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# General Certificate of Education

# Accounting 6121

*ACC6 Published Accounts of Limited Companies and Accounting Standards*

# Mark Scheme

## *2006 examination - June series*

Mark schemes are prepared by the Principal Examiner and considered, together with the relevant questions, by a panel of subject teachers. This mark scheme includes any amendments made at the standardisation meeting attended by all examiners and is the scheme which was used by them in this examination. The standardisation meeting ensures that the mark scheme covers the candidates' responses to questions and that every examiner understands and applies it in the same correct way. As preparation for the standardisation meeting each examiner analyses a number of candidates' scripts: alternative answers not already covered by the mark scheme are discussed at the meeting and legislated for. If, after this meeting, examiners encounter unusual answers which have not been discussed at the meeting they are required to refer these to the Principal Examiner.

It must be stressed that a mark scheme is a working document, in many cases further developed and expanded on the basis of candidates' reactions to a particular paper. Assumptions about future mark schemes on the basis of one year's document should be avoided; whilst the guiding principles of assessment remain constant, details will change, depending on the content of a particular examination paper.

## June 2006 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 / Layout

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. **OF** makes the assumption that there are no extraneous items. Similarly, **OF** marks can be awarded where candidates make correct conclusions or inferences from their incorrect calculations.

### Quality of Written Communication

Once the whole 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 the last question. Candidates will be required to integrate their knowledge, understanding and skills learned in different parts of the A Level course.

**1** **Total for this question: 30 marks**

The directors of Twine plc are in the process of preparing the final accounts for the year ended 31 May 2006. The draft accounts include the following information.

| | £ |
|---|---|
| Net assets | 15 000 000 |
| Net profit | 2 300 000 |

However, the draft accounts need to be amended to take account of the following.

(1) During the year, Twine plc purchased a partnership. The tangible assets of the partnership have been included in the accounts. However, the purchase price included the following:

goodwill valued at £1 200 000, with an estimated economic life of 20 years;
brand names valued at £800 000, with an estimated economic life of 4 years.

(2) Stock originally included in the draft accounts at cost £50 000 has been damaged. It will have to be repaired at a cost of £3000 before it can be sold. It is estimated that, following the repairs, the stock could be sold at auction for £55 000, less 10% commission.

## REQUIRED

(a) Calculate:
(i) net assets;
(ii) net profit;
after making adjustment for items (1) and (2). Show your workings.

| | Workings | | | (i) Net assets £ | | (ii) Net profit £ | |
|---|---|---|---|---|---|---|---|
| | | | | **15 000 000** | | **2 300 000** | |
| **Goodwill** | | | | **1 200 000** | **(1)** | | |
| **Amortisation** | **1 200 000/20 (1)** | | | **(60 000)** | **(1) OF** | **(60 000)** | **(1) OF** |
| | | | | **16 140 000** | | **2 240 000** | |
| **Brand names** | | | | **800 000** | **(1)** | | |
| **Amortisation** | **800 000/4 (1)** | | | **(200 000)** | **(1) OF** | **(200 000)** | **(1) OF** |
| | | | | **16 740 000** | | **2 040 000** | |
| **Stock - NRV** | | | | | | | |
| **Selling price** | **55 000** | **(1)** | | | | | |
| **Repair costs** | **(3 000)** | **(1)** | | | | | |
| **Auction fees** | **(5 500)** | **(1)** | | | | | |
| | **46 500** | **(1) OF for calculating NRV** | | | | | |
| **Cost** | **50 000** | **(1)** | | | | | |
| | **(3 500)** | | | **(3 500)** | **(1)** | **(3 500)** | **(1) OF for deducting** |
| | | | | **16 736 500** | **(1) OF** | **2 036 500** | **(1) OF** |

**17 marks**

**(1)**

(b) State the relevant accounting standard to be applied to item (1) and item (2).

