

Examiners' Report
June 2019

IAL Accounting WAC12 01

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Introduction

The paper saw a wide range of marks.

High marks were achieved by those candidates who had prepared well. Candidates who were unfamiliar with the topics and theory did not achieve such high marks.

Overall, the standard of answers was around average for this exam.

Question 1

This question tested familiar areas in cash budgets and profit and loss budgets but the marks were only reasonable.

Most candidates made a reasonable attempt at producing a cash budget in (a) and were very good with the format. Some of the detail in the calculations was not always correct.

It was good to see that the budgeted statement of profit or loss in (b) usually achieved at least average marks, because many of the calculations were correct.

Answers to (c) rarely achieved Level 3 status because many answers ignored the fact that the question was asking about budgets for a **new** business.

Frequent errors were:

- In (a), assuming sales started in month 1 instead of month 2 and therefore inserting sales receipts into month 1
- Incorrect calculation of commission for Florentia in (a)
- Omission of overdraft interest in (a) or incorrect calculation
- In (b), incorrect calculation of sales and/or purchases
- Including bank loan repayments in (b) instead of only the interest
- In (c), failure to address the question that stated the budget was for a **new** business

This response is typical of an average candidate.

1 (a) Prepare the cash budget, in columnar format, for each of the first three months of the business.

(22)

Workings

W1 sales = $(25+5) \times 6 \times 4 \times 12$
= £8640

W2 electricity
month 1 = $125 + 125$
= £250

W3 Commission:
- manures = $25 \times 12 \times 6 \times 4 =$
= £7200
- $7200 \times 35\%$
= £2520

- Nail accessories = $5 \times 12 \times 6 \times 4$
= £1440
 $1440 \times 50\%$
= £720

Total = $720 + 2520$
= 3240

Marina's Nail Parlour – Cash Budget

	Month 1	Month 2	Month 3
Cash inflow			
Sales (w1)	8,640	8,640	8,640
Cash	10,000		
Bank loan	10,000		
Total cash inflow	28,640	8,640	8,640
Cash outflow			
Loan repayment	165	165	165
Interest	75	75	75
Premises rent	840	840	840
Premises Alteration costs	7,375		
Redecoration Redecoration of premises	1,450		
Fixtures & Fittings	4,700		
Furniture	2,900		
Equipment	1,600		
Nail accessories Purchases	1,200	480	480
Electricity (w2)	250	125	125
Gas	-	-	210
Water	570		
^{commissions} Staff wages (w3)	3,240	3,240	3,240
Drawings	1,600	1,600	1,600
Total cash outflow	25,965	6,525	6,735

	Month 1	Month 2	Month 3
Depreciation:			
- Premises W4			
Net cash flow	2 675	2 115	1 905
Cash ^{flow} opening balance	0	2 675	4 790
Cashflow closing balance	2 675	4 790	6 695

(b) Prepare the budgeted Statement of Profit or Loss and Other Comprehensive Income for Marina's nail parlour for the **first year** of business.

(21)

Budgeted statement of profit or loss and other comprehensive income for first year of business

	£	£
Sales (8640 x 12)		103,680
<u>Cost of sales</u>		
purchases (1200 + (480 x 11))	6,480	
- closing inventory	(480)	(6,000)
		<u>97,680</u>
+ other income		720
<u>Less expenses</u>		
Loan repayment (165 x 12)	1,980	
Loan interest (75 x 12)	900	
Premises rental (840 x 12)	10,080	
Depreciation:		
Premises	295	
Fixtures and fittings	225 4,700	
furniture	290	
Equipment	320	
Premises redecoration	1,450	
Electricity bill (125 x 12)	1,500	
Gas bill (210 x 4)	840	
Water	570	
Staff commission (3240 x 12)	38,880	(57,340)
Budgeted profit for the year		<u><u>41,060</u></u>

(c) Evaluate the use of budgets for a new business.

(12)

Usage of budgets allows for the coordination of different departments of Marina's nail parlour where her employees for example, can inform her when there is a shortage of nail accessories, so they can restock. A budget also allows for the ^{continuous} evaluation of employees performance where ^{for example} budgeted ~~use~~ inventory of nail accessories is assessed against actual inventory of nail accessories, so ^{immediate} action can be taken in case of variance. This also gives ^{Marina and her employees} ~~owner~~ a sense of commitment, so this ~~is~~ is a form of responsibility accounting. It also allows for cost control, where variance in expenses is checked, in order for action to be taken to reduce ^{costs} ~~expenses~~. Budgets moreover help with price setting, so it makes sure price of services ensures all expenses are covered, to be able to make a profit. It also motivates employees, as they have a ^{set} goal to achieve, ensure work can be done more efficiently.

