ASSESSMENT and QUALIFICATIONS ALLIANCE

Mark scheme January 2003

GCE

Accounting

Unit ACC6

January 2003 **AQA Advanced Level** **ACC6**

MARK SCHEME

INSTRUCTIONS TO EXAMINERS

You should remember that your marking standards should reflect the levels of performance of Advanced Level candidates, mainly 18 years old, writing under examination conditions.

Positive Marking

You should be positive in your marking, giving credit for what is there rather than being too conscious of what is not. Do not deduct marks for irrelevant or incorrect answers as candidates penalise themselves in terms of the time they have spent.

Mark Range

You should use the whole mark range available in the mark scheme. Where the candidate's response to a question is such that the mark scheme permits full marks to be awarded, full marks **must** be given. A perfect answer is not required. Conversely, if the candidate's answer does not deserve credit, then no marks should be given.

Alternative Answers / Layouts

The answers given in the mark scheme are not exhaustive and other answers may be valid. If this occurs, examiners should refer to their Team Leader for guidance. Similarly, candidates may set out their accounts in either a vertical or horizontal format. Both methods are acceptable.

Own Figure Rule

In cases where candidates are required to make calculations, arithmetic errors can be made so that the final or intermediate stages are incorrect. To avoid a candidate being penalised repeatedly for an initial error, candidates can be awarded marks where they have used the correct method with their own (incorrect) figures. Examiners are asked to annotate a script with **OF** where marks have been allocated on this basis. Similarly, **OF** marks can be awarded where candidates make correct conclusions or inferences from their incorrect calculations.

Quality of Written Communication

Once the script has been marked the work of the candidate should be assessed for the Quality of Written Communication, using the criteria at the end of the mark scheme. The mark should be shown separately on the candidate's script.

Synoptic Assessment

Synoptic assessment is located in Question 5. Candidates will be required to integrate their knowledge, understanding and skills learned in different parts of the A Level course.

1 **Total marks for this question:** ***10 marks***

REQUIRED

(a) State **three** different types of expenditure that would be included in the valuation of closing stock of finished goods of a manufacturing company.

Any 3 from: **Raw materials, transport costs**
Direct labour
Direct expenses
Production overheads
Other attributable overheads

1 mark per different type <u>**3 marks**</u>

(b) Explain the effects that over-stating the cost of stock would have on the final accounts and balance sheet of a company.

Over-stating of stock would:

(i) over-state profit (1), because closing stock is higher (1) the cost of goods sold is reduced (1) and therefore gross profit increased;

(ii) over-state asset values on the balance sheet (1) – the business could appear to be more stable (1) or more valuable than it actually is (1), + (1) for example;

(iii) make it difficult to compare (1) performance over time (1) as the overvalued stock will distort successive years (1);

(iv) could have a significant impact on decision making (1), + (1) for development.

<u>**max 7 marks**</u>

2 **Total marks for this question:** ***10 marks***

REQUIRED

With reference to FRS 15:

(a) define the term "depreciation";

"Depreciation is the measure of the cost of the fixed assets which have been consumed during the period" (1).

"Consumption includes the wearing out, using up, or other reduction of the useful life of the asset whether arising from use (1), time (1) or obsolescence through technological or market changes (1)".

Maximum 2 marks for causes **3 marks**

(b) explain why companies are allowed to choose between the straight-line and reducing-balance methods of calculating depreciation;

Management are allowed to select the method which is most appropriate (1) to the type of asset to allocate depreciation as fairly as possible (1) to the periods expected to benefit from the use of the asset (1).

1 mark for an example **max 3 marks**

(c) explain why depreciation is provided on freehold buildings but not on freehold land.

Depreciation is a measure of consumption rather than a loss of value (1), therefore depreciation must be provided to match (1) the consumption with the economic benefit generated.

The Companies Act states that all tangible fixed assets must be depreciated (1).

Buildings have a finite life (1) and their use may change (1) therefore depreciate (1). For freehold land, its life is infinite (1) so there is no consumption (1) and, therefore, no depreciation.

max 4 marks

3 **Total marks for this question:** ***12 marks***

REQUIRED

(a) Calculate the following ratios (state the formula used):

(i) dividend per share;

$$\left.\frac{\textbf{equity dividends}}{\textbf{shares issued}}\right\} \textbf{(1)} \qquad \frac{\textbf{35 200 000 (1)}}{\textbf{474 684 480 (1)}} = \textbf{7.4p}$$

<u>**3 marks**</u>

(ii) price earnings ratio.

$$\left.\frac{\textbf{market price}}{\textbf{EPS}}\right\} \textbf{(1)} \qquad \frac{\textbf{120 (1)}}{\textbf{24.08(1)}} = \textbf{4.98}$$

<u>**3 marks**</u>

(b) Explain the purpose of the price earnings ratio.