**FRS 10 Goodwill and intangible assets (1) (Accept IAS 38 Intangible assets)**
**SSAP 9 Stocks and long term contracts (1) (Accept IAS 2 Inventories)** **2 marks**

(c) Explain why it is important for the users of published accounts to know that the accounts are prepared in accordance with accounting standards.

| Descriptor | Marks | Possible answers |
|---|---|---|
| **Explain that users are interested in accounts to make decisions** | **0-2** | **All are using accounts to make decisions such as to invest or to sell shares or to lend money** |
| **Judgement of the purpose of accounting standards in general** | **0-2** | **Accounting standards provide guidance for those preparing accounts in situations where there are alternative accounting treatments or decisions to be made** |
| **Examples of areas where alternative treatments are possible** | **0-1** | **For example, the valuation of stock** |
| **Explanation of the need for accounts to show a true and fair view** | **0-2** | **The users of accounts need to be sure that the accounts show a true and fair view of the profits and the balance sheet figures. If the accounts are prepared in accordance with accounting standards, the user can be confident that they show a true and fair view** |
| **Application/examples supporting the true and fair view** | **0-2** | **FRS 10 ensures that only externally generated goodwill is capitalised, this helps to prevent manipulation of the accounts** |
| **Judgement of the significance of accounting standards in aiding comparability** | **0-2** | **Accounting standards ensure that similar items are dealt with in similar ways in different companies** |
| **Examples supporting judgement** | **0-2** | **For example, FRS 15 ensures that all fixed assets are depreciated** |

**overall max 11**

**2** **Total for this question: 20 marks**

Xiang is considering investing in ordinary shares of either Elriani plc or Nicol plc. The current market price of ordinary shares in both companies is 160p. He has obtained the following ratios for Elriani plc.

| | |
|---|---|
| Dividend per share | 5p |
| Dividend yield | 3% |
| Dividend cover | 1.7 times |
| Earnings per share | 8.5p |
| Price/earnings | 18.82 |

He has also extracted the following information from the accounts of Nicol plc.

| | £ |
|---|---|
| Issued ordinary shares of £1 each fully paid | 50 000 000 |
| Net profit after tax | 10 000 000 |
| Ordinary share dividends | 4 000 000 |

**REQUIRED**

(a) Calculate the following ratios for Nicol plc. State the formula used.
- (i) Dividend per share
- (ii) Dividend yield
- (iii) Dividend cover
- (iv) Earnings per share
- (v) Price/earnings.

**Dividend per share** $\dfrac{\textbf{Dividends}}{\textbf{No. of ordinary shares}}$ **(1)** $\dfrac{4\,000\,000}{50\,000\,000}$ **= 8p (1)**

**Dividend yield** $\dfrac{\textbf{Dividend per share x100}}{\textbf{Market price}}$ **(1)** $\dfrac{8 \times 100}{160}$ **= 5% (1) OF**

**Dividend cover** $\dfrac{\textbf{Net profit after tax}}{\textbf{Dividends}}$ **(1)** $\dfrac{10\,000\,000}{4\,000\,000}$ **= 2.5 times (1)**

**Earnings per share** $\dfrac{\textbf{Net profit after tax}}{\textbf{No. of ordinary shares}}$ **(1)** $\dfrac{10\,000\,000}{50\,000\,000}$ **= 20p (1)**

**Price/earnings ratio** $\dfrac{\textbf{Market price}}{\textbf{Earnings per share}}$ **(1)** $\dfrac{160}{20}$ **= 8 (1) OF**

**10 marks**

**(2)**

(b) Advise Xiang which company he should invest in, in order to:
(i) maximise his income;
(ii) maximise his potential capital gain.
Your advice should be based on the information given and the ratios calculated in (a).

| Descriptor | Marks | Possible answers |
|---|---|---|
| **Comparison of ratios** | **0-3** | **Dividend yield is 3% in Elriani compared with 5% in Nicol plc** |
| **Judgement shown in comparing ratios** | **0-3** | **This means that Xiang will get a higher return if he invests in Nicol** |
| **Explanation of income vs capital gain** | **0-2** | **Investors buy shares to receive income in the form of dividends and/or to sell their shares at a higher price – capital gain** |
| **Discussion of income vs capital gain, including reference to ratios** | **0-2** | **From an income point of view, Nicol looks better as it pays higher dividend per share and has a greater dividend yield. However, Elriani may be the better investment for capital gain, as the market view reflected in the P/E ratio is better** |

**max 8 marks**

| | | |
|---|---|---|
| **Advice and justification** | **0-2** | |
| **Other factors** | **0-2** | **Other factors may influence decision – company ethics, need to compare ratios etc.** |

**4 marks**
**Overall max 10 marks**

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

The directors of Nick Ltd are in the process of preparing the final accounts for the year ended 31 May 2006. The draft balance sheet is shown below.