On the other hand, ~~if~~ all values are just estimates, ~~the~~ Marina cannot be 100% certain that sales would be constant throughout the year. Also if budget is set too high, the employees would find it difficult to achieve which causes demotivation, so lowers their efficiency. So if the budget is set too low, it may, due to desire of employees to keep Marina satisfied with their work, which is not useful for the business. Moreover, if there is a surplus, the employees may use up extra resources to ~~pre~~ prevent budget from being cut, hence is inefficient use of resources.

In conclusion, a budget gives a pathway to estimate profits, or losses for the year, so enables Marina to take corrective actions and help her in decision making, making a budget very useful.



The answer to (a) achieves 12 marks out of 22. Marks are lost in the following areas:

- There are no sales in month 1
- Purchases in months 2 and 3 should have been 720 but are given as 480
- Electricity in month 1 should have been 125 not 250
- Commission to Florentia is given as 3 240 per month but should have been 1 620
- Drawings are entered in month 1 but they do not start until month 2

The answer to (b) attains 10 marks out of 21. Marks are lost in the following areas:

- Sales are based on 12 months sales and not 11 therefore the figure is wrong
- No opening inventory is given
- The closing inventory is given as £480 not £1 200
- The loan repayment is included as an expense, but only interest should be included
- No overdraft interest is included
- Commission is based on 12 months sales not 11 months
- The total payments have no label

Section (c) is a Level 3 answer that receives 7 out of 12 marks. Although several valid points are made about advantages and disadvantages of budgets, no mention is made of the fact that these would be for a new business. The answer is a generic answer about budgets, rather than answering the question about a new business.

29 marks



Read the question carefully – this question states 'the business will be open for customers from the start of Month 2', so do not enter sales receipts for Month 1. The same point applies to section (c) – read the question carefully. The key word is a new business and this is overlooked.

Question 2

This question concerned accounting and investment ratios. There was a wide range of marks. Overall, the average mark was reasonable.

Calculations in (a) were completed successfully by some candidates, although others found them difficult.

Knowledge of Continuing Activities and Discontinued Activities is very limited, despite being on the Specification. Marks obtained for (b) were very low.

Most candidates had a reasonable knowledge of whether or not the ratios were healthy or weak but little development was given.

Frequent errors were:

- In (a), failure to learn formulas correctly, which meant calculations could never arrive at the correct answer
- Not giving answers to two decimal places, as requested by the question
- Failing to give any units or giving incorrect units to the answers in (a)
- Repeating calculations from (a) in the evaluation in (c) without analysing the reasons for, or the consequences of, these figures

This is an excellent response.

2 (a) Calculate, for the year ending 31 March 2019, giving your answers to two decimal places, the:

(i) gross profit as a percentage of revenue

(4)

$$\text{Gross Profit as a \% of revenue} = \frac{\text{Gross Profit}}{\text{Sales Revenue}} \times 100$$

$$\Rightarrow \text{Gross profit} = \text{Revenue} - \text{Cost of Sales}$$

$$= \frac{211\,000,000 - 157,000,000}{211\,000,000} \times 100$$

$$= \frac{54\,000,000}{211\,000,000} \times 100$$

$$= 25.59\%$$

(ii) net profit for the year after tax as a percentage of revenue

(3)

$$\text{Net profit after tax as a \% of revenue} = \frac{\text{Net profit for the year after tax}}{\text{Sales Revenue}} \times 100$$

$$= \frac{3812\,000 - 635\,000}{211\,000,000} \times 100$$

$$= \frac{3177\,000}{211\,000,000} \times 100$$

$$= 1.5\%$$

$$=$$

=

(iii) return on capital employed

(8)

$$\text{ROCE} = \frac{\text{net profit before tax and interest}}{\text{Capital employed}} \times 100$$

$$\textcircled{*} \text{ Net profit before tax} = \text{£}3\,812\,000$$

$$\textcircled{*} \text{ Net profit before interest} \Rightarrow$$

$$9\% \times 6000000 = \text{£}540,000 - \text{Interest on debenture}$$

$$11\% \times 10,000,000 = \text{£}1,100,000 - \text{Interest on bank loan.}$$

$$\textcircled{*} \text{ Net profit before interest} = 3812000 + 540,000 + 1,100,000 \\ = \text{£}5,452,000$$

