The Chartered **Governance** Institute

ICSA Qualifying Programme

Interpreting Financial and Accounting Information

Sample mark scheme 2019

Section A

<table>
<tr><th>Question number</th><th>Answer</th><th>Mark</th></tr>
<tr><td>1</td><td>D - Prudence</td><td></td></tr>
<tr><td colspan="2" align="right">Total</td><td>(1)</td></tr>
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<table>
<tr><th>Question number</th><th>Answer</th><th>Mark</th></tr>
<tr><td>2</td><td>Award 1 mark for each definition of any three of the following:

Assets - An asset is a present economic resource (a right that has the potential to produce economic benefits) controlled by the entity as a result of past events. (1)
Liabilities - A liability is a present obligation or duty of responsibility to transfer an economic benefit as a result of past events that the entity has no practical ability to avoid. (1)
Equity(accept Shareholders’ Equity) - This is the 'residual interest' in the assets of the entity after deducting all its liabilities. It represents what is left when the entity is wound up, all the assets are sold, and all the outstanding liabilities are paid. (1)
Income (accept Revenue) - Income is increases in assets or decreases in liabilities that result in increases in equity, other than those relating to contributions from holders of equity claims. (1)
Expenses - Expenses are decreases in assets or increases in liabilities that result in decreases in equity, other than those relating to distributions to holders of equity claims. (1) (Do not accept Expenditure or Costs.)

Reward other valid responses.</td><td></td></tr>
<tr><td colspan="2" align="right">Total</td><td>(3)</td></tr>
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<table>
<tr><th>Question number</th><th>Answer</th><th>Mark</th></tr>
<tr><td>3</td><td>Award 1 mark for identifying and 1 mark for defining any two of the following:

Philanthropic (accept “what is desired”) (1) - this is discretionary, but still important behaviour to improve the lives of others. It includes charitable donations in areas such as the arts, education, housing, health, social welfare, non-profit organisations, communities and the environment. (1)
Ethical (accept “what is right”) (1) - this relates to acting morally and ethically in issues such as treatment of employees and suppliers. (1)
Legal (accept “compliance”) (1) - this is the obedience of laws and regulations in the society, such as competition, employment, and health and safety laws. (1)
Economic (accept “profit”) (1) - this is the responsibility of business to be profitable, to survive and to benefit society in the long term. For society to thrive, profitable businesses must be developed to create income, provide jobs, tax revenue and philanthropy for society. (1)

Reward other valid responses.</td><td></td></tr>
<tr><td colspan="2" align="right">Total</td><td>(4)</td></tr>
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Question number	Answer	Mark
4	True	
	Total	**(1)**

Question number	Answer	Mark
5	**Award 1 mark for identifying each of the following four main factors:** • The balance between liquidity and profitability. (1) • Efficiency of management. (1) • Terms of trade. (1) • The nature of the industry. (1) **An alternative response would be identifying the main components of the cycle. Award 1 mark for identifying each of the following:** • Level of cash balances held. (1) • Length of inventory holding period. (1) • Length of payables payment period. (1) • Length of receivables collection period. (1) **Reward other valid responses.**	
	Total	**(4)**

Question number	Answer	Mark
6	**Award up to 6 marks from the following:** Investors are rational and possess full knowledge about the market. (1) Investors expect greater returns for taking greater risks. (1) It is possible for an investor to diversify the unsystematic risk by actively managing the portfolio. (1) Borrowing and lending rates are equal. (1) Thereare no transaction costs.(1) Markets are perfect and market imperfections tend to correct themselves in the long run. (1) The Risk-Free Rate (RFR) is the same as the returns on the government bonds. (1) There is no taxation and inflation. (1) **Reward other valid responses.**	
	Total	**(6)**

Question number	Answer	Mark
7	**Award up to 3 marks for explaining 'Substance':** 'Substance of transactions' refers to the economic benefits or economic losses or any kind of economic implications related to the transaction.(1) The accounting concept popularly termed as 'substance over form', emphasises a/the major consequence of accounting for the "substance" of transactions (1).It means the transactions recorded in the financial statements must reflect their economic substance rather than their legal form. (1) **Award up to 3 marks for examples, from any three of the following:** **Sale and leaseback arrangements**(IFRS 16) whereby a company sells an asset (e.g. a property) to another party and gets it back via a lease. The substance of the transaction could be a sale of an asset, but it might not be a genuine sale if all the risks and rewards of ownership substantially remain with the lessee. (1) **Consignment stock** whereby the consignor (seller) ships goods to the consignee (buyer), but the substance of the transaction is that the consignor still owns the stock until it is used, sold or distributed by the consignee. (1) **Debt factoring or invoice factoring**, a type of debtor finance in which a business sells its trade receivables to a third party (called a factor) at a discount in exchange for the rights to cash collected from those receivables. The substance of the transaction will depend if all the risks and rewards of the debt have been transferred. (1) **Sale and repurchase arrangements**: a kind of loan arrangement whereby the sale of an asset takes place between two parties with a view to subsequently repurchase the same asset at a higher price. Whether this is a loan of an asset, or an outright sale of an asset, will depend on the substance of the transaction. (1) **Reward other valid responses.**	
	Total	**(6)**