**Nick Ltd**
**Balance Sheet at 31 May 2006**

| | £ | £ |
|---|---|---|
| **Fixed assets** | | |
| Land and buildings | | 100 000 |
| Other fixed assets | | 45 000 |
| | | 145 000 |
| **Current assets** | | |
| Stock | 20 000 | |
| Debtors | 18 000 | |
| Less provision for doubtful debts | (900) | |
| | 37 100 | |
| **Creditors: amounts falling due within one year** | | |
| Creditors | 16 500 | |
| Bank overdraft | 25 000 | |
| Short-term loan | 35 000 | |
| | 76 500 | |
| **Net current liabilities** | | (39 400) |
| **Total assets less current liabilities** | | 105 600 |
| **Capital and reserves** | | |
| Ordinary shares of 50p each | | 20 000 |
| Profit and loss account | | 85 600 |
| | | 105 600 |

The directors of Nick Ltd have two major concerns.

- Despite making a profit, they are unable to pay a dividend due to a lack of cash.
- They feel that the balance sheet does not reflect the underlying strength of the business.

The directors intend to address these concerns by implementing the following.

(1) Revaluing the land and buildings. They have been advised that the land and buildings should be valued at £200 000.
(2) Rewarding the shareholders by making a bonus issue of shares. The issue would be on the basis of four new shares for every one share held. The directors want to maintain reserves in their most distributable form.
(3) Issuing £80 000 of Debentures redeemable between 2018 and 2020. The proceeds of the issue would be used to buy new fixed assets for £35 000 and to repay the short-term loan. Any remaining amount would be used to reduce the overdraft.
(4) Reducing the provision for doubtful debts to 2% of debtors.

**(3)**

**REQUIRED**

(a) Prepare a revised balance sheet, assuming the directors carry out their intentions.

**Nick Ltd balance sheet at 31 May 2005**

| | | | | | |
|---|---|---|---|---|---|
| **Fixed assets** | ***Workings*** | **£** | **£** | **£** | |
| **Land & buildings at valuation** | ***(100 000 (1) + 100 000 (1))*** | | | **200 000** | **(2)** |
| **Other fixed assets - NBV** | ***(45 000 (1) + 35 000 (1))*** | | | **80 000** | **(2)** |
| | | | | **280 000** | |
| **Current assets** | | | | | |
| **Stock** | | | **20 000** | | |
| **Debtors** | | **18 000** | | | |
| **Less provision** | ***(18 000 x .02) (1)*** | **(360)** | **17 640 (1)** | | |
| | | | **37 640** | | |
| **Creditors: amounts falling due within one year** | | | | | |
| **Creditors** | | | **16 500** | | |
| **Bank overdraft** | ***(25 000 (1) -10 000 (1 )OF)*** | | **15 000 (2)** | | |
| | | | **31 500** | | |
| **Net current assets** | | | | **6 140** | **(1) OF** |
| **Total assets less current liabilities** | | | | **286 140** | |
| **Creditors: amounts falling due after more than one year** | | **(1)** | | | |
| **Debentures 2018-20** | | | | **(80 000)** | **(1)** |
| | | | | **206 140** | |
| **Capital and reserves** | | | | | |
| **Ordinary shares of 50p each** | ***(20 000 + 80 000)*** | | | **100 000** | **(4)*** |
| **Revaluation reserve** | ***(100 000 (1) OF - 80 000 (1) OF)*** | | | **20 000** | **(2)** |
| **Profit and loss account** | ***(85 600 +900 (1) - 360 (1) OF)*** | | | **86 140** | **(2)** |
| | | | | **206 140** | **(1) for balancing** |

