AQA
Realising potential

A-LEVEL ACCOUNTING

A-level (7127)

EXAMPLE RESPONSES

Marked responses

7127 Paper 1 7127/1: 14.2 and 15.3

See responses to 6-mark questions to show how different levels are achieved and understand how to interpret the mark scheme.

Version 1.0 October 2017

Contents

Please note that these responses have been reproduced exactly as they were written and have not been subject to the usual standardisation process.

Specimen paper 1, question 14.2

Question

HQV plc provided the following information on 30 June 2016.

Statement of financial position at 30 June

	2016 £000 Cost/ Valuation	2016 £000 Accumulated Depreciation	2016 £000 Net book value	2015 £000 Cost	2015 £000 Accumulated Depreciation	2015 £000 Net book value
Assets						
Non-current assets						
Property, plant and equipment	21 450	4 845	16 605	14 884	4 113	10 771
Current assets						
Inventories		779			805	
Trade and other receivables		311			214	
Cash and cash equivalents					87	
			1 090			1 106
Total assets			17 695			11 877
Equity						
Ordinary share of 50p each			6 300			4 200
Share premium			2 170			1 120
Revaluation reserve			1 830			
Retained earnings			4 332			3 712
Total equity			14 632			9 032
Non-current liabilities						
8% Debentures (2024)			2 100			1 750
Current liabilities						
Trade and other payables		345			652	
Tax liabilities		557			443	
Cash and cash equivalents		61				
			963			1 095
Total equity and liabilities			17 695			11 877

Additional information

During the year ended 30 June 2016

(1) Additional plant was purchased, cost £6 600 000.
(2) Equipment was sold for £830 000. This had been depreciated by £485 000.
(3) Property was revalued.
(4) There were no other disposals or purchases of non-current assets
(5) Taxation paid totalled £398 000
(6) Dividends paid totalled £1 334 000

The income statement for the year ended 30 June 2016 included:

- Depreciation charges of £1 217 000

- Finance charges of £402 000

- A provision for taxation of £512 000.

One of the company's directors has expressed concern at the company's liquidity at 30 June 2016 compared to 30 June 2015. The company's accountant has provided the following information.

	At 30 June 2016	**At 30 June 2015**	**Industry average**
Current ratio	1.13:1	1.01:1	0.95:1
Liquid capital ratio	0.32:1	0.27:1	0.42:1

Assess the liquidity of HQV plc and the extent to which you agree with the director's concerns.

[6 marks]

Mark scheme

AO2 – 2 marks, AO3 – 4 marks

Level	Marks	Description
3	5–6	Judgements are fully supported by a wide range of evidence. A clear and balanced analysis of data/information/issues is provided, showing a logical chain of reasoning.
2	3–4	Judgements are partially supported by evidence. A reasoned, but unbalanced, analysis of data/information/issues is provided; starts to develop a chain of reasoning. Comprehensive and relevant knowledge and understanding of principles/concepts/techniques has been applied to the context.
1	1–2	Judgements may be asserted but are unsupported by evidence. An analysis of discrete points of data/information/issues provided; no chain of reasoning is attempted. Limited but relevant knowledge and understanding of principles/concepts/techniques has been applied to the context.
0	0	Nothing written worthy of credit.

Answers may include:

- In agreement with the director's concerns:
  - Current ratio: although the current ratio has increased, it was already higher than the industry average. The implication is that the company has tied up resources unnecessarily.
  - Liquid capital ratio: although the ratio has improved it is still below the industry average, so the company may still have difficulties in meeting its short-term obligations.
  - The statement of cash flows shows a net outflow of cash and cash equivalents of £148 000

- Disagreeing with the director's concerns:
  - Current ratio: has increased since 30 June 2015 which would mean the company will find it easier to meet its medium to long-term obligations.
  - Liquid capital ratio: has increased since 30 June 2015 and has moved nearer to the industry average, so the company will find it easier to meet its short-term obligations.

General points

The industry average has been used as the basis of the judgement, it is possible that special factors affecting HQV plc may mean that the industry average may not be an entirely appropriate benchmark to use.