Section B

Question number	Answer
8 (a) 8 marks	Answers should select 8 relevant ratios.1 mark is available for each ratio. It is important to ensure that the ratios selected provide coverage of both performance and financial position to allow the report to address analysis of both. The major ratios that could be calculated are:

	All workings in £000	Forecast 2019	Actual 2018
Profitability ratios:1 mark for ROCE, and 2 marks for any two profit percentages			
1	Return on capital employed = (PBT/(Debt + Equity)) x 100	(185)/ (350+285) x 100 = 29.1%	(50/ (350+130) x 100 = 10.4%
2	Gross profit percentage = (GP/Revenue x 100)	(400/1,020)x100 =39.2%	(280/800) x100 =35.0%
3	Operating profit percentage = (profit before finance costs/Revenue x 100)	(210/1,020) x100 =20.6%	(70/800) x100 =8.8%
4	Net profit percentage= (profit before taxation/Revenue x 100)	(185/1,020) x100 =18.1%	(50/800) x100 =6.3%
Liquidity or solvency ratios: 1 mark for any one liquidity ratio			
5	Current ratio = current assets/current liabilities	320/83 = 3.9:1	180/102 = 1.8:1
6	Quick ratio = (current assets - inventory)/current liabilities	(320-30)/83 = 3.5:1	(180-40)/102 = 1.4:1
Gearing or debt ratios:2 marks for any two gearing ratios			
7	Interest cover = (profit before finance costs/Finance costs)	210/25=8.4 times	70/20=3.5 times
8	Average cost of borrowing = Finance costs/Interest bearing borrowings	25/(350+50)x100 = 6.3%	20/(350+40) x100 =5.1%
9	Gearing = (Debt/(Debt + Equity)) x 100	(350)/(350+ 285)x100=55.1%	(350)/(350+130) x100= 72.9%
Efficiency ratios:2 marks for any two efficiency ratios			
10	Inventory days = (Inventories/Cost of salesx365)	(30/620) x365 =18 days	(40/520) x365=28 days
11	Receivables days = (Receivables/Revenuex365)	(290/1,020) x365 =104 days	(140/800) x365=64 days
12	Payables days = Payables/Cost of sales x 365	(23/620) x 365 = 14 days	(50/520) x365 = 35 days

Marking note: If candidates choose to include bank overdraft as part of the calculations, this will not be penalised.

Question number	Indicative content
8 (b) 17 marks	Answers need to use the above ratios in order to analyse the actual and forecast financial performance and position of Groceries. **Answers could include the following content:** **Profitability** • Returnon capital employed (ROCE) was 10.4% in 2018 and is forecast to increase to 29.1% in 2019, and this forecast increase in profitability is a strong feature of the numbers for Groceries. • Groceries managed to achieve a gross profit margin of 35% and the directors are anticipating an increase in the gross profit margin to 39.2%. • Reason: This could be due to better margins having been negotiated in the contract with the supermarket for the own-brand products or as a result of greater economies of scale in purchasing or indeed greater efficiency in the production process now that the staff are fully trained and presumably working at full efficiency. • The operating profit margin was 8.8% in 2018, however this was after charging professional fees and training costs, which would not be expected to recur in such significant amounts from 2019 onwards. • The directors are still anticipating that the operating profit margin will increase to 20.6% in 2019. This should be a truer reflection of the company's underlying profitability, although the cash rich client will be sensitive to the assumptions behind the forecast information provided. **Liquidity and gearing** • The overall working capital position of Groceries is seen as improving, with the current ratio forecast to increase from 1.8 to 3.9. Given the good trading position forecast by Groceries, this is a result of the increase in receivables and decrease in payables. • However, the key issue with respect to the financial position of Groceries is not profitability, but its lack of cash, high level of gearing and its working capital position. • Reason: the impact that these issues might have on further expansion plans. • The average interest rate for 2018 was 5.1% based upon the overdraft at the year end and is forecast to rise to 6.3% based on existing borrowings. • It is possible that during 2018 the overdraft was not used until later in the year meaning that the interest charge was relatively small, whilst in 2019 the directors are anticipating that the overdraft will be used nearly to its full capacity for the year. • In addition, it is possible that the bank has increased the interest rate charged on the overdraft as a result of its own assessment of increased risk. • At the end of 2019 Groceries has an overdraft of £50,000, although a facility of £75,000. Given the fact that Groceries is still in its start-up phase this level of overdraft should perhaps be expected. • A detailed cash forecast would be required if the directors decide to pursue expansion as it is likely that the working capital requirement would increase, certainly in the short term. The cash rich client would certainly expect to see such information. • The overdraft facility is to be reviewed by the bank in April 2020 and there is always the possibility that they could recall the debt, which would leave Groceries in a precarious financial position. • As at 31 December 2018 the gearing level for Groceries was 72.9% but is forecast to fall to 55.1% at the end of 2019. • Reason: although debt is broadly unchanged,profit for the year is expected to grow from

£30k to £155k, more than doubling the equity, and the director's decision not to pay any dividends in either 2018 or 2019 will maintain that growth.

- This is still a high level of gearing which, coupled with the lack of track record and the fact that Groceries is a new entity, could mean that it would be unlikely that Groceries could raise more debt finance to fund expansion plans even using new property etc as security.
- It is likely therefore that the only option available to the directors of Groceries to expand the business at the current time would be to raise more equity finance, and the cash rich client will be aware of this.