$$\textcircled{*} \text{ Capital employed} =$$

$$\text{Ordinary share capital} = 48,000,000 \times 0.25 \\ = \text{£}12,000,000$$

$$\text{Share premium} = 48,000,000 \times 0.60 \\ = \text{£}28,800,000$$

$$\text{Preference shares} = \text{5 million } 5,000,000 \times 1.20 \\ = \text{£}6,000,000$$

$$\text{total of issued share capital} = \text{£}12,000,000 + \text{£}28,800,000 \\ = \text{£}40,800,000 + \text{£}6,000,000 = \text{£}46,800,000$$

$$\textcircled{*} \text{ ROCE} = \frac{5,452,000}{46,800,000 + 26,950,000 + 6,000,000 + 10,000,000} \times 100$$

$$= 0.0607 \times 100$$

$$= 6.07\%$$

(iv) earnings per ordinary share

(4)

$$\text{earnings per ordinary share} = \frac{\text{net profit available for ordinary shareholders}}{\text{total no. of ordinary shares}}$$

$$= \frac{3177000 - 420,000}{48,000,000}$$

$$= \frac{2757000}{48000,000}$$

$$= \frac{2757000}{48000,000}$$

$$= \frac{2757000}{48000,000}$$

$$= \text{£}0.0574$$

$$= 5.74 \text{ pence per share}$$

5.74

• Preference share dividends =

$$7\% \times 6,000,000$$

$$= 420,000$$

(v) price earnings ratio

(3)

$$\text{Price earnings ratio} = \frac{\text{market price of share}}{\text{earnings per ordinary share}}$$

$$= \frac{\text{£}1.44}{\text{£}0.0574}$$

$$= \frac{\text{£}1.44}{\text{£}0.0574}$$

$$= \frac{\text{£}1.44}{\text{£}0.0574}$$

$$= 25.09 \text{ times}$$

$$= \frac{\text{£}1.44}{\text{£}0.0574}$$

(vi) dividend per share

(4)

$$\text{dividend per share} = \frac{\text{total ordinary dividend}}{\text{no. of ordinary shares}}$$

$$= \frac{(0.008 \times 48,000,000) + 1,152,000}{48,000,000}$$

$$= \frac{384,000 + 1,152,000}{48,000,000}$$

$$= \frac{1,536,000}{48,000,000}$$

$$= 0.032$$

$$= 3.2 \text{ pence per share.}$$

$$\text{(vii) dividend cover} = \frac{\text{profit available for ordinary shareholders (3)}}{\text{total ordinary dividend}}$$

$$= \frac{2,757,000}{1,536,000}$$

$$= 1.794 \text{ times}$$

$$\text{(viii) dividend yield} = \frac{\text{dividend per share}}{\text{market price per share}} \times 100 \quad (3)$$

$$\begin{aligned} &= \frac{0.032}{1.44} \times 100 \\ &= 0.0222 \times 100 \\ &= \underline{\underline{2.22\%}} \end{aligned}$$

$$\text{(ix) gearing ratio} = \frac{\text{debt capital}}{\text{capital employed}} \times 100 \quad (5)$$

$$= \frac{6000,000 + 10,000,000}{46,800,000 + 26,950,000 + 6000,000 + 10,000,000} \times 100$$

$$= \frac{16000,000}{89,750,000} \times 100$$

$$= 0.17827 \times 100$$

$$= \underline{\underline{17.83\%}}$$

(c) Evaluate the financial performance and position of Highlands Fruit Trading plc, to determine if the company would be a good investment for the stockbroker's clients.

(12)

Ratios provide a framework for analysis of the financial performance of the company.

To determine, if the company would be a good investment for the stockbroker's clients, the profitability, liquidity and gearing position of Highlands Fruit Trading plc should be looked into.

Firstly, the gross profit as a % of revenue is at a fairly good position at 25.59% which gives a good scope for profitability. The revenue of Highlands Fruit Trading is also high at 21100,000. Investing in this company would generate further increased sales.

Moreover, the gearing ~~position~~ ratio is below the neutral position of 50%, at 17.83%, which proves that the business is less risky as it has a low gearing position.

Investors would mainly look into the earnings per share, the dividend per share, price per earnings ratio and the dividend yield.

The earnings per share is good at 5.74 pence per share which would boost the investors' confidence and they will be willing to invest as they ~~can~~ can expect high returns for their investment, since the earnings per share is really good.

