

Business Studies

Advanced GCE

Unit **F294**: Accounting

Mark Scheme for January 2011

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Mark schemes should be read in conjunction with the published question papers and the Report on the Examination.

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Question	Expected Answer	Mark	Rationale/Additional Guidance
1	<p>Using Appendix 1, calculate the first year's depreciation charge for ITSL's new production equipment using the following methods:</p> <p>(a) declining (reducing) balance method</p> <p>(b) straight line method</p>		
	<p>(a)</p> <p>New equipment purchase price (historic cost) = £125,000 Declining balance rate to apply= 30% (1)</p> <p>£125,000 x 0.30 = £37,500 (1)</p>	[2]	Answer of £87,500: award 1 mark only.
	<p>(b)</p> <p>New equipment purchase price (historic cost) = £125,000 Estimated residual value = 10% of £125,000 = £12,500 Estimated life of the asset = 15 years (1)</p> <p>$\frac{£125,000 - £12,500}{15} = £7,500$ (1)</p>	[2]	
2	<p>Analyse <u>one</u> advantage to ITSL of using the straight-line depreciation method for the new production equipment.</p> <p>From Harry's point of view, straight-line depreciation is easy to apply and understand. He is also disappointed by the net profit margin, using the figures from Question 1. ITSL's profit would be £30,000 (£37,500 - £7,500) higher if straight-line depreciation was adopted for this equipment. The balance sheet would also have £30,000 higher fixed asset net book value.</p> <p>On the other hand, increasing net profit will mean that ITSL's tax liability will increase. It is also difficult for Harry to predict that the equipment will be used for 15 years. For example, after a few years, new technology might render this equipment almost redundant and Harry will look to</p>		

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	<p>replace it. It is also Harry's estimate that the equipment could be sold after 15 years for 10% of its purchase price. Clearly, it is difficult to predict 15 years into the future!</p> <table border="1" data-bbox="387 376 1144 756"> <tr> <td data-bbox="387 376 1032 411">Level 3</td> <td data-bbox="1032 376 1144 411"></td> </tr> <tr> <td data-bbox="387 411 1032 517">Candidate demonstrates analytical skills when considering adopting a straight-line depreciation method.</td> <td data-bbox="1032 411 1144 517">(5-6)</td> </tr> <tr> <td data-bbox="387 517 1032 552">Level 2</td> <td data-bbox="1032 517 1144 552"></td> </tr> <tr> <td data-bbox="387 552 1032 651">Candidate demonstrates knowledge and understanding of straight-line depreciation. No context required.</td> <td data-bbox="1032 552 1144 651">(3-4)</td> </tr> <tr> <td data-bbox="387 651 1032 686">Level 1</td> <td data-bbox="1032 651 1144 686"></td> </tr> <tr> <td data-bbox="387 686 1032 756">Candidate offers only theoretical knowledge of straight-line depreciation.</td> <td data-bbox="1032 686 1144 756">(1-2)</td> </tr> </table>	Level 3		Candidate demonstrates analytical skills when considering adopting a straight-line depreciation method.	(5-6)	Level 2		Candidate demonstrates knowledge and understanding of straight-line depreciation. No context required.	(3-4)	Level 1		Candidate offers only theoretical knowledge of straight-line depreciation.	(1-2)	[6]	<p>Only award L1 if answer is limited to 'it's easy to calculate and understand'.</p>
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3	<p>'Harry continues to be frustrated by the level of details which the auditors require'. Analyse <u>two</u> ways in which accounting conventions might apply to ITSL.</p> <p>Knowledge of accounting conventions can encompass a wide range of responses:</p> <ul style="list-style-type: none"> • boundary rules (entity, periodicity, going concern, quantitative) • measurement rules (money measurement, historic cost, realisation, matching, dual aspect, materiality) • ethical rules (prudence, consistency, objectivity, relevance) <p>Context and discussion could include reference to:</p> <ul style="list-style-type: none"> • materiality - the necessity to value the closing stock regardless of quantity and cost • prudence - 'if in doubt, overstate losses and understate profits'. This could apply to the bad debt 		<p>L2 for name of accounting convention with reference to case study.</p> <p>Bottom L3 can be achieved if one way is well developed within the context.</p> <p>Bottom L1 if understanding of accounting convention without it being named.</p>												

