67 days **[1]**	**1**		
2(a)(v)	Creditor turnover (in number of days) 2015 $\frac{£62800 \times 365}{£401000\ (OF)}$ = 57.16 days **[1]**	**2**		

Question	Answer	Marks	Guidance	Levels of Response
	Creditor turnover (in number of days) Purchases for 2016 £465000+£108000-£72000=£501000**[1]** Purchases for 2015 £397000+£72000-£68000=£401000**[1]** 2016 $\frac{£92500 \times 365}{£501000\ (OF)}$ =67.39 days **[1]**	**2**		

Question	Answer	Marks	Guidance	Levels of Response
2(b)	**Indicative content**: • increase cash sales • offer cash discount for early settlement • tighter credit control • penalty clause (i.e. interest) on late payment • debt factoring. **Exemplar response:** One way to improve debtor turnover is to offer cash discount to customers. **[1]** Cash discount on the amount owed by debtors is to encourage debtors to pay earlier. Although the full amount is not received, Thornley Ltd can avoid the loss arising from bad debt and expenses incurred in chasing the trade debt. **[1]**	**4**		

Question	Answer	Marks	Guidance	Levels of Response
2(c)	**Indicative content**: • regular and stable supply of goods • long-term relationship • financially viable • consistent credit policy • trust. **Exemplar response:** Customers are those who buy the goods from Thornley Ltd. **[1]** A company which is financially stable can guarantee the continuous supply of goods without shortage. **[1]** A company with good liquidity also suggests a consistent credit policy. **[1]**	**3**		
				[Total: 19]

Question	Answer	Marks	Guidance	Levels of Response
3	**Indicative content**: • cash flows from operating activities • cash flows from investing activities • cash flows from financing activities. **Exemplar response:** Cash flows from operating activities **[1]** – cash inflows and outflows derived from the principal revenue-producing activities of the entity. They generally result from the day to day transactions and other events that enter into the determination of profit or loss. **[1]** For example cash received from customers and cash paid to suppliers. **[1]** Cash flows from investing activities **[1]** – cash flows representing the extent to which expenditures have been made for the resources intended to generate future income and cash flows. The expenditures are those resulting in a recognised asset in the statement of financial position. **[1]** For example cash paid for acquisition of fixed assets and cash received from disposal of fixed assets. **[1]** Cash flows from financing activities **[1]** – cash flows to or from providers of capital to the entity. **[1]**. For example, cash received from issue of shares or cash paid for redemption of shares. **[1]**	**9**		
				[Total: 9]

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<tr><td>4</td><td>Indicative content:
• future growth
• cheaper source of finance
• higher return on equity in the future
• precautionary measure
• lowering the gearing ratio
• less dividend
• market response to dividend policy
• misuse of funds
• wrong use of funds
• overcapitalisation.
Exemplar response:
One advantage of retaining profits within the business is so that there is enough capital available for investment should opportunities arise. [1] In time of recession there are often opportunities for a business to negotiate lower costs. If a business has enough capital available they can acquire as a form of investment and growth.[1]
One disadvantage of retaining profits in the business is that the business is paying less dividend and this may dissatisfy the shareholders who are looking for high dividend payout. [1]. The business with low dividend track record may convey a wrong signal to the market that will affect the share price. [1]</td><td>8</td><td></td><td></td></tr>
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Question	Answer	Marks	Guidance	Levels of Response
				[Total: 8]