



Think Ahead

Managing Costs and Finances (MA2) September 2020- August 2021 Examiner's report

The examining team share their observations from the marking process to highlight strengths and weaknesses in candidates' performance, and to offer constructive advice for those sitting the exam in the future.

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General Comments

The intention of this report is that, when considered in conjunction with previous reports, candidates at future sittings will have a resource which maximises their chance of success. The most effective way to use these reports is to consider both the technical content of each question, and the approach to answering the question – noting that different question types will require slightly different approaches.

The examination consists of 50 objective test questions, each worth 2 marks. The purpose of this report is to provide illustrations of questions which have especially posed problems for candidates.

The six sample multiple-choice questions below cover different aspects of the syllabus. The approach to correctly answering each question is explained and the common incorrect approaches, along with the misunderstandings which they indicate, are highlighted. Answering objective test questions requires candidates to have both a clear understanding of the subject matter being examined and a logical approach.

Example 1

Which of the following are features of a bank overdraft?

- (1) It is repayable on demand
- (2) It is always charged a fixed amount of interest
- (3) Security may be required by means of a charge on assets

Choices:

1. 1 and 2
2. 2 and 3
3. 1 and 3
4. 2 only

The correct answer is choice 3. 1 and 3.

Feature 1 is correct

An overdraft is repayable on demand, although this is unlikely unless the business enters into financial difficulties.

Feature 2 is incorrect

Due to the flexible nature of overdrafts the most common type of interest rate charged will be variable. The interest charged depends on the variable interest rate and the amount overdrawn on each day of the charging period.

Feature 3 is correct

In some larger facilities, the cost of borrowing can be reduced if the overdraft is secured, as the risk to the lender will generally be lower. The security provided by the borrower can be business assets, guarantees or security, or third-party guarantees or security.

Example 2

Which of the following could cause an adverse labour rate variance?

Choices:

1. Use of unskilled instead of skilled labour
2. Use of superior material
3. Change in the national minimum wage
4. Errors in allocating labour time to jobs

The correct answer is 3. Change in the national minimum wage

The key here is to think what would cause the rate (cost) of labour variance to be adverse i.e. to increase. This would mean we are paying more per hour/unit than expected as per the budget.

Consider each of the choices:

1. Use of unskilled instead of skilled labour – this will make the rate (cost) cheaper and thus lead to a favourable rate variance.
2. Use of a superior material - this will hopefully make the labour work faster and thus increase labour efficiency, but will have no impact on the labour rate variance.
3. Change in the national minimum wage – this will cause an increase to the minimum rate of pay and thus cause an adverse rate variance. **This is the correct answer.**
4. Errors in allocating labour time to jobs – this again will impact labour efficiency and not the labour rate variance.

Example 3

A company has two production departments (Cutting and Finishing) and two service departments (Maintenance and Materials). The following are the details of overheads allocated and apportioned to these departments:

	\$'000
Finishing	500
Cutting	300
Maintenance	200
Materials	100

The costs of the Maintenance department are shared by Finishing, Cutting and Materials departments in the ratio of 4:3:3 respectively. The costs of the Materials department are shared by the Finishing and Cutting departments in the ratio of 60:40.

What would be the total overhead cost for the Cutting department?

The correct answer is \$424,000.

The Maintenance cost is split 4:3:3 - so this is a total of 10; which means Finishing is 4/10th (0.4), Cutting 3/10th (0.3) and Materials 3/10th (0.3) of the Maintenance Cost.

The costs of the Materials department are shared by the Finishing and Cutting departments in the ratio of 60:40 so that means that 40/100th (0.4) of the cost is apportioned to Cutting and 60/100th (0.6) of the cost is apportioned to Finishing.