The ROCE is good at 6.07% which would ~~motivate~~ motivate investors to invest as they can expect higher returns



The dividend per share is also high at 3.2 pence per share which would mean investors can expect to be paid higher dividends if they invest in the business. The price earnings ratio is also good at 25.09 times which shows that the investors can expect better returns for their ordinary shares held at the current market price.

However, the net profit as a % of revenue is quite low at 1.5%, which brings down the profitability of the business. The low net profit shows that Highlands Fruit Trading is facing increased expenditures during its trading period. This may lower the profit margins and thus investors may be paid less dividends on profit if they become shareholders.

Moreover, the company has a large amount of debt capital employed in the form of debentures and bank loans. This would mean more profits would be taken out to pay interests on these loans and thus further reducing profits for shareholders.

The dividend yield is not so high at 2.22%, which would mean dividends at current market share price could be limited.

In conclusion, the Highlands Fruit trading is a good company to invest in taking into consideration its profitability and gearing, and profitability can be improved in the future by reducing fixed costs.

(Total for Question 2 = 55 marks)

- In (a)(ii) the candidate has not rounded to two decimal places, or has rounded it wrongly. The correct answer is 1.51% – 2 marks out of 3
- In (a)(vii), the candidate has not expressed their answer to two decimal places, but uses three
- In (a)(ix), the candidate has omitted £6 million from the numerator above the line, and therefore loses a mark
- No answer is given for (b) so no marks are given
- The response to (c) is a top Level 3 answer
- The evaluation is very well structured – there is a good introduction, then both sides of the argument are considered in a clear and logical fashion, followed by an excellent conclusion

The conclusion summarises the arguments that have gone before and recommends a direction the business could take in the future, ie lower fixed costs.

However, some of the argument in the main body of the text is rather thin, only stating in words the figures previously calculated.

The reasons or consequences of these figures are not really developed. There is often mention of "higher" or "better" but the candidates does not say what the ratio is "higher" than. For example, dividends per share.

9 marks out of 12

43 marks



Read the question carefully and follow the instructions exactly.

If the question asks you to give your answer to two decimal places, do exactly that – not one or three decimal places.

- Structure the evaluation questions with an introduction
- Consider both sides of the argument
- Finish with a conclusion, which may include the main reason for your decision, or an action the business could take

Question 3

Question (Q) 03 was on a familiar topic, variance analysis.

However, there was a difference between the budget production volume and the actual production volume. Many candidates did not take this into account and compared the budget production of 2 400 pairs of shoes to the actual production of 2 280 pairs of shoes.

Candidates should have flexed the budget to compare a budget of 2 280 pairs of shoes with an actual production of 2 280 pairs of shoes. Candidates were led towards doing this by being asked in (a) the costs of producing 2 280 shoes.

Marks for (a) were disappointing because all that was required was to multiply the 2 400 budget figures by $\frac{2\,280}{2\,400}$ which is 95% of 2 400. Candidates appeared confused when attempting to calculate the budgeted costs of producing 2 280 units.

Candidates achieved quite well on (b) because formulas had been learnt well.

Marks awarded for (c) were reasonably good, although many candidates did little more than repeat in words the variance calculated as figures in (b).

This candidate's mark was above average for this question.

- 3 (a) Prepare the flexed budget to show the total material cost and the total labour cost of producing 2 280 pairs of shoes in May 2019.

(4)

Flexed budget

$$\begin{aligned} \text{Total material cost} &= \cancel{1520} \frac{1600}{2400} \times 2280 \times 120 + \cancel{\frac{1800}{2400} \times 2280 \times 14} \\ &= \pounds 182\,400 + \cancel{\pounds 23\,940} \end{aligned}$$

$$= \pounds 206\,340$$

$$\text{Total labour cost} = \frac{1800}{2400} \times 2280 \times 14 = \pounds 23\,940$$

- (b) Calculate, for May 2019, the following variances:

- (i) material usage

(4)

$$\begin{aligned} &= (\text{Actual usage} - \text{Standard usage}) \times \text{Standard material price per square metre} \\ &= (1440 - 1600) \times 120 \\ &= 19\,200 \text{ FAV} \end{aligned}$$

(iii) total material

(2)

$$\begin{aligned} &= \text{Actual material price} \times \text{Actual usage} - \text{Standard material price} \times \text{Standard usage} \\ &= 125 \times 1440 - 120 \times 1600 \\ &= 12000 \text{FAV} \end{aligned}$$

(v) labour rate

(4)

$$\begin{aligned} &= (\text{Actual labour rate} - \text{Standard labour rate}) \text{ per hour} \times \text{Actual hours} \\ &= (14.5 - 14) \times 1584 \\ &= 792 \text{ADV} \end{aligned}$$

(c) Evaluate the performance of Colombo Footwear Ltd for May 2019.