Efficiency

- The forecast inventories levels are not expected to increase despite more than a 25% expected growth in revenue in 2019. This is probably due to the nature of the items as Groceries are likely to hold mainly work-in-progress and low levels of finished goods as these have a limited shelf life. In fact, the inventories days are forecast to reduce from 28 days to just 18 days.
- Reason: this could be the result of the investment in training making the production process more efficient and/or meeting the requirements of the supermarkets who hold the own brand products themselves.
- Receivables are forecast to almost double what they are at the end of 2018, with receivables days increasing from 64 to 104 days.
- Reason: This could be due to the new contracts with supermarkets that may be able to demand extended credit terms from Groceries. This is definitely a concern for a relatively new entity, especially one which will be purchasing fresh goods on a regular basis.
- Payables are forecast to reduce from 35 to 14 days.
- Reason: Groceries has been paying its creditors very quickly, maybe as a response to concerns of suppliers, or as part of an overall approach of better prices but in return for quicker payment. The concern is the huge gap between this payables days and the Receivable Days and the strain that could put on the liquidity of groceries.

The cash rich client may be concerned about limitations on the conclusions that can be drawn from the ratio analysis performed on the financial information of Groceries:

- The entity is new and therefore limited information is available in order to establish any trends.
- Using forecast figures has less reliability as the information is based on the assumptions of the directors.
- We are unaware of what these assumptions are and so our conclusions are limited.

The success of the business in the future could be dependent on how long Groceries can utilise the technology exclusively, however information on its protection is not found in the financial information although the patented technology remains an important asset.

The directors are likely to be open to discussion with the cash-rich client given that they are open to offering shares in return for a capital injection. Therefore:

- The investor would be seeking clarification on how Groceries has protected the intellectual property surrounding the technology i.e. the nature and extent of the patent, especially since this appears to be affording Groceries a competitive advantage at present.
- Detailed information on the supermarket contracts would also be invaluable in assessing how realistic the forecasts are for the coming year, and whether it is a model that could be extended to other supermarkets to increase their market share.
- Given there is no plan for further capital investment it would be important to confirm what capacity exists for further expansion on the current capital base, as future expansion would require additional finance.
- It would also be essential that the cash-rich client discuss with the directors of Groceries

	the level of finance being sought and the shareholding they would be looking to offer in return, to allow the negotiations to commence. It is quite possible that candidates may refer to the marketplace and/or competitors for Groceries and the dilution of control from the two directors/existing shareholders if another (substantial) equity shareholder is brought into the company.

Level	Mark	Descriptor
	0	No rewardable material.
Level 1 (Fail)	1-8	Knowledge • There is limited understanding of what the ratios indicate about company performance, and what might influence these e.g. they mention and calculate a ratio but cannot describe what about a business it might show. Comprehension • The answer demonstrates limited understanding of the factors that underpin company performance. This is communicated in a simple way with simple or generalised comments. • Points made are superficial and not directly linked to the scenario in the question. Analysis/evaluation • There is little application of relevant knowledge and understanding which may be supported by an evaluative statement. • The answer includes limited critical analysis of the factors that underpin company performance. • Any analysis is not used to make a judgement and is not supported by evidence.
Level 2 (Pass)	9-11	Knowledge • There is some understanding of what the ratios indicate about company performance, and what might influence these e.g. they mention and calculate a ratio and describe what it could show about a business but find it hard to outline a plausible cause for any movement. Comprehension • The answer demonstrates some understanding of the factors that underpin company performance and expresses some ideas with clarity. • Some points made are relevant and linked to the scenario in the question. Analysis/evaluation • There is some application of relevant knowledge and understanding but supported by a limited evaluative statement. • The answer includes some critical analysis of the factors that underpin company performance. • The analysis is used to make a judgement, but this may be unclear and is supported by limited evidence.
Level 3 (Merit/ Distinction)	12-17	Knowledge • There is a good understanding of what the ratios indicate about company performance, and what might influence these e.g they mention and calculate a ratio, and can outline what it could show about a business, and what might be causing any movement. Comprehension

		• The answer demonstrates a good understanding of the factors that underpin company performance and is communicated in a logical writing structure. • A range of points are relevant and linked to the scenario in the question. Analysis/evaluation • There is a good application of relevant knowledge and understanding which may be supported by an evaluative statement. • The answer includes a good critical analysis of the factors that underpin company performance. • The analysis is used to make a clear judgement which is supported with appropriate examples.