The PE ratio measures the number of years of earnings that investors are willing to buy (1). It represents the market's view of the future of the business (1). The higher the PE ratio, the better the market's view (1).

<u>**max 2 marks**</u>

(c) Outline **two** limitations of using published accounts to make investment decisions.

The figures are historic (1) and may not actually reflect the future (1).

The accounts take time to prepare (1) and may not reflect the current state of markets (1).

The figures are total (1) and do not reflect the performance of individual parts of the operation (1).

The accounts are purely financial (1) and do not necessarily reflect the performance of the management (1), workforce, new products, etc.

(0-2) for each limitation – for identification (1), for development (1), max of 2 limitations.

<u>**max 4 marks**</u>

4 **Total marks for this question:** ***18 marks***

REQUIRED

(a) Prepare balance sheet extracts for Mellors plc and Balden plc to show the position **before** the rights issues.

Balance Sheet extracts as at 1 December 2002

	Mellors plc £m		Balden plc £m	
Creditors amounts falling due after more than one year				
Debentures (125 + 75) (1)	**200**		**200**	
Capital and Reserves				
Called up share capital (ordinary shares of £1 each)	**100**	**(1OF)**	**100**	
150/3 = 50 (1)				
Share premium account	**50**	**(1OF)**	**(1OF)**	**(only if**
Profit and loss account	**25**		**75**	**consistent)**

5 marks

(b) Calculate the gearing ratios for Mellors plc and Balden plc before the rights issues (show the formula used). *(3 marks)*

$\left.\dfrac{\text{debenture}}{\text{equity funds}}\right\}$ (1) **Mellors plc $\dfrac{200}{175}$ = 114% (1)** **Balden plc $\dfrac{200}{175}$ = 114% (1)**

Accept any other valid gearing ratio. **3 marks**

(c) Explain the term "gearing".

Gearing is using debt as a means of financing (1) the company rather than using share capital (1).

The gearing ratio measures the amount of long term debt compared (1) to the equity investment in the business (1).

A highly geared company is considered to be a more risky investment (1) as the company has to meet higher debt repayments (1).

Any other acceptable explanation. **max 4 marks**

(d) Assess the usefulness of the gearing ratio as a guide to investment decisions. Use examples from the information given.

The gearing ratio measures the riskiness of the business from an investors point of view – the higher the gearing ratio the greater the risk (0-2). However, in times of increasing profits the benefits to shareholders will increase in a highly geared company (0-2).
Max 0-2 marks for general comments on gearing.

Investors should consider other information (1), + (1) for development/example.

In this case – Mellors (1) have used the funds generated to repay part of their long term debt (1) and have thus reduced their gearing ratio (1).
0-4 marks for relevant comments on Mellors.

Balden plc have used the funds to invest in new technology (1) – this may enable them to compete more effectively (1) and profitably (1) and thus may benefit the shareholders in the long run (1) – the gearing ratio will not show this (1).
0-4 marks for relevant comments on Balden.

Own figures consistent with (b).

max 6 marks

5 **Total for this question:** ***50 marks***

REQUIRED

(a) Prepare an extract from the cash flow statement based on the figures above. Follow the format given in FRS 1.

Cash flow statement for Crosby plc for the year ended 30 September 2002
Reconciliation of operating profit to operating cash flows (1)

	£m	
Operating profit	**112**	**6 items = 3 marks**
Depreciation charges	**58**	**5 items = 2 marks**
Profit on sale of assets	**(1)**	**3-4 items = 1 mark**
Decrease in stocks	**4**	
Increase in debtors	**(122.7)**	
Increase in creditors	**55.3**	
	105.6	
Net cash inflow from operating activities (1)	**105.6**	
Returns on investment and servicing of finance (1)		
Interest paid	**(48)**	
Tax	**(18)**	**(1)**
Capital expenditure and financial investment (1)		
Purchase of fixed assets	**(194)**	
Sale of fixed assets	**2**	
Equity Dividends paid	**(36)**	**(1)**
Cash outflow before use of liquid resources and financing (1)	**(188.4)**	**10 marks**

(b) Analyse the cash flow statement, identifying clearly the major sources and uses of cash.

Crosby plc have generated £105.6m (1) from their operations (1) – the company makes a profit which contributes £112m of cash (1). This has to be adjusted for non-cash items (1) such as depreciation (1), which is an expense but does not involve the movement of cash (1).
Debtors have increased significantly during the year (1), which means that over £122m (1) of cash has been tied up (1).