(6)

Support:

- The variance of material usage has 19200 FAV, which may mean the materials not be wasted, ~~or the material~~
- ~~Don't achieve the~~
- The variance of labour efficiency has 3024 FAV, which may mean the company may has some high skilled workers and they saved the time. and high efficiency
- The variance of total labour has 2232 FAV.

Against:

- The variance of material price has 7200 ADV, which may mean the price is higher than budget or there may would ~~be~~ some materials be wasted.
- The variance of labour rate has 792 ADV, which may mean the price is higher than budget or there one some low efficiency workers in the company.
- ~~The company don't achieve~~
- Don't achieve the budget to produce # 2400 productions, only produced 2280 pairs of shoes.

Conclusion = Colombo Footwear Ltd may ~~performance~~ has a good performance as the variance of total labour has 2232 FAV.

This candidate achieves a full 4 marks for (a). The working shows that the candidate tries to work out the cost of one unit for materials and labour and then multiply it by 2 280. 'Materials' is 1 600 square metres divided by 2 400 then multiplied by 2 280 to give the cost of actual production.

Unfortunately, in (b)(i), the candidate now compares actual usage of 1 440 square metres for 2 280 shoes with 1 600 square metres the budget for 2 400 shoes.

This only receives 2 out of 4 marks.

In (b)(ii) the candidate applies the formula correctly and the substitution into the formula is also correct.

The candidate achieves the full 4 marks.

In (b)(iv) the candidate wrongly uses 1 800 as the standard hours. 1 800 hours is the standard hours for producing 2 400 units. The standard hours of 1 710 should be used ($1\ 800 \times 2\ 280 / 2\ 400$). This receives 2 marks out of 4

In (b)(vi), the candidate decides not to add together the two labour variances calculated in (b)(iv) and (v).

If this had been done correctly, the candidate could have gained 2 out of 2 marks, using the own figure rule.

Unfortunately, the candidate now decides to compare the actual cost of 2 280 pairs of shoes with the budget cost of 2 400 shoes and receives zero marks.

The answer to (c) just reaches Level 3 and gains 5 out of 6 marks. All variances are described correctly as adverse or favourable and the own figure rule is applied. A correct reason for each variance is given.

Some extra reasons for variances are given but these are not all correct. The candidate mentions that the production target has not been met. The answer concludes that performance has been good because the total labour variance is favourable, although the candidate could have added total material variance favourable as well.

21 marks



Always compare the actual cost of production with the same level of budgeted production.

This may mean some calculations are needed to find the budget figures for this production level, if it is not the same as the original budget output level.

When evaluating the performance of the company by considering the variances, try to develop the answer rather than just stating what the variance figure was.

Points that could be included are the possible reasons for the variances and the consequences of the variance.

Question 4

This question was on the topic of company mergers and followed a familiar format except for part (a). This section asked for factors to be considered when agreeing values for assets and liabilities.

Candidates achieved quite well in part (a), because many were able to state a factor for each item.

Section (b) was a calculation of goodwill after revaluations but some found this a little difficult.

Extracts from the statement of financial position in (c) gave a mixed response. Candidates found part (i), the non-current assets reasonably straightforward, but found (ii) very difficult and received low marks.

The final section (d) was answered quite well because candidates were able to suggest reasons for the success or drawbacks of the merger.

This candidate achieved 24 marks out of 30, which indicates a very good response.

Calculations were strong but evaluation was weaker.

- 4 (a) State **one** factor that would be considered when deciding on the value to be agreed for each of the following. You should use a different factor for **each** asset or liability.

(5)

- Property, plant and equipment

The current market value

- Motor vehicles

~~the~~ the wear and tear on the machinery

- Other inventory

if inventory is obsolete or not.

- Trade receivables

amount of expected bad debts.

- Trade payables

~~the~~ the creditors payment period.

(b) Calculate the value of the goodwill paid by Autoflow plc for Pumping Gas plc.