Section C

Question number	Answer
9 (a) (i) 8 marks	The NPV of the CRM system project cash flows excluding possible new business:

Year	0 £000	1-4 £000	Marks
Initial investment	(600.0)		(1)
Maintenance costs		(40.0)	(1)
One off redundancy costs	(200.0)		(1)
Annual staff cost saving		100.0	(1)
	(800.0)	60.0	
Discount factor @ 12%	1.000	3.037	(1)
Present value	(800.0)	182.2	(1 for each)
NPV before new business	(617.8)		(1)

Question number	Answer
9 (a) (ii) 5 marks	• In order to break even, the present value of the net cash flows from the new business must be equal to £617.8k. (1) • Assuming that the benefit is spread evenly over the 4 years, we can use a four-year annuity factor to estimate the annual cash flows required from new business.(1) • A present value of £617.8k is equivalent to a net cash inflow of £203.4k a year for four years. (Workings: £203.4k = £617.8k/3.037 (1)) • In this case, given that the new business is expected to generate a net cash inflow of 52% of new cash inflows, additional annual net cash inflows of £203.4k wouldcome from additional new business of £391.2k a year. (Workings: £391.2k = £203.4k/52%) (1) Conclusion: the amount of additional revenue required to break even is £391.2k a year. (1)

Question number	Indicative content
9 (b) 12 marks	**Answers could include the following content:** The scenario of Bella refers to past and future cash flows, not accounting profits. In project appraisal decisions future cash flows are more relevant than accounting profits because: • Profits are subjective and cannot be spent; • Cash is required to pay dividends. Long-term cash flow forecasting of revenues, savings and costs is an essential part of project appraisal. It is extremely difficult to produce reliable forecasts, but every effort should be made to make them as reliable as possible. The Directors of Bella are unsure how much new business

would be generated by the new CRM system, but have tried to make an informed estimate.

In making assumptions during the project appraisal process, we should take into account relevant factors – that is those factors vital for making investment decisions based on future net incremental cash flows. These include:

- Future costs – for Bella, the on-going future maintenance costs of £40,000 pa are future costs;
- Incremental costs – the savings on staff costs for Bella are incremental cost savings;
- Cash-based costs – all the costs quoted for Bella are cash costs, and there are no non-cash costs e.g. depreciation on the £600,000 is not relevant;
- Financing costs – there is no mention of how the £600,000 initial investment is financed for Bella, but Bella does incur an opportunity cost on the interest foregone on investing that capital, if not a real-cost if the funds were borrowed;
- The timing of returns – early returns are preferred over later ones;
- Working capital – Bella does not appear to incur any costs in relation to inventory or receivables on this type of project;
- Taxation – the question asks candidates to ignore taxation, but any profits subject to taxation, and any tax relief from the capital cost of the project, would normally be relevant;
- Future inflation – future revenues and costs will be affected by inflation to different degrees, and this is true for Bella.

It is equally important not to include non-relevant factors, those that are irrelevant for project appraisal decision making:

- Sunk costs – past expenditure that cannot be recovered and hence cannot be influenced by the current decision;
- Committed costs – obligations that cannot be revoked;
- Non-cash items – items such as depreciation and accrued revenue are just accounting entries, not cash flows. So, for Bella, depreciation on the £600,000 investment is not relevant;
- Allocated costs – such as the apportionment of overheads.

<table>
<tr><th>Level</th><th>Mark</th><th>Descriptor</th></tr>
<tr><td>9(b)</td><td>0</td><td>No rewardable material.</td></tr>
<tr><td>Level 1
(Fail)</td><td>1–5</td><td>Knowledge
They identify that this sort of project investment appraisal is about cash flows, but limited understanding of the practical considerations within this e.g. they cannot identify or explain any/many considerations around relevant or non-relevant factors.
Comprehension
The answer demonstrates limited understanding of the factors that underpin capital investment appraisal based upon it. This is communicated in a simple way with simple or generalised comments.
Points made are superficial and not directly linked to the scenario in the question.
Analysis/evaluation
There is little application of relevant knowledge and understanding which</td></tr>
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		may be supported by an evaluative statement. • The answer includes limited critical analysis of the factors that underpin company performance. • Any analysis is not used to make a judgement and is not supported by evidence.
Level 2 (Pass)	6-7	Knowledge • They identify that this sort of project investment appraisal is about cash flows, and some understanding of the practical considerations within this e.g. they can identify or explain several considerations around relevant or non-relevant factors. Comprehension • The answer demonstrates some understanding of the factors that underpin capital investment appraisal and expresses some ideas with clarity. • Some points made are relevant and linked to the scenario in the question. Analysis/evaluation • There is some application of relevant knowledge and understanding but supported by a limited evaluative statement. • The answer includes some critical analysis of the factors that underpin company performance. • The analysis is used to make a judgement, but this may be unclear and is supported by limited evidence.
Level 3 (Merit/ Distinction)	8-12	Knowledge • They identify that this sort of project investment appraisal is about cash flows, and a good understanding of the practical considerations within this e.g. they can identify or explain many considerations around relevant or non-relevant factors. Comprehension • The answer demonstrates a good understanding of the factors that underpin investment appraisal and is communicated in a logical writing structure. • A range of points are relevant and linked to the scenario in the question. Analysis/evaluation • There is a good application of relevant knowledge and understanding which may be supported by an evaluative statement. • The answer includes a good critical analysis of the factors that underpin company performance. • The analysis is used to make a clear judgement which is supported with appropriate examples.

