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**June 2018****A2 GCE APPLIED BUSINESS****F253/SM** Constructing a Financial Strategy**STIMULUS MATERIAL FOR ACADEMIC YEAR 2017–2018****SERIES 12****This stimulus material must be used for the June 2018 examination session.****OCR supplied materials:**

None

**Other materials required:**

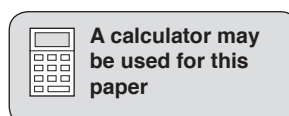
- A calculator may be used

**INSTRUCTIONS TO TEACHERS**

- This stimulus material provides a vocational context for the internally assessed unit: F253 – Constructing a Financial Strategy.
- Each year **one** scenario will be released on OCR's website which will provide an authentic vocational context for candidates' subsequent investigations.
- It is imperative that this material is used for the **June 2018** examination session.
- There are no separate marking criteria with this stimulus material. A solution will, however, be provided for **Series 12** in the **Principal Moderator's report for June 2018**.
- Please bear in mind that, due to the nature of this unit, candidates will have many opportunities to revisit their figures and you need to be able to ensure that the work of each candidate is their own. Therefore, it may be that **Tasks B–G** of this unit are supervised to ensure that individual, authentic evidence is produced.

**INFORMATION FOR CANDIDATES**

- This stimulus material has been created to provide you with a vocational context for the internally assessed unit: F253 – Constructing a Financial Strategy.
- If you have any questions regarding the stimulus material, you must consult both your teacher and the unit specification.
- It is anticipated that, where necessary, you use an approved calculator to complete the **Tasks** as outlined in the stimulus material.
- This document consists of **16** pages. Any blank pages are indicated.



## Introduction

After obtaining her food science degree in 2011, Ava worked as an Assistant Purchasing Manager in a food manufacturing company near to her home town in the Midlands. Her main duties were to conduct research and liaise with suppliers to ensure that the raw ingredients were of the best quality and value.

While Ava was at university in Cardiff she had become a healthy eater, mainly because she studied food science. During her three years of study, organic food became her food of choice even though she had to pay a higher price for it. Ava strongly believes that organic food has more health benefits and higher nutritional value than non-organic food. 5

The philosophy of Ava's employer was 'buy low and sell low'. Its target market was the price-conscious customer. Ava realised that her ideal of promoting organic food could not be achieved because the customers of the company she worked for were highly price-sensitive. 10

In 2013 Ava inherited £8000 from her late aunt. Ava rented a small store in the centre of her home town and started her own retailing business. Ava was able to source good quality organic produce from local farmers. She was also assisted by her brother, Calvin, who had just finished a retailing course at a local college. Ava printed flyers about the benefits of organic food and distributed them through letter boxes and in the high street. Ava was pleased to do this because she could educate local people on the health benefits of eating organic food, as well as reach potential customers. All sales made over the counter in the store were cash sales. Ava also made credit sales to local restaurants. Her business started making a profit three months after it had begun trading. 15 20

In July 2014 Betty, one of Ava's friends from university, was shopping in Ava's store. Six months before their chance meeting Betty had begun working for a business solutions company located in a business park five miles away from Ava's store. Betty had studied e-commerce at university. Betty and Ava agreed to have dinner together the following day.

Betty is also an advocate of healthy eating. During the dinner Betty told Ava that her company was the first tenant in the business park. More companies, including architecture, insurance, accounting and IT firms, would be moving to the business park shortly. Quite a large number of young professionals would be working there and most of them were likely to be keen on eating healthily. Betty also observed that Ava's store was the only one in the town centre selling organic food. Although a large out-of-town supermarket was also selling organic food, the variety was limited and the display was not eye-catching. Betty saw a potential gap in the market to sell organic food in the local area and she suggested that Ava and herself should form a limited company to expand Ava's existing business. Ava suggested that Calvin could be part of the company too. 25 30

*Organic Plus Limited* was formed in November 2014. The three shareholders of the company – Ava, Betty and Calvin – remain its only three directors. The issued share capital is £10 000, comprising 10 000 ordinary shares of £1 each. Ava has 5000 shares, Betty 4000 shares and Calvin 1000 shares. They agreed that the financial year of *Organic Plus Limited* would end on 30 June each year. After the first six months of operation, Betty set up a computerised stock control system and created a website to advertise the company. Thanks to social media promotion, such as Facebook and Twitter, there was a marked increase in the company's sales revenue, both cash sales and credit sales. Ava also used the company website to write articles and share the results of latest research about organic food. 35 40