(5)

Net assets =	341		147
	7		25
	1		34
	55		37
	8		5
	4		
	1		
	<u>18</u>		<u>187</u>
187 =	435	-	248

purchase price = Net assets + goodwill

$$200 = 187 + x$$

$$x = \text{£}13 \text{ million.}$$

(c) Prepare extracts from the Statement of Financial Position of Autoflow plc at 1 April 2019, showing the individual items and the total, of:

(i) non-current assets

(6)

Non-current assets	£	£
Property plant and equipment (341 + 190)	531	
Fixtures and fittings (7 + 3)	10	
Motor vehicles (1 + 1)	2	
goodwill (13 + 3)	18	561
total non current assets		561

(ii) equity.

(8)

$$\text{Pumping gas} = \frac{200}{1.25} = 160 \text{ shares.}$$

$$\text{ordinary shares } (160 \times 0.50) = 80$$

$$\text{share premium } (160 \times 0.75) = 120.$$

Roadride fuel =

$$\text{total assets} = 262$$

$$\text{purchase price} = 145 + 5$$

$$\text{total liabilities} = 117.$$

$$= 150.$$

$$\text{Net assets} = 145$$

$$\frac{150}{1.25} = 120 \text{ shares}$$

$$1.25$$

$$\text{ordinary shares} = 120 \times 0.50 = 60$$

$$\text{share premium } (120 \times 0.75) = 90$$

	£	£ -
<u>equity and liabilities</u>		
<u>equity</u>		
ordinary shares at 0.50 (60 + 80)	140	
share premium (90 + 120)	210	340
		<u>340</u>

Natalie is an investor, who held shares in Pumping Gas plc.

(d) Evaluate the merger from Natalie's point of view.

(6)

~~The merger would be beneficial for Natalie as she now receives a~~

The merger would not be beneficial for Natalie as she would now earn lower dividends. ~~Earlier~~ she would earn a dividend of 1.38 per share.

The merger would be beneficial for Natalie as she would now receive more shares in the bigger company which means she has more shares which are now entitled for dividend payments. The two firms may ~~merged firm~~ have merged as there was some kind of benefit which should increase the market price of the share making Natalie's share more valuable.

However, the merged company Autoflow is issuing a large number of shares which means Natalie would now own a smaller percentage of the company and may dilute the power of her shares. There would now be less dividend payment available for Natalie's shares reducing the return on investment.

In conclusion the Merger may not be beneficial for Natalie as dividend payment may fall.



In section (a) the candidate gained 4 out of 5 marks, with the first 4 points being correct.

Section (b) gained 4 out of 5 marks. The only error was the revaluation of the fuel. The own figure rule allowed all other marks to be attained.

Section (c)(i) gained a full 6 out of 6. The own figure rule applied for the good-will figure.

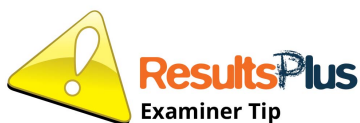
7 out of 8 marks were achieved for a good answer to (c)(ii). The only error was the final addition for the equity total.

The evaluation for section (d) was a Level 2 answer and received 3 marks.

The answer was vague and made references to dividends being larger or smaller but did not really give a valid reason for this.

Dividends paid would depend upon the profit levels of the company and the dividend policy pursued. Reference was made to the market price of the share rising "for some reason" but no reason was suggested. The conclusion was valid but the reason given was weak.

24 marks



When answering the evaluation section, there is a need not only to develop answers but also to use a logical reason.

For example, a simple statement that more shares must equal "more dividends" may not be true.

The level of profits made is an obvious factor that affects the size of the dividend.

Question 5

This question tested candidates' knowledge of project appraisal and was answered well.

Most candidates were able to calculate correctly the weighted average cost of capital in (a).

Only a few candidates made the mistake of thinking 'bigger is better' in (b) when selecting an option.

Explaining why the interest rate on a loan may be higher than a return on a share was generally answered quite poorly.

Section (d) required many calculations and there was a wide spread of marks attained for the calculation of net present value.

Evaluations in (e) were often quite good and it was pleasing to see that non-financial factors were usually considered as well.

This candidate achieves a total of 19 marks, which is above average for this question.

5 (a) Calculate the weighted average cost of capital for **Option B**.

(6)

<u>Option B</u>	<u>Interest rate / Expected return</u>
Debt (150,000 × $\frac{15}{100}$)	22,500
Bank loan (100,000 × $\frac{12}{100}$)	12,000
Redeemable preference shares (20,000 × $\frac{7}{100}$)	1,400
Ordinary Shares (50,000 × $\frac{8}{100}$)	<u>2,500</u>
Average cost of capital	±38,400

$$\begin{aligned} \therefore \text{Weighted Average Cost of Capital} &= \frac{38,400}{320,000} \times 100 \\ &= \underline{\underline{12\%}} \end{aligned}$$

(b) Identify which of the two options, A or B, would be the best to finance the project, giving a reason for your answer.