	Finishing \$'000	Cutting \$'000	Maintenance \$'000	Materials \$'000
Overheads	500	300	200	100
Maintenance department (split 4:3:3)	80 (200 x 0.4)	60 (200 x 0.3)	(200)	60 (200 x 0.3)
Sub total	580	360	0	160
Materials department (split 60:40)	96 (160 x 0.6)	64 (160 x 0.4)		(160)
Total	676	424	0	0

Example 4

The following information is given for three products which have joint processing costs of \$45,000.

	Product Output (kg)	Selling price per kg
A	5,000	\$10
B	4,000	\$8
C	6,000	\$4

Joint costs are apportioned on the basis of physical output.

What is the gross profit per kg of product B?

The correct answer is \$5.

Total output in kg = 5,000 + 4,000 + 6,000 = 15,000. This is the basis for apportioning the joint costs. Joint costs per kg = \$45,000/15,000kg = \$3/kg.

Gross profit of B = selling price – cost (\$8 - \$3) = \$5.

Key mistakes that occur in questions of this nature are to quote the total profit for product B, or simply the costs for product B, total or per kg. Some errors occur when the joint costs are apportioned incorrectly, for example by selling price or total sales value rather than the stated physical output.

Example 5

The following statements have been made in relation to absorption costing:

- (1) Absorption costing is only beneficial in manufacturing organisations
- (2) Absorption costing cannot be used in not-for-profit organisations

Are the above statements true or false?

Choices/Answers:

	True	False
1. Statement 1		
2. Statement 2		

The correct answer is: Statement 1 – False, Statement 2 – False

Both statements are false. Absorption costing is a method by which the overheads of a company can be allocated and apportioned along with all other costs, to the organisation's products or services. Any organisation with overheads will benefit from being aware of how much of these costs each product or service uses. Therefore, all organisations (including non-manufacturing and not-for-profit) can find benefit from using absorption costing.

Example 6

A new project requires an immediate investment in machinery of \$200,000. The project will generate additional sales (occurring evenly in each year) of \$150,000 in the next 5 years, with additional variable costs of \$40,000 per year. Fixed head office overheads of \$20,000 per year will be apportioned to the project, resulting from the company absorption rate of \$4.00 per labour hour.

What is the payback period of the project (to the nearest month)?

1. 1 year 10 months
2. 2 years 3 months
3. 1 year 4 months
4. 2 years 10 months

The correct answer is 1. 1 year 10 months

First calculate the relevant cashflows. The investment is our starting point – this is the outflow we need to recover over the payback period. The relevant cash inflows are revenue earned minus variable costs. The fixed head office overheads are not relevant as they are simply an allocation based on output and will be incurred if the project goes ahead or not.

Initial outlay	(200,000)	
Net income in year 1 (150,000 – 40,000)	<u>110,000</u>	
Cumulative cash flow end of year 1		(90,000)
Net income in year 2 (150,000 – 40,000)	<u>110,000</u>	
Cumulative cashflow end of year 2		<u>20,000</u>

Payback happens in the second year. To work out exactly when we assume that the inflows occur evenly over the year and work out how many months' worth of income is needed to cover the remaining negative balance.

Cash received in the year 110,000

Outstanding balance 90,000

Paid back in $90,000/110,000$ years = 0.818 years
 0.818×12 months = 10 months

Total time to payback is 1 year and 10 months.

Incorrect answers

2. If you had included the allocated overheads in the annual cash inflows you would have incorrectly answered 2 years 3 months
3. If you had not included any costs, just sales you would have incorrectly answered 1 year 4 months
4. This answer may be reached by making the calculations for the correct answer and simply mistaking the year of payback as the third not the second.

Conclusion

It is imperative that candidates study and prepare well for all topics in the syllabus and not just a select few. Candidates must bear in mind that questions in the examination will include questions from all topics of the syllabus. Equipping themselves with adequate knowledge of all topics will certainly maximise and improve the performance of candidates in future examinations. Thus, candidates are advised to plan their revision timetable so that they have sufficient time to revise all the topics in the syllabus. Candidates are also reminded to try and attempt all questions.