**** workings*** ***20 000 (1) x 4 (1)= 80 000 (1) + (1) for adding to ordinary shares***

**20 marks**

**(3)**

(b) Discuss to what extent you think the directors have been successful in reflecting the strength of the business in the revised balance sheet. Use accounting ratios to support your answer.

| Descriptor | Marks | Possible answers |
|---|---|---|
| **Explanation of the impact of revaluation, debentures and bonus issue on balance sheet** | **0-3** | **The revaluation increases the assets of the business by £100 000**<br>**The debenture increases long-term liabilities**<br>**The bonus issue increases the issued share capital** |
| **Judgement of the impact** | **0-3** | **The net assets have increased by £100 000 – almost doubling the size of the business. The issued share capital now represents almost half the shareholders' funds compared with a fifth before the changes** |
| **Explain the impact on liquidity** | **0-2** | **The repayment of the short-term loan and reduction of the overdraft have reduced current liabilities from £76 500 to £31 500** |
| **Evaluate the impact on liquidity** | **0-2** | **This has improved the liquidity situation as the business now has net current assets of £6140 rather than net current liabilities of £39 400** |
| **Calculation of current ratios** | **0-2** | **Before 0.48:1 after 1.19:1** |
| **Calculation of acid test ratios** | **0-2** | **Before 0.22:1 after 0.56:1** |
| **Calculation of gearing ratios** | **0-2** | **Before 0% after 39% (27.96%)** |
| **Assessment of change in ratios** | **0-6**<br><br><br><br><br><br>**0-2** | **Current ratio now looks acceptable**<br>**Acid test ratio could still be worrying as the business only has 56p of liquid assets to pay every £1 of current liabilities**<br>**Gearing ratio has increased but still low geared**<br><br>**Need to compare ratios before making assessment** |
| **Overall assessment** | **0-2**<br><br><br>**0-2** | **The balance sheet looks stronger, but there is still a worrying lack of cash**<br><br>**Consideration of non-financial factors** |

**overall max 20 marks**

**(3)**

(c) Distinguish between the roles of the directors and the auditors in the preparation of the published accounts of a limited company.

| Descriptor | Marks | Possible answers |
|---|---|---|
| **Identify the role of the directors** | **0-2** | **Directors are appointed by the shareholders to run the business on their behalf** |
| **Explain the role of the directors in relation to the published accounts** | **0-3** | **The directors are required by law to prepare accounts for the shareholders which show a true and fair view of the state of affairs and of the profit or loss for the year** |
| **Identify the role of the auditors** | **0-2** | **Because of the divorce of ownership and control, auditors are appointed by shareholders to check the accounts** |
| **Explain the role of the auditors in relation to the published accounts** | **0-3** | **The auditors report to the shareholders to assure them that the accounts show a true and fair view, and that they comply with the Companies Acts and have been prepared in accordance with accounting standards** |
| **Clear distinction between the role of the directors and auditors** | **0-2** | **The directors' role is to prepare the accounts, while the auditors' role is to check them and report their findings to the shareholders** |

**max 10 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.<br>There is little or no attempt to show workings or calculations.<br>Descriptions and explanations lack clarity and structure.<br>There is very limited use of specialist vocabulary.<br>Answers may be legible but only with difficulty.<br>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.<br>Workings are missing or are not clearly linked to the answers.<br>Descriptions and explanations are understandable but they lack a logical structure.<br>There is some use of specialist vocabulary but this is not always applied appropriately.<br>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.<br>Workings are shown and there is some attempt to link them to the relevant account(s).<br>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.<br>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.<br>Workings are clearly shown and easy to follow. Descriptions and explanations are clearly expressed.<br>Arguments are logically structured. There is wide use of specialist vocabulary which is used relevantly and precisely.<br>Answers are clearly written and legible. Spelling is accurate and the standard conventions of punctuation and grammar are followed so that meaning is clear. |