(2)

Option A would be the best to finance the project because the interest rate for Option A is less than Option B.

(c) Explain **two** reasons why the interest rate on a bank loan may be higher than the expected return of an ordinary shareholder.

(4)

1 The Company ~~might have~~ had borrowed more loan than issuing ordinary shares.

2 The ordinary shares issued are less than the money borrowed as bank loan.

(d) Calculate the net present value of the project at the end of Year 5.

(12)

$$\begin{aligned} \text{Inflow} &= \text{Number of staff} \times \text{hour rate} \times \text{number of hours} \times \\ &\quad \text{number of weeks} \times \text{number of robots} \\ &= 2 \times £8 \times 40 \times 50 \times 6 \\ &= \underline{\underline{£192,000}} \end{aligned}$$

	Cash Inflows	Cash Outflows	Net Cash Flows
Year 0	£192,000	£320,000	(320,000)
Year 1	£192,000	£35,200 + [800 × 6] + [£750 × 6] £29,400 = £56,500	135,500
Year 2	£192,000	£56,500	135,500
Year 3	£192,000	£58,630	133,370
Year 4	£192,000	£58,630	133,370
Year 5	£192,000	£60,973	<u>131,027</u>

	Net Cash Flow	Discount factor	Present Value
Year 0	(320,000)	1	(320,000)
Year 1	135,500	0.901	122,085.5
Year 2	135,500	0.812	110,026
Year 3	133,370	0.731	97,493.47 99,252.5
Year 4	133,370	0.659	87,890.83
Year 5	131,027	0.593	<u>77,699.011</u>
	Net Present Value		<u>175,194.811</u>

(e) Evaluate the robot project for the company, using the calculations made, and considering any other relevant factors.

(6)

The Net Present Value was £ 175,194-8.11 which was positive for Mega Media plc. Replacement of the staff to robots will reduce the overall labour cost for Mega Media plc for five years. On the other hand the robots will require maintenance and electricity costs. The staff will be made redundant. In conclusion, ~~the introduction of the robots~~ give the staff will be made redundant and after the introduction of robots who require external maintenance and electricity costs, Mega Media plc will therefore be receiving a positive response from this project.



It is good to see all workings shown for section (a) and that the candidate's calculation is correct.

The right choice of option is made in (b) and a good reason given. 'Bigger is better' does not always apply to accounting!

Part (c) receives no marks because this is not really a reason for the difference. It is also a way of stating the same reason in two different ways.

Section (d) receives 8 out of 12 marks. Labour cost savings of £192 000 are calculated correctly but electricity and maintenance are incorrect.

The candidate is not able to benefit from the own figure rule for electricity and maintenance because the increase is not 10%. However, they do benefit from the own figure rule in the table of calculations and achieve the full 6 out of 6 for the table.

The evaluation in (e) is a Level 2 answer and attains 3 marks.

Most of the answer has already been stated in the question eg staff will be made redundant.

The calculation is the candidate's own, and the own figure rule still applies to the evaluation section.

The candidate considers both sides of the argument and reaches a conclusion.

19 marks



Always show all workings – if only an answer is given and it is wrong, then the mark will be 0. Showing workings allows the own figure rule to be applied.

Try to avoid giving the same answer expressed in two different ways if the question is asking for two reasons.

If information that is stated in the question is given as part of an answer, it will not receive very high marks unless it is developed. For example just stating "staff will be made redundant" could be developed by stating "this may have a negative effect on the community with higher unemployment".

Question 6

This question tested knowledge of capital structure and the marks achieved were disappointing.

Most candidates were able to calculate correctly the number of bonus shares issued to Ali and Dev. Some candidates divided present shareholdings by 5 instead of multiplying.

Answers to (b) were often good, although some candidates did not add on the existing holdings.

In (c), many candidates were able to explain two reasons why a bonus issue may be made.

Answers to (d) were often disappointing, with little knowledge of how to journalise an issue of bonus shares.

The total amount paid in dividends in (e) was often incorrect. Many answers failed to add the original 80 000 shares to the 400 000 bonus issue.

There were very few correct answers to the Retained Earnings Account because errors and omissions were commonplace.

This candidate achieves an above average mark for this question.