In a directors' meeting held in August 2017, Betty suggested that the company's sales revenue could be further increased in two ways. First, Betty proposed that the company could upgrade its website to an e-commerce site and begin selling online. Second, the company could launch a new product – an organic meal box. The organic meal box would involve Ava preparing several 45

recipes which changed each week. When customers ordered a recipe online a cardboard box, containing the necessary ingredients to cook the meal, would be delivered to the customers. Ava and Calvin liked both proposals. The directors have agreed to go ahead with both proposals towards the end of 2018. 50

To proceed with these proposals the company will need to rent a warehouse (annual rent approximately £15 000 with an upfront cost of £6 000 for fixtures and fittings), buy a refrigerator (at an estimated cost of £8 000) and acquire a delivery van (with an approximate value of £12 000). In addition, three additional employees would need to be recruited: a driver, a packer and someone to handle the online orders. Additional annual staff costs would be in the region of £60 000. 55

The directors estimate that the new proposals would require the company to seek additional funding. £10 000 could be raised by issuing 10 000 new shares, contributed by each shareholder according to the ratio of their respective shareholdings. An additional £20 000 could be financed through a bank loan. However, the directors are uncertain as to whether this is the best way to finance the proposals. 60

**TASK A**

You are Ava's cousin and are a final year student of an accounting degree course at a local university. She has asked you to write a report to help Betty, Calvin and herself to improve their understanding of the need for, and the importance of, financial record keeping.

- (i) The directors of *Organic Plus Limited* currently do not fully understand the implications for a business if it fails to accurately record all its financial transactions. They have asked you to explain the reasons, using examples, why accurate financial records need to be kept by a business such as *Organic Plus Limited*. These include the need to:
- accurately calculate profit and loss
  - meet legal requirements
  - show the assets and liabilities of the business
  - compare the business' financial position to previous years
  - prepare accurate budgets/forecasts for future years
  - obtain additional finance
  - plan any future expansion.
- (ii) The directors are unsure of the consequences for *Organic Plus Limited* if its financial information is found to be inaccurate. To help Ava, Betty and Calvin, you have been asked to explain the following consequences to *Organic Plus Limited* of its financial information being inaccurate:
- possible criminal action
  - cash-flow problems from a high tax bill or criminal action
  - existing shareholders losing confidence
  - potential shareholders being unwilling to invest
  - bad public image
  - change in management structure.
- (iii) Ava, Betty and Calvin do not understand some technical accounting terms. They would welcome your explanation of the different types of income and expenditure which are often included in a set of final accounts. You need to explain each of the following to them so that they understand how and why the following are accounted for in the books:
- capital and bank loans
  - fixed assets such as equipment and vehicles, including items bought on credit
  - expenses for running a business, e.g. wages, electricity
  - items purchased for resale, including those bought on credit
  - items/services sold, including those sold on credit.

You should also include an explanation of the following source documents and how they are used:

- invoices
- credit notes
- banking records, e.g. direct debits and till receipts.

- (iv) You must also explain to the directors of *Organic Plus Limited* how a set of final accounts are created, including the processes and financial documents used.

Your explanation must demonstrate your understanding of each of the following processes:

- the division of ledgers
- double-entry transaction recording
- the balancing-off of accounts accurately
- the preparation of a trial balance
- the creation of a profit and loss account and a balance sheet.

These could be in written format and/or with the use of diagrams.

- (v) In your report to Ava, Betty and Calvin, you must explain the types of error which can occur when preparing accounts. You should include an example for each type of error to demonstrate depth of understanding. These include:

- omissions
- compensating errors
- errors of principle.

**[On completion of TASK A you will be assessed on Assessment Objective 1 which has a 9 mark tariff].**

*Note: For the purpose of this stimulus material, VAT transactions and Corporation Tax have been ignored.*

**Task B**

At the start of business on 1 April 2017, the following selected balances were extracted from the books of *Organic Plus Limited*.

	£
Curry Queen (Debtor)	200
Health n Taste (Debtor)	234
Purple Orchid (Debtor)	366
Alto Farm (Creditor)	1280
Landford Organics (Creditor)	640
Zac & Son (Creditor)	130
Sales	75 665
Purchases	30 428
Carriage inwards	1 356
Carriage outwards	720
Discount allowed	240
Discount received	526
Insurance	865
Rent	7 600
Telephone and Internet	965
Interest received	65
Bank (Dr)	6 780
Cash	732

During trading on 1 April 2017 the following source documents required processing.