The industry average ratios may be distorted by one or two atypical businesses.

The indicative content is not exhaustive; other creditworthy material should be awarded marks as appropriate.

Student responses

Student response 1

The current ratio has increased from 1.01:1 in 2015 to 1.13:1 in 2016. This means HQV plc has more short term asset to pay short term liabilities. The industry average is only 0.95:1 which suggests they have more cover than the industry so they have lower risk.

However, the liquid capital ratio shows there is a higher risk of not being able to pay the short-term liabilities if they were pressed for payment. The liquid capital ratio does not include inventory which is slow to convert back into cash. The industry average is 0.42:1 but HQV is only 0.32:1 which means they have less liquidity (almost 25% less liquidity). The director is correct to be concerned as this could have serious implications for the company. However, the ratio has improved by 0.05:1 since 2015 so it is getting better.

This is a level 2 response.

Answer contains partially supported judgement. Only the ratios in question have been considered, other evidence has not been included. Demonstrates a clear level of knowledge and understanding which has been applied to the context.

Student response 2

The directors should be concerned as HQV plc has got a large overdraft of £61,000 which is repayable on demand and a massive tax bill of £557,000 to be paid next year. Trade receivables are taking longer to pay (increased by £97,000) whereas trade payables are being paid faster (£307,000). This is all bad for liquidity.

The best ratio to use to check the liquidity is the liquid capital ratio as this removes inventory which cannot be turned into cash quickly (fallen by £26,000). HQV only has £0.32 of quick assets to pay every £1 of current liabilities. This means they do not have enough available to pay if the businesses they owe money to want their money back quickly. The industry average is also low but is £0.42 to pay every £1, so £0.10 better. HQV needs to raise more capital to address this problem.

This is a level 2 response.

Answer contains partially supported judgement. Only considers one of the ratios but does bring other evidence into the answer. Demonstrates knowledge and understanding which has been applied to the context.

Student response 3

For HQV plc the current assets and current liabilities almost match and for both years are greater than 1 which means they have enough current assets to pay the current liabilities. The industry average is less than 1 so HQV is in a better position but we do not know how similar HQV is to the average company in this sector. It could be that HQV needs to be above 1 whereas the other firms can operate below 1. The fact the ratio is increasing suggests it is improving, as more cover is less risk of not being able to pay their debts. The ratio is not too high, say above 4, which would indicate they have too much current assets and are wasting resources as a result.

The acid test paints a different picture though. The ratio is only 0.32:1 (up from 0.27:1) which indicates they have serious liquidity problems as they do not have sufficient quick assets to pay to pay their debts. However, the industry average is only 0.42:1 which is better but still low. Perhaps in this industry it is acceptable to be this low and so does not indicate too much of a problem. HQV has just raised more shares and more debentures which shows investors are not worried so perhaps they are able to run their business with a lower ratio.

Overall, I do not think the directors should be too worried as the ratios are very similar to the industry average and are getting better. HQV has been investing in new assets which is good as this means profits and cash flow will get better in the future.

This is a level 3 response.

Answer contains fully supported judgement. Considers both ratios and does bring other evidence into the answer (albeit rather limited). Demonstrates knowledge and understanding which has been applied to the context.

Student response 4

Liquidity is concerned with cash and the ability to turn assets into cash quickly. A business that has liquidity problems will find it difficult to operate and may go into bankruptcy if they are unable to raise additional funds.

HQV has low liquidity and the directors are quite correct to be concerned about this. The current ratio is better for HQV compared to the industry average but we do not know if they are all using the same accounting policies so it may be difficult to compare. It is improving slightly for HQV because for both ratios 2016 is higher than 2015. For the current ratio, it has £0.12 more current assets to pay £1 of current liability, and for the liquid capital ratio it has £0.05 more quick asset to pay £1 of current liability. In addition, they are paying their suppliers faster so they may be taking advantage of cash discounts which will improve profitability.

To conclude the directors should be concerned because cash flow is always important but it does seem to be improving. They are below the industry average for the liquid capital ratio so they need to be monitoring this.