Question number	Indicative content
10 (a) 11 marks	**Answers could include the following content** The main sources of equity finance are: • Internally generated – retained earnings; or • Ordinary or equity shares – via a new issue or rights issue. Retained earnings are the most common and important source of finance, for both short-term and long-term purposes. **Advantages** • As a recently formed company it might still be founder owned, or at least its ownership structure will only have been recently put in place.Therefore, it is an important consideration that using retained earnings allows the existing shareholders the ability to maintain full control (or the degree they currently have) • There is no obligation on the part of the company to either pay interest or pay back the earnings (important in terms of management of liquidity). • Since these are internally generated funds, they are the cheapest source of capital. • Directors who view that their company's equity is under-priced, which can definitely include recently formed companies, might have a preference to fund investments using retained earnings (or debt) rather than new equity. • The cash is immediately available (possibly), depending on cash flows of a recently formed business. • The management have more flexibility to decide how or where this money can be used. **Disadvantages** • Firstly, it is slow. You run the risk of missing business opportunities while you build up the necessary funds. Internally generated funds may not be sufficient for financing purposes – for example, in new companies that require a lot of cash investment, which a company looking to grow rapidly is likely to. • A newly formed business also needs cash to fund ongoing operations. If the business devotes too many of its resources to growth, it may be starving the company of the cash it needs to be healthy right now. • Although outside investment means giving up a degree of control, as a recently formed company you might gain from the experience and insight of these new investors in your business, or the disciplines they might impose. • The investment requirements might not match the availability and the timing of the funds. A company runs the risk of missing business opportunities. • If no suitable investments are available, shareholders' money is being tied up in the company. This incurs an opportunity cost by having their money kept in the company. • The excessive ploughing back of profits or the accumulated reserves may result in overcapitalisation. • Excessive savings may be misused against the interest of the shareholders. • The money is not made available to those who can use it by devoting too much of resources to growth. It will also starve the company of the cash it needs to fund ongoing operations.

	For ordinary or equity shares the advantages and disadvantages are nearly the opposite of that for Retained Earnings: **Advantages** • Equity shares produce permanent capital, that is not returned to shareholders in most circumstances, which is likely to be attractive to a newly formed company. • Equity shareholders are paid the residual funds (in the form of dividends) after the running costs of the business have been fully met, so do not utilise vital working capital of a newly formed company. • Although issuing equity shares means giving up a degree of control, as a recently formed company you might gain from the experience and insight of these new investors in your business, or the disciplines they might impose, which could be crucial for a newly formed company. • In theory, equity issues can be made so that funds are available when a company requires them in order to fund a substantive investment. **Disadvantages** • In return for accepting the risk of ownership, equity shares carry voting rights, through which equity shareholders jointly own the company. This is a big decision for a newly formed company, in particular. • The issue of additional shares may be unfavourable to existing shareholders, as it will dilute their existing voting rights and it may also affect future dividends.

Level	**Mark**	**Descriptor**
10 (a)	0	No rewardable material.
Level 1 (Fail)	1–5	Knowledge • They identify retained earnings and equity shares as the two main types but show limited understanding of the advantages or disadvantages of either e.g.they don’t identify correctly the key advantages and disadvantages. Comprehension • The answer demonstrates limited understanding of the factors that underpin retained earnings and ordinary share issues. This is communicated in a simple way with simple or generalised comments. • Points made are superficial and not directly linked to the question. • The answer makes few links between theory and practice Analysis/evaluation • There is little application of relevant knowledge and understanding which may be supported by an evaluative statement. • The answer includes limited critical analysis of the factors that underpin long-term financing. • Any analysis is not used to make a judgement and is not supported by evidence.
Level 2 (Pass)	6-7	Knowledge • They identify retained earnings and equity shares as the two main types and show some understanding of the advantages or disadvantages of either e.g. they identify several of the key advantages and disadvantages. Comprehension • The answer demonstrates some understanding of the factors that underpin

		retained earnings and ordinary share issues and expresses some ideas with clarity. • Some points made are relevant and linked to the question. • The answer makes some links between theory and practice Analysis/evaluation • There is some application of relevant knowledge and understanding but supported by a limited evaluative statement. • The answer includes some critical analysis of the factors that underpin long-term financing. • The analysis is used to make a judgement, but this may be unclear and is supported by limited evidence.
Level 3 (Merit/ Distinction)	8-11	Knowledge • They identify retained earnings and equity shares as the two main types and show a good understanding of the advantages or disadvantages of either e.g. they identify many of the key advantages and disadvantages. Comprehension • The answer demonstrates a good understanding of the factors that underpin retained earnings and ordinary share issue and is communicated in a logical writing structure. • A range of points are relevant and linked to the question. • The answer makes strong links between theory and practice. Analysis/evaluation • There is a good application of relevant knowledge and understanding which may be supported by an evaluative statement. • The answer includes a good critical analysis of the factors that underpin long-term financing. • The analysis is used to make a clear judgement which is supported with appropriate examples.

Question number	Indicative content
10 (b) 14 marks	**Answers could include the following content** Ultimately, the decision between whether debt or equity financing is best depends on the type of business you have and whether the advantages outweigh the risks. This scenario talks about a newly formed company looking to grow rapidly. The advantages of debt financing are: • The benefit of debt financing is that it allows a business to leverage a small amount of money into a much larger sum, enabling more rapid growth than might otherwise be possible. This could be particularly crucial for a newly formed company. • In addition, payments on debt are generally tax-deductible. The downsides of debt financing are that: • Lenders require the payment of interest, meaning the total amount repaid exceeds the initial sum. • Also, payments on debt must be made regardless of business revenue and profit. For smaller or newer businesses, this can be especially dangerous. • Ultimately the sum raised will need to be repaid; will the liquid funds be available at that