Sales Invoice	£140	to	Purple Orchid
Sales Invoice	£170	to	Health n Taste
Sales Invoice	£120	to	Restaurant Viva
Cash sales	£458		Paid £350 into the bank, kept the rest in cash till
Purchase Invoice	£962	from	Landford Organics
Purchase Invoice	£768	from	Zac & Son, this includes carriage inwards of £48
Purchase Invoice	£745	from	Greenwood Farm
Cheque received	£400	from	Purple Orchid
Cheque received	£196	from	Curry Queen in full settlement of £200 after a 2% cash discount
Cheque issued	£640	to	Landford Organics
Cheque issued	£788	to	Alto Farm in settlement of £800 after a 1.5% discount
Cheque issue	£950	to	Landlord for the rent of the store
Invoice for carriage outwards	£55		Paid DH Transportation Co by cash

In addition, the bank statement shows:

Direct Debit paid	£115	to	BT for telephone and Internet
Direct Debit paid	£169	to	MMK Insurance
Credit Transfer received	£300	from	Health n Taste
Direct credit	£12		Interest received

**You are required to:**

- (i) open the relevant ledger accounts ensuring the opening balances are clearly shown
- (ii) post the information from the source documents and the bank statement to the relevant ledger accounts
- (iii) balance off the accounts as at the close of trading on 1 April 2017
- (iv) bring down the balances ready to start trading on 2 April 2017.

**TASK C**

On 31 May 2017 Ava wanted to check that the books of *Organic Plus Limited* balanced by producing a trial balance. She is aware that a suspense account may need to be created if the trial balance does not balance. Ava extracted the following balances as at 31 May 2017.

	£
Equipment (cost)	12000
Provision for depreciation of equipment	2400
Motor vehicle (cost)	5000
Provision for depreciation of motor vehicle	1800
Ordinary share capital @ £1 each	10000
Retained profits	8700
Sales	91545
Purchases	38260
Carriage inwards	1748
Carriage outwards	930
Discount allowed	380
Discount received	744
Insurance	1430
Rent	10450
Telephone and Internet	1379
Water and electricity	2010
Membership of the Federation of Small Businesses	200
Advertising costs	2900
Motor expenses	1940
Bad debt	450
Directors' remuneration	22000
Stock at 1 July 2016	1240
Debtors	2640
Creditors	2880
Bank (Dr)	5370
Cash	623
Dividend paid	8000
Interest received	81



**You are required to:**

- (i) prepare the trial balance as at 31 May 2017, creating a suspense account if appropriate
- (ii) prepare a statement clearly showing how each of the errors below should be corrected. You should use journal entries and a suspense account.

After preparing the trial balance, the following errors were found:

- 1 Discount received of £41 was incorrectly recorded as discount allowed.
- 2 No record had been made of a motor expense of £220, which was paid in cash.
- 3 Carriage inwards of £88 had been debited to the carriage outwards account.
- 4 A cheque for £125 received from Purple Orchid, a debtor, had been entered on the wrong side of the debtor's account.
- 5 A cash sale of £208 was entered in the sales account as £280.
- 6 The purchases account had been overstated by £540.

- (iii) Prepare a corrected trial balance as at 31 May 2017.

**TASK D**

On 30 June 2017, the following balances were extracted from the books of *Organic Plus Limited*.

	£
Equipment (cost)	15 000
Provision for depreciation of equipment	2 400
Motor vehicle (cost)	5 000
Provision for depreciation of motor vehicle	1 800
Ordinary share capital @ £1 each	10 000
Retained profits	8 700
Sales	102 800
Purchases	42 624
Carriage inwards	1 864
Carriage outwards	866
Discount allowed	355
Discount received	818
Insurance	1 748
Rent	10 450
Telephone and Internet	1 485
Water and electricity	2 144
Membership of the Federation of Small Businesses	200
Advertising costs	2 900
Motor expenses	2 545
Bad debt	450
Directors' remuneration	22 000
Stock at 1 July 2016	1 240
Debtors	2 950
Creditors	5 134
Bank (Dr)	8 951
Cash	965
Dividend paid	8 000
Interest received	85

**Additional information:**

- 1 Stock as at 30 June 2017 is valued at £1364.
- 2 The insurance includes a prepayment of £85.
- 3 There are accrued advertising costs of £240, accrued rent of £950 and accrued electricity of £113.
- 4 Depreciation on equipment is to be provided at 10% using the straight line method. Depreciation on motor vehicle is to be provided at 20% using the reducing balance method.
- 5 Another debtor owing *Organic Plus Limited* £150 has gone bankrupt. This needs to be written off as an additional bad debt. Furthermore, the directors consider that it would be prudent to set up a doubtful debt provision at 4% of the debtor's figure (after writing off all the bad debt).

