



UNIVERSITY OF CAMBRIDGE INTERNATIONAL EXAMINATIONS
Cambridge International Diploma in Business
Advanced Level

BUSINESS FINANCE

5173/01

Optional Module

October 2011

2 hours plus 15 minutes' reading time

Additional Materials: Answer Booklet/Paper



READ THESE INSTRUCTIONS FIRST

Write your Centre number, candidate number and name on all the work you hand in.

Write in dark blue or black pen.

You may use a soft pencil for any diagrams, graphs or rough working.

Do not use staples, paper clips, highlighters, glue or correction fluid.

Attempt **all** tasks.

Start each task on a new piece of paper.

Please leave a margin on the right and left hand side of each new page.

At the end of the examination, fasten all your work securely together, in the correct order.

The number of marks is given in brackets [] at the end of each question or part question.

This document consists of **5** printed pages and **3** blank pages.



You must read the case study below and attempt ALL of the tasks that follow.

(This case study is fictitious.)

Lee Electricals

Chong Lee has been running Lee Electricals for three years and he is pleased with the performance of the business. The turnover of the business has grown every year and although gross profits have never been as estimated, the net profit figures have always been better than expected.

The firm sells and distributes electrical products and Chong has managed to obtain three franchises for selling computer products. He estimates that these franchises account for 40% of the turnover of the firm, but only 25% of its profits. Chong believes that the firm has a sufficiently good reputation to allow the manufacture of the products rather than operating within these franchises. He has discussed this proposal with the firm's bank manager and he has received a favourable response. However, the bank manager has stressed that it will be necessary to monitor the working capital of the business very closely and the proposal needs to be fully costed before taking any decisions. Chong has done some alternative costings which are shown in **Item A**.

The bank manager has also expressed concerns regarding the structure of the business. Presently, the business is run as a sole trader organisation, with Chong as the owner, but the bank manager has suggested that an incorporated structure may well be more suitable for an organisation that is involved in the manufacture of products. Chong's brother-in-law, who is a qualified electrical engineer, has indicated that he would be prepared to invest in the business and that he would be happy to supervise the manufacturing activities, if he was given a share of the profits. Chong is uncertain about this proposal, as he is used to working on his own.

The latest bulletin from the Electrical Trades Federation contains mixed news. The recent downturn in the economy has led to a fall in business confidence and a number of firms have announced that redundancies will be inevitable unless consumer spending increases. They also point out that many firms are operating with much smaller margins of safety and more factory closures could be seen in the near future.

There is, however, some good news. The national government is to introduce a simpler method of financial reporting for small and medium sized business organisations and a system of non-repayable grants for businesses that create employment opportunities for their local communities. The Federation has also reported that there has been a surge of interest in engineering as a career and many more young people, especially women, have expressed a desire to enter training courses. Changes in technology appear to be taking place at an increasing pace and the Federation is undertaking a research project to monitor the effects that these changes are having on its members. Preliminary findings seem to suggest that some firms are benefiting, whilst others are suffering.

Financial Information

Item A

The following data is extracted from Chong Lee's initial costings for the proposed machines.

Machine A

| | |
|------------------------|------------------------|
| Initial purchase price | \$500 000 ¹ |
| Residual value | \$80 000 |
| Useful life | 8 years |
| Gross returns per year | \$120 000 |
| Running costs per year | \$50 000 |

Machine B

| | |
|------------------------|-----------|
| Initial purchase price | \$800 000 |
| Residual value | \$100 000 |
| Useful life | 10 years |
| Gross returns per year | \$220 000 |
| Running costs per year | \$75 000 |

¹ Quoted in US dollars

You must attempt ALL of the following tasks.

- 1 (a) Suggest and explain **one** reason why the net profit figures were better than expected, even though the gross profit figures were below estimate. [3]
- (b) Explain why the sales from the franchises account for 40% of the turnover but only 25% of the profits. [3]
- (c) (i) Explain what is meant by working capital. [2]
- (ii) Explain why it is necessary to monitor the level of working capital. [3]
- (d) (i) Explain what is meant by an incorporated organisation. [3]
- (ii) Explain **one** financial advantage and **one** financial disadvantage that would result from the process of incorporation. [2 x 2 = 4]
- (e) Explain **one** advantage of operating as a franchisee. [2]
- [Total: 20]**
- 2 (a) Distinguish clearly between a trial balance and a balance sheet. [6]
- (b) Outline and explain the basic balance sheet equation. [2]
- (c) An audited set of accounts will represent a true and fair view of the financial affairs of a business.
- Identify and explain **three** possible adjustments that may be necessary to ensure that the accounts are accurate. [3 x 4 = 12]
- [Total: 20]**
- 3 Firms often use investment appraisal techniques to assess the viability of possible investment opportunities.
- (a) Explain how the payback method can be used to assess the viability of a proposed investment. [4]
- (b) Explain how the accounting rate of return percentage (ARR %) method can be used to assess the viability of a proposed investment. [4]
- (c) Using the information in **Item A**, calculate the payback period for **both** of the machines. [8]
- (d) (i) More modern investment appraisal methods involve discounting future cash flows. Explain why this is necessary. [2]
- (ii) Explain what is meant by Net Present Value (NPV). [2]
- [Total: 20]**

- 4 Explain how **each** of the external (PEST) factors outlined in the case study could affect the future profitability of the firm. **[Total: 20]**
- 5 (a) Using the information in **Item A** and employing the straight-line method of depreciation:
- (i) Calculate the annual depreciation allowances for machine A and for machine B. **[2 x 4 = 8]**
 - (ii) Calculate the book value of **both** machines at the end of Year 3. **[6]**
- (b) Identify and explain **one** alternative method of depreciation that could be employed by the firm, and explain the circumstances when this method would be more suitable than the straight-line method. **[6]**
- [Total: 20]**

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