This is a level 2 response.

Answer contains partially supported judgement. Considers both ratios and does mention other evidence. Demonstrates knowledge and understanding which has been applied to the context.

Specimen paper 1, question 15.3

Question

Serena owns a retail clothes business called 'Looking Sharp' which was opened on 1 January 2014. Serena does not keep proper books of account.

The following information is available for the year ended 31 December 2015.

	1 January 2015	31 December 2015
	£	£
Inventory	18 940	14 720
Other payables: rent of shop premises		950
Other receivables: rent of shop premises	830	
Shop fittings and equipment at book value	32 400	29 600
Trade payables	14 730	16 390

Serena is able to provide the following additional information for the year ended 31 December 2015.

(1) Summary of bank statements for year ended 31 December 2015

	Debit	Credit	Balance
	£	£	£
Balance			2 300
Cash takings banked		228 730	231 030
Payments to trade payables	178 300		52 730
Drawings	21 340		31 390
Sale of shop fittings		390	32 780
Rent of shop premises	14 350		17 430
General expenses	9 470		7 960

(2) At 31 December 2015 there are unpresented cheques for payments to trade suppliers totalling £2330 and amounts for cash takings not yet credited of £1960.
(3) Serena remembers that she took some goods for her own use during the year, but she is unsure of the value of these goods.
(4) All purchases are made on credit; all sales are on a cash basis.
(5) The shop fittings sold during the year had a net book value of £750 at 1 January 2015.
(6) Serena's policy is to have a mark-up on all goods sold of 25%.

Serena has told her accountant that she is disappointed by the business's performance. Her accountant has looked at the business's results for the year ended 31 December 2015 and has highlighted the fact that revenue has fallen by 10% and the rate of inventory turnover has also worsened by 20 days.

Assess the actions that Serena could take to overcome the weaknesses highlighted by the accountant.

[6 marks]

Mark scheme

AO2 – 2 marks, AO3 – 4 marks

Level	Marks	Description
3	5–6	Judgements are fully supported by a wide range of evidence. A clear and balanced analysis of data/information/issues is provided, showing a logical chain of reasoning.
2	3–4	Judgements are partially supported by evidence. A reasoned, but unbalanced, analysis of data/information/issues is provided; starts to develop a chain of reasoning. Comprehensive and relevant knowledge and understanding of principles/ concepts/techniques has been applied to the context.
1	1–2	Judgements may be asserted but are unsupported by evidence. An analysis of discrete points of data/information/issues provided; no chain of reasoning is attempted. Limited but relevant knowledge and understanding of principles/concepts/ techniques has been applied to the context.
0	0	Nothing written worthy of credit.

Answers may include:

Actions to improve revenue – Serena could consider:

- increasing mark-up but must consider effect on demand of increasing prices
- increased or more effective marketing, but must consider impact on profits of increase budget for marketing
- reducing the selling price to encourage more sales – this will increase revenue if percentage increased volume is greater than percentage reduction in selling price. This would also improve inventory turnover
- offering credit to customers to encourage increased sales, however this could increase the costs of the business in terms of administration and possible bad debts. It would also affect the cash flows.

Actions to improve rate of inventory turnover – Serena could consider:

- reducing her average inventory – this may restrict what is on offer to customers and may reduce demand
- finding cheaper supplies to reduce the cost of sales, perhaps negotiating larger trade discounts – but she will need to avoid compromising the quality of what is on offer to avoid deterring customers
- reducing the selling price to encourage more sales. However this may affect the profitability of the business.

The indicative content is not exhaustive; other creditworthy material should be awarded marks as appropriate.

Student responses

Student response 5

Serena's accountant has told her sales revenue is down by 10% and inventory turnover has slowed by 20 days, this means she is selling fewer clothes and therefore holding more inventory. She needs to sell more units. To do this she needs to reduce her prices to encourage more demand. This will work if her customers respond favourably to lower prices, e.g. if a 20% price reduction results in 50% more units being sold. This will improve profits and cash flow, and mean lower closing inventory which will mean inventory turnover is faster provided she does not purchase too much to replace the items sold. However, if her customers want exclusive clothes then price may not be the answer, e.g. lowering price will not increase sales.