Reward any other valid comments – for identification (1), for development (0-2)
max 6 marks

The company had used cash to pay interest £48m (1) and dividends of £36m (1).
The largest (1) use of cash has been to purchase fixed assets (1), this has used £194m (1) which is more than the organisation has generated from operations (1).
Overall, the company has used £188.4m (1) more cash (1) than it has generated during the year (1).

overall max 10 marks

(c) Evaluate **three** appropriate sources of finance to meet the cash outflow.

Possible sources:
Long term – probably better due to amount of financing required

Type of finance – long term	Advantages	Disadvantages
Share issue	Dividends – don't have to pay and can vary	Change of control
Debentures	Often cheaper than shares e.g. reduced tax Don't have vote	Have to pay interest
Long term loans	Can be cheaper	May have to offer security
Sale of investments	No interest to pay	Lose income - permanently

Type of finance – short term	Advantages	Disadvantages
Overdraft	Flexible – only borrow the amount needed	Repayable on demand Can be expensive
Bank loan	Can be cheaper than overdraft	Have to use all of loan Fixed repayments

0-3 marks for identifying sources of finance
0-4 marks for stating potential advantages/disadvantages
Max 7 marks if no judgement shown
0-6 marks for judgement i.e. evaluating the most appropriate sources, advantages outweighing disadvantages, relating source to the situation e.g. due to amount required – long term better.

max 10 marks

(d) Explain the difference between a cash flow statement and a cash budget.

Cash flow statements are:
a statutory requirement for plcs (1)
historic (1)
prepared for external users (1)
prepared to show sources and uses of cash (1)

Cash budgets are:
prepared for internal users (1)
forecasts (1)
used to plan and control cash flows and to obtain financing when needed (1)

max 4 marks

Additional 0-2 marks for highlighting the differences.

overall max 6 marks

(e) Evaluate the significance of preparing cash budgets when making investment decisions.

Cash budgets show:
the availability of cash (1), for example/development (1)
the amount of financing required (1), for example/development (1)
the ability to meet debt repayments (1), for example/development (1)

max 4 marks

Evaluation – without budgets may make serious errors (1), could lead to closure of the business (1), difficult to justify any decision taken if budgets not prepared (2)

0-2 for examples

overall max 6 marks

(f) Crosby plc has a loss-making operation, which is draining vital cash from the business. Analyse **two** factors which the board would have to take into account before deciding to close down the loss-making operation.

Location of loss making operation (2) – is it in rural area, area of high unemployment; what impact would the closure have on the local community/economy. (0-2) for development

Size of losses (2) – if the losses are not significant then the board may be willing to maintain the operation. (0-2) for development

Length of time (2) – the losses could just have occurred or the board may believe they are temporary, in which case the board may decide to keep the operation open – otherwise they will probably close it down. (0-2) for development

Affect on workforce (2) – there may be a significant impact on the remaining workforce in terms of motivation and performance. (0-2) for development

Affect on company image (2) – customer relations may suffer as the result of adverse publicity. (0-2) for development

Two factors only

max 8 marks

QUALITY OF WRITTEN COMMUNICATION

After the candidate's script has been marked, the work should be assessed for the Quality of Written Communication, using the following criteria.

Marks

0 Accounts and financial statements are unclear and poorly presented.
There is little or no attempt to show workings or calculations.
Descriptions and explanations lack clarity and structure.
There is very limited use of specialist vocabulary.
Answers may be legible but only with difficulty.
Errors in spelling, punctuation and grammar are such that meaning is unclear.

1-2 There is some attempt to present accounts and financial statements in an appropriate format. Workings are missing or are not clearly linked to the answers.
Descriptions and explanations are understandable but they lack a logical structure.
There is some use of specialist vocabulary but this is not always applied appropriately. In most cases answers are legible, but errors in spelling, punctuation and grammar are such that meaning may be unclear.

3-4 Accounts and financial statements are generally well presented but there are a few errors.
Workings are shown and there is some attempt to link them to the relevant account(s). Descriptions and explanations are usually clearly expressed but there are some weaknesses in the logical structure. There is a good range of specialist vocabulary which is used with facility.
Answers are legible. Spelling is generally accurate and the standard conventions of punctuation and grammar are usually followed.

5 Accounts and financial statements are well organised and clearly presented.
Workings are clearly shown and easy to follow. Descriptions and explanations are clearly expressed. Arguments are logically structured. There is wide use of specialist vocabulary which is used relevantly and precisely.
Answers are clearly written and legible. Spelling is accurate and the standard conventions of punctuation and grammar are followed so that meaning is clear.