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	<p>provision and the use of the declining balance method of depreciation</p> <ul style="list-style-type: none"> • consistency - once specific accounting policies have been adopted; they should be followed in all subsequent accounting periods. Would changing the depreciation method compromise this rule? • relevance - auditors should try to present accounts in a 'true and fair view'. This is achieved through applying accounting standards, in the context of ITSL this could apply to depreciation, bad debts and stock valuations. <table border="1" data-bbox="387 619 1164 965"> <tr> <td>Level 3</td> <td></td> </tr> <tr> <td>Candidate demonstrates analytical skills when considering accounting conventions in context.</td> <td>(5-6)</td> </tr> <tr> <td>Level 2</td> <td></td> </tr> <tr> <td>Candidate demonstrates knowledge and understanding of accounting conventions. No context required.</td> <td>(3-4)</td> </tr> <tr> <td>Level 1</td> <td></td> </tr> <tr> <td>Candidate offers only theoretical knowledge of accounting conventions.</td> <td>(1-2)</td> </tr> </table>	Level 3		Candidate demonstrates analytical skills when considering accounting conventions in context.	(5-6)	Level 2		Candidate demonstrates knowledge and understanding of accounting conventions. No context required.	(3-4)	Level 1		Candidate offers only theoretical knowledge of accounting conventions.	(1-2)	<p>[6]</p>	
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<p>4</p>	<p>Refer to Table 3. Using variance analysis, evaluate how ITSL could improve the costing problem with carrot and coriander soup highlighted by Sheryl Blake.</p> <p>Knowledge:</p> <ul style="list-style-type: none"> • planned unit cost of products • a benchmark measurement of resource usage, set in defined conditions • a very detailed analysis known as variance analysis. • variance - the difference between a standard cost and the actual cost incurred 														

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	<ul style="list-style-type: none"> key to the benefit of a standard cost system is investigating why variances have arisen. <p>In the context of ITSL variance calculations could include:</p> <p>Basic</p> <table border="1" data-bbox="389 376 1133 692"> <thead> <tr> <th>Ingredient</th> <th>Standard Cost £</th> <th>Actual Cost £</th> <th>Standard-Actual £</th> </tr> </thead> <tbody> <tr> <td>Carrots</td> <td>0.24</td> <td>0.28</td> <td>0.04 adverse</td> </tr> <tr> <td>Onions</td> <td>0.06</td> <td>0.05</td> <td>0.01 favourable</td> </tr> <tr> <td>Fats</td> <td>0.05</td> <td>0.06</td> <td>0.01 adverse</td> </tr> <tr> <td>Herbs</td> <td>0.03</td> <td>0.06</td> <td>0.03 adverse</td> </tr> <tr> <td>Other</td> <td>0.02</td> <td>0.03</td> <td>0.01 adverse</td> </tr> <tr> <td>Carton</td> <td>0.04</td> <td>0.04</td> <td>0.00</td> </tr> <tr> <td>Total</td> <td>0.44</td> <td>0.52</td> <td>0.08 adverse</td> </tr> </tbody> </table> <p>Higher level analysis could include:</p> <ul style="list-style-type: none"> Actual cost is 18.2% above standard. $(0.52 - 0.44/0.44) \times 100$ Carrots account for 50% of adverse variance. $(0.04/0.08) \times 100$ Herbs account for 37.5 % of adverse variance. $(0.03/0.08) \times 100$ <p>Basic</p> <table border="1" data-bbox="389 1038 1133 1422"> <thead> <tr> <th>Ingredient</th> <th>Standard Quantity grammes (g)</th> <th>Actual Quantity grammes (g)</th> <th>Standard-Actual grammes (g)</th> </tr> </thead> <tbody> <tr> <td>Carrots</td> <td>252</td> <td>256</td> <td>4 adverse</td> </tr> <tr> <td>Onions</td> <td>54</td> <td>50</td> <td>4 favourable</td> </tr> <tr> <td>Fats</td> <td>10</td> <td>12</td> <td>2 adverse</td> </tr> <tr> <td>Herbs</td> <td>5</td> <td>5</td> <td>0</td> </tr> <tr> <td>Other</td> <td>279</td> <td>277</td> <td>2 favourable</td> </tr> <tr> <td>Carton</td> <td>-</td> <td>-</td> <td>-</td> </tr> <tr> <td>Total</td> <td>600</td> <td>600</td> <td>0</td> </tr> </tbody> </table>	Ingredient	Standard Cost £	Actual Cost £	Standard-Actual £	Carrots	0.24	0.28	0.04 adverse	Onions	0.06	0.05	0.01 favourable	Fats	0.05	0.06	0.01 adverse	Herbs	0.03	0.06	0.03 adverse	Other	0.02	0.03	0.01 adverse	Carton	0.04	0.04	0.00	Total	0.44	0.52	0.08 adverse	Ingredient	Standard Quantity grammes (g)	Actual Quantity grammes (g)	Standard-Actual grammes (g)	Carrots	252	256	4 adverse	Onions	54	50	4 favourable	Fats	10	12	2 adverse	Herbs	5	5	0	Other	279	277	2 favourable	Carton	-	-	-	Total	600	600	0		<p>L3/4 can only be achieved if there is evidence of good use of Table 3.</p>
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	<p>Higher level analysis could include:</p> <ul style="list-style-type: none"> • There is no overall variance • The actual quantity for carrots is 1.6% above standard $(256-252/252) \times 100$ • The actual quantity for onions is 8.0% below standard $(50-54/54) \times 100$ • The actual quantity for fats is 20.0% above standard $(12-10/10) \times 100$ • The actual quantity for other ingredients is 0.7% below standard $(277-279/279) \times 100$ • There is no overall variance for quantity. <p>Summary</p> <p>The main reasons for the variance in actual costs are the costs for carrots and herbs. The quantities are largely under control and the main ingredients carrots (42%), onions (9%) and other ingredients (46.5%) are either below standard or marginally above. The fats, at 20% above standard, seem to be an issue but still only account for 2% of the total weight. The quantity variances might simply be due to what proportion of ingredients was available at the time of production. Therefore, a standard cost system for analysing the variance of quantity used might be insignificant. The cost variance, therefore, is not largely due to the inefficiency of the production method but due to the price of ingredients, especially the price of carrots and herbs. As indicated in the case study, there are fluctuations in the price of materials due to the fact that many ingredients are imported. Other external factors not mentioned in the case could also be mentioned, eg supply shortages due to poor growing conditions etc.</p> <p>Overall the benefits of introducing a standard cost system need to set against the costs such as IT systems and</p>		