	time? For a newly formed company looking to grow rapidly, this management of liquidity and working capital is vital. The main benefit of equity financing is that funds need not be repaid. However, equity financing is not the "no-strings-attached" solution it may seem: • Shareholders purchase their shares with the understanding that they then own a stake in the business. The business is then beholden to shareholders and must generate consistent profits in order to maintain a healthy sharevaluation and pay dividends in line with their expectations. Do the owners of a newly formed business want to give away part of their business? • Since equity financing is a greater risk to the investor than debt financing is to the lender, the cost of equity is often higher than the cost of debt. A company's cost of capital is the rate of return required by the providers of capital for making an investment in the company. While equity investors receive their returns in the form of dividends and capital growth from increases in the share price, debt providers (normally in the form of a bond) carry fixed interest payments and a set date when it will be redeemed. The amount of money that is required to obtain capital from different sources, called cost of capital, is crucial in determining a company's optimal capital structure. Finding the mix of debt and equity financing that yields the best funding at the lowest cost is a basic tenet of any prudent business strategy. Therefore, the owners of the newly formed company could look at the current capital structure, and some proposed alternatives, to compare different capital structures, and aid their decision making. To compare different capital structures, accountants use a formula called the WACC. The WACC multiplies the percentage costs of debt - after accounting for the corporate tax rate - and equity under each proposed or existing capital structure, by a weight equal to the proportion of total capital represented by each capital type. This allows businesses to determine which levels of debt and equity financing are most cost-effective. The best answers will refer to: The cost of equity is the return investors expect to achieve on their shares in a company. The rate of return an investor requires is based on the level of risk associated with the investment. To work out the cost of equity financing normally involves a calculation involving the capital asset pricing model (CAPM) or the dividend valuation model. The cost of equity capital obtained under CAPM is called the risk-adjusted discount rate (RADR). The RADR is based on the risk-free rate (such as a short-term interest rate from government securities, a fixed deposit rate or the LIBOR) and a risk premium for the riskier assets.

Level	Mark	Descriptor
10 (b)	0	No rewardable material.
Level 1 (Fail)	1–6	Knowledge • The answer demonstrates limited knowledge of debt and equity financing, and the advantages and disadvantages of either. Comprehension • The answer demonstrates limited understanding of the factors that underpin long-term financing and WACC. This is communicated in a simple way with

		simple or generalised comments. • Points made are superficial and not directly linked to the question. • The answer makes few links between theory and practice Analysis/evaluation • There is little application of relevant knowledge and understanding which may be supported by an evaluative statement. • The answer includes limited critical analysis of the factors that underpin company performance. • Any analysis is not used to make a judgement and is not supported by evidence.
Level 2 (Pass)	7-9	Knowledge • The answer demonstrates some knowledge of debt and equity financing, and the advantages and disadvantages of either e.g. it identifies best funding at lowest cost as a tenet and that WACC is used to compare different capital structures. Comprehension • The answer demonstrates some understanding of the factors that underpin long-term financing and WACC and expresses some ideas with clarity. • Some points made are relevant and linked to the question. • The answer makes some links between theory and practice Analysis/evaluation • There is some application of relevant knowledge and understanding but supported by a limited evaluative statement. • The answer includes some critical analysis of the factors that underpin company performance. • The analysis is used to make a judgement, but this may be unclear and is supported by limited evidence.
Level 3 (Merit/ Distinction)	10-14	Knowledge • The answer demonstrates a good knowledge of debt and equity financing, and the advantages and disadvantages of either e.g. it outlines the use of WACC effectively and introduces the concepts of risk and CAPM. Comprehension • The answer demonstrates a good understanding of the factors that underpin long-term financing and WACC and is communicated in a logical writing structure. • A range of points are relevant and linked to the question. • The answer makes strong links between theory and practice. Analysis/evaluation • There is a good application of relevant knowledge and understanding which may be supported by an evaluative statement. • The answer includes a good critical analysis of the factors that underpin company performance. • The analysis is used to make a clear judgement which is supported with appropriate examples.

Question number	Indicative content
11 (a) 8 marks	**Answers could include the following content** The different users of Dillon's financial reports will look at the statements of cash flows as part of their review of the financial reports: • **Investors:** shareholders are interested in Dillon's earning capacity, its future prospects and its wellbeing. Part of this is helping investors to see Dillon's prospects, its liquidity position and demonstrate how the company's cash generation compares with those of its competitors. Dillon's net cash inflow from operating activities in 2018 was significant (at £312m), but down from the £363m the previous year, despite the introduction of the new product. This could be a concern for investors, especially if it is part of a longer-term trend, and if it does not compare favourably with the industry sector in which Dillon performs. Equity investors would also be interested in the level of dividends being paid, and in 2018 Dillon increased this to £130m, from £115m the previous year with no additional shares issued for cash. • **Employees**: the company's performance is related to the security of employment and future prospects for jobs. As Dillon is producing net cash each year from its operating activities, albeit the cash and cash equivalents at year end reduce slightly, employees would not appear to have major causes for any imminent concerns based on this information. • **Lenders**: the information in the statement of cash flows should help lenders decide whether to lend to Dillon. This information is checked for adequacy of the value of security (if any) and the ability to make interest and capital repayments, so cash generation and retention is important. For Dillon, lenders can see that the company has been decreasing its lease obligations and borrowings in both of the last two years, from the cash it is generating, so would appear to be a low risk. • **Suppliers**: are interested in information to assess whether Dillon will be a good customer and pay its debts, and good cash generation and liquidity would be one strong indicator of this. Dillon has positive and significant net cash flows from operating activities, so there would appear to be no material need for suppliers to have concerns. • **Customers**: Dillon should be in a good financial position to be able to continue producing and supplying goods or services, so again good cash generation and retention would be important. As above, cash generation looks strong, but the fact that cash and cash equivalents retained have reduced from £199m down to £187m, might be of modest concern, especially if it is part of a longer-term trend.