6 (a) Calculate the number of bonus ordinary shares of £1 issued to:

(4)

- Ali

$$80,000 \times 26\% \div 5$$
$$= 4,160 \text{ (shares)}$$

- Dev.

$$80,000 \times 8\% \div 5$$
$$= 1,280 \text{ (shares)}$$

(b) Calculate the number of shares now held by shareholders not in the family after the bonus issue.

(4)

$$80,000 \times (1 - 26\% - 26\% - 10\% - 8\% - 6\%) \div 5 + 80,000 \times (1 - 26\% - 26\%$$
$$- 10\% - 8\% - 6\%)$$
$$= 38,400 + 19,200$$
$$= \underline{\underline{23,040 \text{ (shares)}}}$$

(c) Explain **two** reasons why a bonus issue of shares may be made by a company.

(4)

1 To make the company look stronger by increasing ordinary share capital.

2 The issue of bonus share may be used to replace the payment of dividend.

(d) Prepare the Journal entries for the issue of the bonus shares.
Dates and narratives must be shown.

(4)

Date	Dr	Cr
	£	£
2 Apr Share premium	12,000	
2 Apr General reserve	4,000	
	Ordinary share capital (£0,000 ÷ 5)	16,000
Issue of bonus shares		

An interim dividend of 0.6 pence (£0.006) per share was paid in October 2018.

At the end of the financial year 2018–2019, the company decided to pay a final dividend of 1.8 pence (£0.018) per share, to be paid on 28 March 2019.

(e) Calculate the total amount paid as dividends for the financial year 2018–2019.

(4)

$$\begin{aligned} & \cancel{86.00} (80,000 + 16,000) \times £0.006 + £0.018 \times (80,000 + 16,000) \\ & = £576 + £1,728 \\ & = \underline{\underline{£2,304}} \end{aligned}$$

Sunshine Stores Ltd proposed raising further capital to open another store. The company decided to issue 5% preference shares, but was not sure whether they should be redeemable preference shares or irredeemable preference shares. Ali prepared a summary of the two types of preference shares, which was to be discussed at the next board meeting.

(g) Evaluate, from the viewpoint of the company, whether Sunshine Stores Ltd should issue redeemable preference shares or irredeemable preference shares.

(6)

Sunshine Stores Ltd should issue redeemable preference shares since when they have a large excess of money, they can redeem the preference shares in order to reduce preferred dividend in the future. Redeemable preference shares is a secured liabilities, so if the company fail to operate, they can redeem shares in order not to pay dividends. Moreover, shares which can be redeemed can have a higher market price when ~~redem~~ redeem it.

Sunshine stores should ~~not~~ issue irredeemable preference shares since this can ~~im~~ increase share capital, which means that company looks stronger.

It also give investors confidence to buy shares if the share is not redeemable.



In (a), the candidate has divided by 5 instead of multiplying by 5, therefore no marks are given.

Part (b) gains 2 marks for the 19 200 calculation, but then divides by 5 again, losing the other 2 marks.

The two reasons given in (c) are correct but neither is developed to obtain a second mark.

The account entries are allowed in (d) and the own figure number of shares from (a) is £16 000. However, there is no narrative or date shown.

The own figure rule applies in (e) to shares issued in (a) and this answer is correct, to receive 4 marks.

Similarly, the own figure rule is applied in (f) as well. The answer uses the dividends paid in (e) and the Journal entry shown in (d) to calculate the Retained earnings balance.

The answer in (f) is a Level 2 answer receiving 3 marks.

The first part of the opening paragraph is acceptable, with a developed point made, although the rest of the paragraph is weak.

A point is made on the opposite side of the argument in the second paragraph. Unfortunately, there is no conclusion.

15 marks



Learn the basic theory - "bonus issue of five shares for every one held" means if you hold 10 shares you will receive another 50, not just another 2 shares.

This candidate has shown a good number of workings and can therefore benefit from the own figure rule.

The error made in (a) surfaces again in (d), (e) and (f) but the own figure rule means the figures can be marked correct.

Paper Summary

Based on their performance on this paper, candidates should:

- Read the question carefully, underlining key words and numbers. This is very important if there is a lot of information given after this key number or word, which may then be forgotten
- Follow instructions carefully eg give to two decimal places
- Learn all formulas eg for investment ratios and variances
- Show all workings
- In evaluations, try to develop points made eg by giving a possible cause or reason and also a possible effect or consequence
- When evaluating, do not forget application – try to see how the point being made applies to the scenario

Grade Boundaries

Grade boundaries for this, and all other papers, can be found on the website on this link:

<http://www.edexcel.com/iwantto/Pages/grade-boundaries.aspx>