In this case, she needs to look at her range of clothes and identify which are not selling or are out of fashion. She needs to change her range to something customers want. The old range should either be put into a sale at very low prices (bad for profit but good for cash flow and inventory turnover) or given to a charity shop to dispose of (bad for profit and cash flow but good for inventory turnover).

This is a level 3 response.

The judgement is fully supported for the revenue aspect but not for the inventory turnover. There is a clear chain of reasoning, and knowledge and understanding have been applied to the context.

Student response 6

Inventory turnover is (Average Inventory x 365)/Cost of Sales. As closing inventory is smaller than opening inventory, then average inventory must be smaller this year than the previous year. So, for inventory turnover to be worse, i.e. slower, then cost of sales must also be much smaller than the previous year.

((18940 + 14720)/2 x 365)/184552 = 33.3 days

If this is 20 days slower than the previous year then her inventory turnover in the previous year must have been 13.3 days. I don't think she needs to worry too much because 33.3 days for a clothes shop is probably not too bad although I would want to compare to her competitors to be certain. If her cost of sales is falling then she is either buying cheaper supplies, hence her closing inventory is falling even though it is taking her longer to sell it. Or, she is just selling less and we are told revenue is down 10%.

Maybe she is selling a larger quantity of cheaper clothes at lower prices, but they do not sell as fast as her normal clothes. To improve the inventory turnover she either needs to reduce her average inventory, perhaps stock a smaller range of clothes, or find a cheaper supplier. Shoppers like to have choice so I think she needs to find a cheaper supplier, perhaps China. If she can find a cheaper supplier she can lower her prices and so increase revenue because shoppers like lower prices and more choice. If she does buy from China she may need to buy in bulk because of the lead times but this will increase her inventory and the turnover will not improve. She may get a bulk discount though which will help her lower her prices.

This is a level 2 response.

The judgement is partially supported for both elements. There is a clear chain of reasoning, and knowledge and understanding have been applied to the context. The answer makes an interesting observation at the start but the logic is slightly floored given the age of the business.

Student response 7

The quicker your inventory turnover the more profit you make and the sooner you turn inventory back into cash which is good for the business. To improve her inventory turnover Serena needs to hold less inventory. I think she needs to use JIT (just in time) because then you don't hold any inventory which would be good. But JIT has problems she needs to trust her suppliers to deliver whenever she needs more inventory to fill her shop.

To increase he revenue she either needs to sell more clothes at the same price, or sell the same quantity at a higher price (revenue = quantity x price). As this is a relatively new business perhaps Serena is concerned that increasing her prices will turn customers away. To sell more clothes she needs more customers so I think she needs to promote her business with advertising. This will increase her expenses so she has to be careful not to spend too much or revenue will increase but profit will fall.

This is a level 3 response.

The judgement is fully supported for both aspects although more so for the revenue issue. There is a clear chain of reasoning, and knowledge and understanding have been applied to the context.

Student response 8

Serena has only recently started her business so she does not have much information to compare to in order to identify trends in her ratios, i.e. only trading for two years. When she launched her shop it would have been new and so would have attracted potential customers easily. To keep her footfall high she needs to continue to have events to attract new customers to her shop. Regular sales events are popular with customers and are a good way of clearing slow selling items out of the business. I would suggest she holds a sale event every few months. This will increase revenue.

The sale events would also mean less inventory will be held provided she does not buy too much to replace what she has sold. In clothes retailing you need to be aware of fashion trends so Serena should only buy what is currently in fashion but not in large quantities or she may be left with old fashions that make her inventory turnover even slower.

This is a level 1 response.

Answer contains weak/partially supported judgement. Limited knowledge and understanding have been applied to the context. Considering the impact on profit of holding regular sale events would have been beneficial.

Get help and support

Visit our website for information, guidance, support and resources at aqa.org.uk/7127

You can talk directly to the accounting subject team

E: business-studies@aqa.org.uk

T: 01483 477 863