

# ***INSIGHT***

## ***Trial Exam Paper***

# **2008**

# **ACCOUNTING**

## **Written examination 2**

### ***Suggested solutions***

#### **This book presents:**

- correct solutions
- mark allocations
- tips and guidelines

This trial examination produced by Insight Publications is NOT an official VCAA paper for the 2008 Accounting written examination 2.

This examination paper is licensed to be printed, photocopied or placed on the school intranet and used only within the confines of the purchasing school for examining their students. No trial examination or part thereof may be issued or passed on to any other party including other schools, practising or non-practising teachers, tutors, parents, websites or publishing agencies without the written consent of Insight Publications.

Copyright © Insight Publications 2008

**Question 1****Coates Clothing**

Tara Coates operates a small business, Coates Clothing, selling clothing purchased from a factory in Geelong. Tara's accountant maintains a double-entry accrual accounting system. The business uses a perpetual stock recording system with the FIFO cost assignment method. Control accounts are used for Debtors, Creditors and Stock.

- 1.1** Tara sells two different types of winter jackets. Details relating to the "Wind-breaker" jackets for June 2008 are shown below.

June 1 Balance: 3 Wind-breaker jackets at cost price of \$60 each

***Coates Clothing***  
 ABN 86 218 677 535  
 Tax Invoice Number 76  
 Date 07/06/2008  
 To: Daniel Bohem  
 For 1 Wind-breaker Jacket  
 \$200 plus GST \$20  
 Total \$220  
 Terms: n/60

**Geelong Clothing Co.**  
 Tax Invoice 328 Date: 12/6/08  
 Charged to: Coates Clothing  
 Items 10 Wind-breaker jackets  
 Cost per item \$70 plus \$7 GST  
 Total Invoice \$770  
 Credit Terms 2/7 n/30  
  
 ABN 86 971 121 871

**Firefly Freight Company**  
 ABN 86 313 612 236  
**Invoice 255**  
 For: Freight of 10 Jackets Geelong  
      to Melbourne (inv 328)  
 Amount \$100 plus GST \$10  
 Total Charge \$110  
 Due: strictly 7 days  
 Date 13/06/2008

***Coates Clothing***  
 ABN 86 218 677 535  
 Tax Invoice Number 79  
 Date 17/06/2008  
 To: Kew Basketball Club  
 For 8 Wind-breaker Jackets  
 @\$200 plus GST \$20 each  
 Total \$1 760  
 Terms: n/60

***Coates Clothing***  
 ABN 86 218 677 535  
 Credit Note Number 9  
 Date 23/06/2008  
 To: Kew Basketball Club  
 For 1 Wind-breaker Jacket  
 @\$200 plus GST \$20  
 Total \$220  
 Reason: Damaged stitching

**Geelong Clothing Co.**  
 Credit Note 18 Date: 25/6/08  
 Given to: Coates Clothing  
 Items 1 Wind-breaker jacket  
 Total Credit \$88  
 Reason for Credit – Broken stitching  
 ABN 86 971 121 871

**Coates Clothing**  
**Memo No. 42**

*A physical stocktake conducted on 30 June revealed 3 Wind-breaker Jackets on hand. However, one is shop soiled and will be sold online for \$60 Plus \$6 GST less \$5 EBay costs. Please adjust the records accordingly*

**SIGNED:** Tara C      **DATE** 30/6/08

**DATE:** 30 June 2008  
**TO:** MLC INSURANCE  
**FOR:** Shop Stock Insurance  
 \$350 plus GST \$35  
**BAL C/F**  
**AMOUNT:** \$385  
**BALANCE:**  
**CHEQUE NO** 108

**Required**

**1.1.1 State** the special journal that would be used to record the transaction on 7 June 2008 (Invoice 76).

**Solution 1.1.1**

**Special Journal** *Credit Sales Journal*

1 mark

**1.1.2 Record** all relevant information into the Stock card for Wind-breaker Jackets.

**Solution 1.1.2**

**STOCK CARD: WIND-BREAKER JACKETS**

| Date<br>2008 | Details | IN  |                    |                     | OUT |                    |                     | BALANCE |                    |                     |
|--------------|---------|-----|--------------------|---------------------|-----|--------------------|---------------------|---------|--------------------|---------------------|
|              |         | Qty | Unit<br>Cost<br>\$ | Total<br>Cost<br>\$ | Qty | Unit<br>Cost<br>\$ | Total<br>Cost<br>\$ | Qty     | Unit<br>Cost<br>\$ | Total<br>Cost<br>\$ |
| June 1       | Balance |     |                    |                     |     |                    |                     | 3       | 60                 | 180                 |
| 7            | Inv 76  |     |                    |                     | 1   | 60                 | 60                  | 2       | 60                 | 120                 |
| 12           | Inv 328 | 10  | 70                 | 700                 |     |                    |                     | 2       | 60                 | 120                 |
|              |         |     |                    |                     |     |                    |                     | 10      | 70                 | 700                 |
| 13           | Inv 255 | 10  | 10                 | 100                 |     |                    |                     | 2       | 60                 | 120                 |
|              |         |     |                    |                     |     |                    |                     | 10      | 80                 | 800                 |
| 17           | Inv 79  |     |                    |                     | 2   | 60                 | 120                 |         |                    |                     |
|              |         |     |                    |                     | 6   | 80                 | 480                 | 4       | 80                 | 320                 |
| 23           | CN 9    | 1   | 80                 | 80                  |     |                    |                     | 5       | 80                 | 400                 |
| 25           | CN 18   |     |                    |                     | 1   | 80                 | 80                  | 4       | 80                 | 320                 |
| 31           | Memo 42 |     |                    |                     | 1   | 80                 | 80                  | 2       | 80                 | 160                 |
|              |         |     |                    |                     | 1   | 25                 | 25                  | 1       | 55                 | 55                  |
|              |         |     |                    |                     |     |                    |                     |         |                    |                     |
|              |         |     |                    |                     |     |                    |                     |         |                    |                     |