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	<p>administrative time. However, a standard cost system would become part of a company wide budget system and, in the long-term, help ITSL to improve profitability.</p> <table border="1" data-bbox="385 376 1164 863"> <tr> <td data-bbox="385 376 1032 411">Level 4</td> <td data-bbox="1032 376 1164 411"></td> </tr> <tr> <td data-bbox="385 411 1032 517">Candidate demonstrates evaluative skills when considering standard cost data and other factors.</td> <td data-bbox="1032 411 1164 517">(9-13)</td> </tr> <tr> <td data-bbox="385 517 1032 552">Level 3</td> <td data-bbox="1032 517 1164 552"></td> </tr> <tr> <td data-bbox="385 552 1032 657">Candidate demonstrates analytical skills when considering standard cost data and other factors.</td> <td data-bbox="1032 552 1164 657">(6-8)</td> </tr> <tr> <td data-bbox="385 657 1032 692">Level 2</td> <td data-bbox="1032 657 1164 692">(3-5)</td> </tr> <tr> <td data-bbox="385 692 1032 759">Candidate offers knowledge and understanding of standard cost data. No context required.</td> <td data-bbox="1032 692 1164 759"></td> </tr> <tr> <td data-bbox="385 759 1032 794">Level 1</td> <td data-bbox="1032 759 1164 794">(1-2)</td> </tr> <tr> <td data-bbox="385 794 1032 863">Candidate offers only theoretical knowledge of standard cost data.</td> <td data-bbox="1032 794 1164 863"></td> </tr> </table>	Level 4		Candidate demonstrates evaluative skills when considering standard cost data and other factors.	(9-13)	Level 3		Candidate demonstrates analytical skills when considering standard cost data and other factors.	(6-8)	Level 2	(3-5)	Candidate offers knowledge and understanding of standard cost data. No context required.		Level 1	(1-2)	Candidate offers only theoretical knowledge of standard cost data.		[13]	
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5	<p>Discuss reasons why all of ITSL's departments should be involved in setting financial budgets.</p> <p>Knowledge Financial budgets: quantitative statements, for a defined period of time, which may include planned revenues, expenses, assets, liabilities and cash flows. Budgets lay down framework in order for the business to achieve its overall financial objective. In practice a range of budgets need to be prepared and then combined into an overall budget or a master budget including</p> <ul style="list-style-type: none"> • Budgeted profit and loss account • Budgeted balance sheet • Budgeted cash flow statement. 																		