**You are required to prepare in an appropriate professional format for *Organic Plus Limited*:**

- (i) a trading, profit and loss and appropriation account for the year ended 30 June 2017
- (ii) a balance sheet as at 30 June 2017.

**[On completion of TASKS B, C and D you will be assessed on Assessment Objective 2 which has a 14 mark tariff]**

**TASK E**

*Organic Plus Limited* is a private limited company.

- (a) Explain the key issues and potential pitfalls the company must consider when constructing its final accounts, particularly in relation to:
  - (i) possible templates and/or layouts
  - (ii) legal requirements.
- (b) Compare the summary reports which would be provided to shareholders by a public limited company with the information provided by a private limited company such as *Organic Plus Limited*.

**TASK F**

The following ratios have been calculated from *Organic Plus Limited's* final accounts for the year ended 30 June 2016.

	<b>Year ended 30 June 2016</b>
Gross profit percentage	55.02%
Net profit percentage	9.98%
Return on capital employed (based on year end capital employed)	47.06%
Current ratio	2.04:1
Acid test ratio	1.82:1
Stock turnover	12 days
Debtor collection period	35 days
Creditor payment period	40 days
Earnings per share	£0.88
Dividend cover	1.31 times

**Note:** For the purpose of your calculations, 100% of *Organic Plus Limited's* purchases are on credit and 25% of sales are on credit.

**You are required to:**

- (i) use the formulae provided in Appendix 1 to calculate (where appropriate to two decimal places) relevant ratios from *Organic Plus Limited's* final accounts for the year ended 30 June 2017
- (ii) analyse and interpret these ratios, explaining the limitations of using ratios to make judgements about the financial performance and viability of a business, in order to comment on the financial performance and financial position of *Organic Plus Limited*.

**[On completion of TASK E and F you will be assessed on Assessment Objective 3 which has a 12 mark tariff]**

**TASK G**

The directors are pleased with how *Organic Plus Limited* is developing and its success to date. Although they have made plans for the future of *Organic Plus Limited*, they are unsure of the best way to finance these plans.

You are required to:

write a report to Ava, Betty and Calvin, recommending an appropriate course of action for *Organic Plus Limited* with regard to its future plans to:

- finance the rental of the warehouse
- finance the fixtures and fittings for the warehouse
- acquire a new van and refrigerator
- finance the recruitment, wages and possible training costs of the new staff
- promote the new organic meal box
- ensure the liquidity of the company is not adversely affected.

Justify your recommendations.

**Please note:** this task will be assessed for *Quality of Written Communication*.

**[On completion of TASK G you will be assessed on Assessment Objective 4 which has a 15 mark tariff]**

## Appendix 1

## Accounting Ratios

**Profitability**

$\frac{\text{Gross Profit}}{\text{Net Sales}}$	$\times 100$	=	Gross Profit Percentage
$\frac{\text{Profit before Tax}}{\text{Net Sales}}$	$\times 100$	=	Net Profit Percentage
$\frac{\text{Profit before Tax}}{\text{Capital Employed}}$	$\times 100$	=	Return on Capital Employed
$\frac{\text{Expenses}}{\text{Net Sales}}$	$\times 100$	=	Expenses as a Percentage of Sales

**Solvency/Liquidity**

$\frac{\text{Current Assets}}{\text{Current Liabilities}}$		=	Current Ratio
$\frac{\text{Current Assets} - \text{Stock}}{\text{Current Liabilities}}$		=	Acid Test Ratio

**Performance**

$\frac{\text{Average Stock}}{\text{Cost of Sales}}$	$\times 365$	=	Stock Turnover
$\frac{\text{Net Sales}}{\text{Fixed Assets (NBV)}}$		=	Fixed Asset Turnover
$\frac{\text{Closing Debtors}}{\text{Credit Sales}}$	$\times 365$	=	Debtor Collection Period (days)
$\frac{\text{Closing Creditors}}{\text{Credit Purchases}}$	$\times 365$	=	Creditors Payment Period (days)

**Shareholder**

$\frac{\text{Profit attributable to Ordinary Shareholders}}{\text{Number of Ordinary Shares}}$		=	Earnings per share
$\frac{\text{Earnings per share}}{\text{Dividend per share}}$		=	Dividend Cover





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