Level	Mark	Descriptor
11 (a)	0	No rewardable material.
Level 1 (Fail)	1–3	Knowledge • The answer demonstrates limited understanding of the users of financial statements e.g. it only identifies up to two types of users and gives brief description of what they would look for, and why. Comprehension • The answer demonstrates limited understanding of the users of financial information. This is communicated in a simple way with simple or generalised comments. • Points made are superficial and not directly linked to the scenario in the question. • The answer makes few links between theory and practice

		• The answer makes strong links between theory and practice. Analysis/evaluation • There is little application of relevant knowledge and understanding which may be supported by an evaluative statement. • The answer includes limited critical analysis of the factors that underpin working capital management. • Any analysis is not used to make a judgement and is not supported by evidence.
Level 2 (Pass)	4-5	Knowledge • The answer demonstrates some understanding of the users of financial statements e.g. it identifies up to four types of users and gives a good description of what they would look for, and why. Comprehension • The answer demonstrates some understanding of the users of financial information and expresses some ideas with clarity. • Some points made are relevant and linked to the scenario in the question. • The answer makes some links between theory and practice Analysis/evaluation • There is some application of relevant knowledge and understanding but supported by a limited evaluative statement. • The answer includes some critical analysis of the factors that underpin working capital management. • The analysis is used to make a judgement, but this may be unclear and is supported by limited evidence.
Level 3 (Merit/ Distinction)	6-8	Knowledge • The answer demonstrates a good understanding of the users of financial statements e.g. it identifies at least four types of users and gives a good description of what they would look for, and importantly clarity on why they are looking for this. Comprehension • The answer demonstrates a good understanding of the users of financial information and is communicated in a logical writing structure. • A range of points are relevant and linked to the scenario in the question. Analysis/evaluation • There is a good application of relevant knowledge and understanding which may be supported by an evaluative statement. • The answer includes a good critical analysis of the factors that underpin working capital management. • The analysis is used to make a clear judgement which is supported with appropriate examples.

Question number	Indicative content
11 (b) 8 marks	**Answers could include the following content** The cash flow statements for Dillon show £261m being invested, in cash terms, in new property, plant and equipment in 2017, and £190m in 2018. We also know, however, that a further payment of £140m is due in 2019. This last payment, assuming it is made on time, would appear in the statement of cash flows for the year ended 31 December 2019. This question asks candidates to outline the recognition issues under IAS 16 for accounting fully and appropriately for the investment in new plant made by Dillon. A major issue is the initial recognition and measurement of the property, plant and equipment on Dillon's statement of financial position. It would appear that the cost to Dillon of this new plant, property and equipment should be fully recognised as an asset in 2017, because: • Future economic benefits associated with this plant flow to Dillon, by way of revenues from the sale of the new products; and, • It would appear that the cost of the plant can be measured reliably (£591m for Dillon, paid across 3 years). In terms of the initial recognition, this plant asset should be measured at its cost, or the cash equivalent date at the initialrecognition date. This would appear to be at £591m, as long as this cost only includes: • The purchase price, including duties and non-refundable purchase taxes, • Costs directly attributable to bringing the asset to the location and condition necessary for it to operate, and • The estimated costs of dismantling and removing the item and restoring the site on which it was located. Furthermore, the property, plant and equipment would need to be depreciated, and have this cost systematically spread as an expense in the statement of profit or loss. So to work out the annual depreciation charge for Dillon we would need to know its residual value estimate, the useful life of the asset and the depreciation method already used for similar assets(e.g. straight-line or reducing balance). We could also note that the replacement of any component parts of the property, plant and equipment during the useful life would need to be recognised as part of the asset. This would not include the cost of day-to-day repairs and maintenance, which would be charged to Dillon's statement of profit or loss as an expense.

Level	Mark	Descriptor
11 (b)	0	No rewardable material.
Level 1 (Fail)	1–3	Knowledge • The answer demonstrates limited understanding of IAS 16 e.g. it fails even to identify why the investment in plant will be likely to have created an asset, which would need including on the balance sheet. Comprehension • The answer demonstrates limited understanding of the factors that underpin consolidated cash flow statements and reporting. This is communicated in a

