

- 6 Hercules Baggage Limited produces suitcases for travellers. Inventory is valued using both the marginal costing method and the absorption costing method.

The following information is available for the year ended 30 April 2017:

Opening inventory	850 units
Opening inventory value:	Marginal costing £21 250
	Absorption costing £27 200
Production	33 000 units per year
Direct materials	£19.75 per unit
Direct labour	45 minutes work per unit at a wage rate of £8.40 per hour
Semi-variable costs	£8 000 fixed element per month plus £1.40 per unit of production
Fixed overheads	£12 762.50 per month
Sales units	32 750
Selling price	£64 per unit

Required

- (a) Prepare a Statement of Profit or Loss and Other Comprehensive Income for the year ended 30 April 2017, in **columnar format**, showing:
- marginal costing inventory valuation.
 - absorption costing inventory valuation.
- (18)
- (b) Explain to management:
- (i) **two** advantages of valuing inventory using absorption costing.
- (4)
- (ii) **one** disadvantage of valuing inventory using absorption costing.
- (2)
- In April 2017, a potential customer is interested in buying the product, but is only prepared to offer £30 per unit.
- (c) Evaluate the offer of £30 per unit and advise Hercules Baggage Limited whether this offer should be accepted.
- (6)

(Total for Question 6 = 30 marks)

TOTAL FOR SECTION B = 90 MARKS
TOTAL FOR PAPER = 200 MARKS

Question Number	Answer	Mark
6 (a)	<p>AO1 (2), AO2 (12), AO3 (4) AO1: Two marks for sales and direct materials AO2: Twelve marks for calculation of closing inventory, direct labour, semi-variable costs, fixed overheads, opening and marginal closing inventory, and profit. AO3: Four marks for calculation of closing inventory using absorption costing</p>	(18)

Statement of profit or loss and other comprehensive Income

	Opening inventory		Production	Sales units		Closing Inventory	
Calculation of Closing inventory	850		33 000	(1) AO2 32 750	(1) AO2	1 100	(1) AO2
	(i)Marginal		(ii)Absorption				
Sales	2 096 000		2 096 000	(1) AO1 both			
Less							
Direct materials	651 750		651 750	(1) AO1 both			
Direct labour	207 900		207 900	(1) AO2 both			
Semi-variable costs	96 000		96 000	(1) AO2 both			
	46 200		46 200	(1) AO2 both			
Fixed overheads	<u>153 150</u>		<u>153 150</u>	(1) AO2 both			
	1 155 000		1 155 000				
Opening inventory	21 250		27 200	(1) AO2 both			
Closing inventory	(30 195)		(38 500)				
Profit	949 945	(1) AO2 o/f	952 300	(1) AO2 o/f			
Calculation of closing inventory							
Marginal	(19.75+6.30+1.40)	(1) AO2	27.45	1 100		30 195	(1) AO2
Absorption	<u>1 155 000</u>	(1) AO3 o/f	35	(1) AO3 o/f 1 100		38 500	(1) AO3 o/f
	33 000	(1) AO3					

Question Number	Answer	Mark
6 (b)	<p>AO1(3) , AO3 (3) AO1: 1 mark for each point made. AO3: 1 mark for each development.</p> <p>(i) <u>Advantages of absorption costing (Maximum of 2 points)</u></p> <ul style="list-style-type: none"> • All are costs allocated to products. This could be useful for management when fixing prices. • If used financial statements would give a true and fair view and be signed off by auditors. Recommended by IAS 2. • This follows the matching concept. Here the revenues of a product are matched against the costs of the product. <p style="text-align: right;">(4)</p> <p>(ii) <u>Disadvantage of absorption costing (Maximum of 1 point)</u></p> <ul style="list-style-type: none"> • All costs are not allocated to the time period in which they are incurred. So it may be argued that profit for that time period is not accurate as external accounts are drawn up on the basis of a time period. • Does not follow the prudence concept. The closing inventory and the profit figures are higher than in marginal costing. • Absorption costing is not suitable for decision making in the short term. .In the long term fixed costs need to be covered so absorption costing is suitable for long term decision making only. <p style="text-align: right;">(2)</p>	<p style="text-align: right;">(6)</p>

Question Number	Indicative content		Mark
6 (c)	<p>AO4 (6)</p> <p><u>For accepting order</u></p> <ul style="list-style-type: none"> The order could be accepted on the grounds that £30 is greater than the marginal cost of £27.45 (o/f). A positive contribution of £2.55 per item would be made. New customer may result in more orders in the future, perhaps at a higher price. <p><u>For rejecting order</u></p> <ul style="list-style-type: none"> However in the long term, selling at £30 would result in a Net Loss/ not all costs are covered. Existing customers would be unhappy to hear of this low price on offer. <p><u>Conclusion</u></p> <p>Marginal costing states order should be accepted</p>		(6)
Level	Mark	Descriptor	
	0	A completely incorrect response.	
Level 1	1-2	Isolated elements of knowledge and understanding that are recall based. Generic assertions may be present. Weak or no relevant application to the scenario set.	
Level 2	3-4	Elements of knowledge and understanding, which are applied to the scenario. Some analysis is present, with developed chains of reasoning, showing causes and/or effects applied to the scenario, although these may be incomplete or invalid. An attempt at an evaluation is presented, using financial and perhaps non-financial information, with a decision.	
Level 3	5-6	Accurate and thorough knowledge and understanding. Application to the scenario is relevant and effective. A coherent and logical chain of reasoning, showing causes and effects is present. Evaluation is balanced and wide ranging, using financial and perhaps non-financial information and an appropriate decision is made.	