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	<p>Budgetary control features and why all departments need to be involved</p> <ul style="list-style-type: none"> • Department budgets contribute to master budget • Department budgets are very detailed and become a plan of action for individuals and departments • Managerial responsibilities have to be defined and managers have a responsibility to effectively manage budgets • Action needs to be taken if actual results differ from the budget and variances analysed. <p>Summary Benefits In the context of ITSL, budgeting does not currently happen. Harry sets a sales target and has an expectation for profit levels. ITSL's latest gross profit margin is 55% $(289,603/526,720) \times 100$ and net profit margin is 6% $(31,603/526,720) \times 100$. With budgetary control and departmental involvement, could these margins have been improved and come closer to Harry's 15% target? How realistic are Harry's targets? Harry appears to set the sales target without referring to his key employees; there is reference to his autocratic leadership and a very hands on approach. There could be major operational issues if Harry's sales target needs a significant increase in output, eg machine capacity, direct labour hour, overtime costs, recruitment, maintenance, product promotion costs, direct sales expenses, etc. Involvement in setting budgets could motivate employees in terms of empowering them and giving them responsibility and greater control over their expenditure. Involvement will also help to improve communication and greater understanding of each other's role within the business.</p>		

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	<p>Analysis of Table 3: Standard costing illustrates the value of budgeting and involving departments. The variance per carton of £0.08 equates to a £400 decrease in gross profit if the whole production run is taken into account. (5,000 x £0.08= £400). Regular meetings with relevant departments to discuss budgets would throw light on variances and possibly lead to improved performance and greater profit margins, eg in this case, the purchasing department (review suppliers of ingredients), product development (review recipes in light of rising costs), production (review wastage level).</p> <table border="1" data-bbox="389 647 1167 1166"> <thead> <tr> <th data-bbox="389 647 1050 683">Level 4</th> <th data-bbox="1050 647 1167 683"></th> </tr> </thead> <tbody> <tr> <td data-bbox="389 683 1050 786">Candidate demonstrates evaluative skills when discussing the implications of involving departments in setting financial budgets.</td> <td data-bbox="1050 683 1167 786">(9-13)</td> </tr> <tr> <th data-bbox="389 786 1050 821">Level 3</th> <th data-bbox="1050 786 1167 821"></th> </tr> <tr> <td data-bbox="389 821 1050 925">Candidate demonstrates analytical skills when discussing the implications of involving departments in setting financial budgets.</td> <td data-bbox="1050 821 1167 925">(6-8)</td> </tr> <tr> <th data-bbox="389 925 1050 960">Level 2</th> <th data-bbox="1050 925 1167 960"></th> </tr> <tr> <td data-bbox="389 960 1050 1064">Candidate demonstrates knowledge and understanding of setting financial budgets. No context required.</td> <td data-bbox="1050 960 1167 1064">(3-5)</td> </tr> <tr> <th data-bbox="389 1064 1050 1099">Level 1</th> <th data-bbox="1050 1064 1167 1099"></th> </tr> <tr> <td data-bbox="389 1099 1050 1166">Candidate offers only theoretical knowledge of setting financial budgets.</td> <td data-bbox="1050 1099 1167 1166">(1-2)</td> </tr> </tbody> </table>	Level 4		Candidate demonstrates evaluative skills when discussing the implications of involving departments in setting financial budgets.	(9-13)	Level 3		Candidate demonstrates analytical skills when discussing the implications of involving departments in setting financial budgets.	(6-8)	Level 2		Candidate demonstrates knowledge and understanding of setting financial budgets. No context required.	(3-5)	Level 1		Candidate offers only theoretical knowledge of setting financial budgets.	(1-2)	[13]	
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6	<p>Considering accounting <u>and other issues</u>, should ITSL accept the contract with JR Stores? Justify your view.</p> <p>Total Profit/Contribution Statement derived from Table 2.