		simple way with simple or generalised comments. • Points made are superficial and not directly linked to the scenario in the question. • The answer makes few links between theory and practice Analysis/evaluation • There is little application of relevant knowledge and understanding which may be supported by an evaluative statement. • The answer includes limited critical analysis of the factors that underpin working capital management. • Any analysis is not used to make a judgement and is not supported by evidence.
Level 2 (Pass)	4-5	Knowledge • The answer demonstrates some understanding of IAS 16 e.g. it identifies why the investment in plant will be likely to have created an asset, which would need including on the balance sheet, including the issue of at which cost. Comprehension • The answer demonstrates some understanding of the factors that underpin consolidated cash flow statements and reporting and expresses some ideas with clarity. • Some points made are relevant and linked to the scenario in the question. • The answer makes some links between theory and practice Analysis/evaluation • There is some application of relevant knowledge and understanding but supported by a limited evaluative statement. • The answer includes some critical analysis of the factors that underpin working capital management. • The analysis is used to make a judgement, but this may be unclear and is supported by limited evidence.
Level 3 (Merit/ Distinction)	6-8	Knowledge • The answer demonstrates a good understanding of IAS 16 e.g. it identifies why the investment in plant will be likely to have created an asset, which would need including on the balance sheet, but also the issues around what cost to recognise, and the subsequent need to depreciate the asset. Comprehension • The answer demonstrates a good understanding of the factors that underpin cash flow statements and reporting and is communicated in a logical writing structure. • A range of points are relevant and linked to the scenario in the question. Analysis/evaluation • There is a good application of relevant knowledge and understanding which may be supported by an evaluative statement. • The answer includes a good critical analysis of the factors that underpin working capital management. • The analysis is used to make a clear judgement which is supported with appropriate examples.

Question number	Indicative content
11 (c) 9 marks	**Answers could include the following content** All companies, including Dillon, need working capital to keep the business running. For example, a company which has sufficient working capital will be able to make the usual disbursements of salaries, wages and other day-to-day obligations. Meeting these obligations might raise the morale of its employees, increase their effectiveness, decrease wastage, save costs and increase profits. Not being able to make these disbursements might have rather more drastic effects – to employees, suppliers and other stakeholders. For Dillon overall cash levels are still high – £187m at 31 December 2018. However, the net cash from operating activities reduced between 2017 and 2018, and the overall level of cash decreased, from £199m. Although details are not given, it will be noted that cash generated from operations (which includes adjustments to elements of working capital) has fallen from £478m at 31 December 2107 to £420m at 31 December 2018 suggesting more funds have been tied up in working capital during 2018. The main objective of working capital management is to get the balance of current assets and current liabilities "right". An aggressive approach that chooses to have a lower level of working capital and more cash savings will result in higher profitability and higher risk, while a conservative approach that chooses for a higher level of working capital will result in lower profitability, lower risk and more 'tied up'cash. A moderate working capital policy is the balance between the two, where the risk and return balance is maintained by using funds in an efficient and effective manner. It would appear that Dillon is following a moderate working capital policy: During 2018 Dillon was able to spend significant amounts on the acquisition of property, plant and equipment (£190m) and to pay equity dividends (£130m). At the same time, cash and cash equivalents only reduced by £12m from £199m to £187m. If cash generation and working capital management started to limit either of those two (acquisition of PPE or paying dividends), that would be a concern for Dillon, and its stakeholders. It is probably too early to say whether this significant investment in new property, plant and equipment to support the launch of a new product has been successful, but future net cash inflows from operating activities would be expected to increase in order to repay this investment. Management decides on the optimal level and proper management of working capital that results in no idle cash or unused inventory, but also does not put a strain on liquid resources needed for the daily running of the business. The company faces a trade-off between profitability and liquidity. From the statements of cash flows provided it is not possible to see the movement in inventories, trade payables or trade receivables which would provide further information regarding the management of working capital during both years.

Level	Mark	Descriptor
11 (c)	0	No rewardable material.
Level 1 (Fail)	1–4	Knowledge • The answer demonstrates limited understanding of working capital management e.g. little is included on some of the possible consequences of good or bad working capital management. Comprehension • The answer demonstrates limited understanding of the factors that underpin working capital management. This is communicated in a simple way with simple or generalised comments. • Points made are superficial and not directly linked to the scenario in the question. • The answer makes few links between theory and practice Analysis/evaluation • There is little application of relevant knowledge and understanding which may be supported by an evaluative statement. • The answer includes limited critical analysis of the factors that underpin working capital management. • Any analysis is not used to make a judgement and is not supported by evidence.
Level 2 (Pass)	5	Knowledge • The answer demonstrates understanding of working capital management e.g. it identifies the main objective of working capital management, and how this might apply to Dillon. Comprehension • The answer demonstrates understanding of the factors that underpin working capital management and expresses some ideas with clarity. • Some points made are relevant and linked to the scenario in the question. • The answer makes some links between theory and practice Analysis/evaluation • There is some application of relevant knowledge and understanding but supported by a limited evaluative statement. • The answer includes some critical analysis of the factors that underpin working capital management. • The analysis is used to make a judgement, but this may be unclear and is supported by limited evidence.
Level 3 (Merit/ Distinction)	6-9	Knowledge • The answer demonstrates a good understanding of working capital management e.g. it identifies possible future working capital impacts of the significant investment by Dillon. Comprehension • The answer demonstrates a good understanding of the factors that underpin working capital management and reporting and is communicated in a logical writing structure. • A range of points are relevant and linked to the scenario in the question. Analysis/evaluation • There is a good application of relevant knowledge and understanding which may be supported by an evaluative statement. • The answer includes a good critical analysis of the factors that underpin

		working capital management. • The analysis is used to make a clear judgement which is supported with appropriate examples.