</p> <table border="1" data-bbox="389 373 1167 687"> <thead> <tr> <th></th> <th>£</th> <th>Calculations</th> </tr> </thead> <tbody> <tr> <td>Total Revenue</td> <td>26,400</td> <td>0.88 x 30,000</td> </tr> <tr> <td>Less</td> <td></td> <td></td> </tr> <tr> <td>Total Direct Materials</td> <td>13,200</td> <td>0.44 x 30,000</td> </tr> <tr> <td>Total Direct Labour</td> <td>6,300</td> <td>0.21 x 30,000</td> </tr> <tr> <td>Total Gross Profit/ Contribution</td> <td>6,900</td> <td>0.23 x 30,000</td> </tr> <tr> <td>Total Fixed Overheads</td> <td>6,000</td> <td>0.20 x 30,000</td> </tr> <tr> <td>Total Net Profit</td> <td>900</td> <td>0.03 x 30,000</td> </tr> </tbody> </table> <p>Knowledge/Summary Contract makes a positive contribution to overheads (£6,900) and a net profit margin of £900 or 3.4% $(900/26,400) \times 100$. Net profit margin is well below the average for the last year of 6% (see Table 1 = $131,603/526,720) \times 100$. Gross profit margin at 26.1% $(6,900/26,400) \times 100$ is well below the average for the last year of 55% (see Table 1 = $289,685/526,720) \times 100$.</p> <p>This is a new customer and could lead to larger contracts in the future. In a competitive market it guarantees business and uses up production capacity. The contract equates to 5% of last year's sales revenue $\{(26,400/526,720) \times 100\}$ What about ITSL's existing customers? How will they react if information about the average price of £0.88 is discovered? There is no guarantee that at the end of the contract JR Stores will re-new it. ITSL soups are being sold under JR</p>		£	Calculations	Total Revenue	26,400	0.88 x 30,000	Less			Total Direct Materials	13,200	0.44 x 30,000	Total Direct Labour	6,300	0.21 x 30,000	Total Gross Profit/ Contribution	6,900	0.23 x 30,000	Total Fixed Overheads	6,000	0.20 x 30,000	Total Net Profit	900	0.03 x 30,000		<p>A one sided argument <u>cannot</u> achieve a Level 4 mark.</p>
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	<p>Stores' own label and so ITSL could be replaced by another soup manufacturer.</p> <p>Although there is no reference to liquidity issues, the extension of credit terms to 60 days will impact on cash flow. However, there is implied concern, from the auditors, about some of ITSL's customers' credit worthiness and potential bad debts.</p> <p>On the other hand, Harry is concerned about increasing levels of competition.</p> <p>Should Harry seek to re-negotiate terms, eg price and/or credit and/or stocking the ITSL brand.</p> <table border="1" data-bbox="383 699 1178 1420"> <thead> <tr> <th data-bbox="383 699 1032 734">Level 4</th> <th data-bbox="1032 699 1178 734"></th> </tr> </thead> <tbody> <tr> <td data-bbox="383 734 1032 1042"> Candidate demonstrates evaluative skills when discussing the implications of the decision. Complex ideas have been expressed clearly and fluently using a style of writing appropriate to the complex subject matter. Sentences and paragraphs, consistently relevant, have been well structured, using appropriate technical terminology. There may be few, if any, errors of spelling, punctuation and grammar. </td> <td data-bbox="1032 734 1178 1042" style="text-align: center;">(13-18)</td> </tr> <tr> <th data-bbox="383 1042 1032 1077">Level 3</th> <th data-bbox="1032 1042 1178 1077"></th> </tr> <tr> <td data-bbox="383 1077 1032 1420"> Candidate demonstrates analytical skills when discussing decision in terms of outcomes and resource requirements. Relatively straightforward ideas have been expressed with some clarity and fluency. Arguments are generally relevant, though may stray from the point of the question. There will be some errors of spelling, punctuation and grammar, but these are unlikely to be intrusive or obscure meaning. </td> <td data-bbox="1032 1077 1178 1420" style="text-align: center;">(7-12)</td> </tr> </tbody> </table>	Level 4		Candidate demonstrates evaluative skills when discussing the implications of the decision. Complex ideas have been expressed clearly and fluently using a style of writing appropriate to the complex subject matter. Sentences and paragraphs, consistently relevant, have been well structured, using appropriate technical terminology. There may be few, if any, errors of spelling, punctuation and grammar.	(13-18)	Level 3		Candidate demonstrates analytical skills when discussing decision in terms of outcomes and resource requirements. Relatively straightforward ideas have been expressed with some clarity and fluency. Arguments are generally relevant, though may stray from the point of the question. There will be some errors of spelling, punctuation and grammar, but these are unlikely to be intrusive or obscure meaning.	(7-12)		
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		Level 2	(3-6)	[18]	
		Candidate demonstrates knowledge and understanding of issues. No context required. Some simple ideas have been expressed in an appropriate context. There are likely to be some errors of spelling, punctuation and grammar of which some may be noticeable and intrusive.			
		Level 1	(1-2)		
		Candidate offers only theoretical knowledge of issues in decision. Some simple ideas have been expressed. There will be some errors of spelling, punctuation and grammar, which will be noticeable and intrusive. Writing may also lack legibility.			
Total				[60]	

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