8 marks

**Mark allocation**

- 1 mark per entry except Memo 42 which is worth 2 marks
- Maximum 1 mark subtracted for incorrect details

**Tips**

- *Date order is essential in the stock cards.*
- *The Total Cost can be combined where there are two or more item values however this is not recommended as it increases the chances of an arithmetic error.*
- *It would **not** be recorded as an error if students balanced the stock card after the 13 June transaction and did not do each one separately.*

**1.1.3 Explain**, with reference to one accounting principle **and** one qualitative characteristic, why the information in Memo 42 should be recognised in the financial reports of Coates Clothing.

**Solution 1.1.3**

|                                                                                                                                                                                                                                                                                                                                                                 |
|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Explanation</b> <i>When stock is lost or no longer worth what the business paid for it then to not record this at the time would be a breach of conservatism, which requires that assets not be overstated and expenses recognized when probable. This ensures that the users of the reports have relevant information in order to make better decisions</i> |
|                                                                                                                                                                                                                                                                                                                                                                 |
|                                                                                                                                                                                                                                                                                                                                                                 |
| <b>Accounting Principle</b> <i>Conservatism</i>                                                                                                                                                                                                                                                                                                                 |
| <b>Qualitative Characteristic</b> <i>Relevance</i>                                                                                                                                                                                                                                                                                                              |

4 marks

**Mark allocation**

- 1 mark for Conservatism as the accounting principle
- 1 marks for either assets not overstated **or** recognizes expenses when probable
- 1 mark for Relevance as the qualitative characteristic
- 1 mark for decision making

**1.1.4** Referring to your answer in 1.1.2 **explain** your treatment (product or period cost) of the cost of insurance on all stock (Cheque 108).

**Solution 1.1.4**

|                                                                                                                                                                                                                                                                 |
|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Explanation</b> <i>The insurance should be treated as a PERIOD COST</i>                                                                                                                                                                                      |
| <i>As the insurance relates to all stock items carried by the business, it could not reasonably be allocated to individual units of stock on a logical basis and therefore should be expensed in the reporting period rather than treated as a product cost</i> |
|                                                                                                                                                                                                                                                                 |
|                                                                                                                                                                                                                                                                 |
|                                                                                                                                                                                                                                                                 |

2 marks

**Mark allocation**

- 1 mark for identifying that it is treated as a period cost
- 1 mark for the explanation including that it is difficult to allocate **and** either expensed **or** not product cost

**1.1.5 Show** the General Journal entries necessary to record the transactions from Credit Note 9, Credit Note 18 and Memo 42. (Narrations are **not** required)

**Solution 1.1.5**

**GENERAL JOURNAL**

| Date<br>2008 | Particulars                 | General Ledger |           | Subsidiary Ledger |           |
|--------------|-----------------------------|----------------|-----------|-------------------|-----------|
|              |                             | Debit \$       | Credit \$ | Debit \$          | Credit \$ |
| June23       | Sales Return                | 200            |           |                   |           |
|              | GST Clearing                | 20             |           |                   |           |
|              | Debtors Control             |                | 220       |                   |           |
|              | Debtor – Kew B.Ball Club    |                |           |                   | 220       |
|              | Stock Control               | 80             |           |                   |           |
|              | COS                         |                | 80        |                   |           |
|              |                             |                |           |                   |           |
| June25       | Creditors Control           | 88             |           |                   |           |
|              | Creditor – Geelong Clothing |                |           | 88                |           |
|              | Stock Control               |                | 80        |                   |           |
|              | GST Clearing                |                | 8         |                   |           |
|              |                             |                |           |                   |           |
| June30       | Stock Loss                  | 80             |           |                   |           |
|              | Stock Control               |                | 80        |                   |           |
|              |                             |                |           |                   |           |
|              | Stock Write Down            | 25             |           |                   |           |
|              | Stock Control               |                | 25        |                   |           |
|              |                             |                |           |                   |           |

12 marks

**Mark allocation**

- 1 mark per line (except Control account and Subsidiary Account worth 1 mark if both correct)
- Maximum 1 mark subtracted for incorrect titles. Must have the words “Control” and “Clearing”

**Tips**

- Students may place the control account and subsidiary account on the one line although space is often limited.

**Question 1 – continued**

**1.1.6 Define** the term 'Net Realisable Value'.**Solution 1.1.6**

|                                                                                |
|--------------------------------------------------------------------------------|
| <b>Net Realisable Value</b> <i>The estimated selling price of a stock item</i> |
| <i>Less any costs involved in its selling, marketing and distribution.</i>     |
|                                                                                |
|                                                                                |

2 marks

**Mark allocation**

- 1 mark per line

**1.2** On 1 July 2008 Coates Clothing purchased a new vehicle on credit to be used for deliveries. Although the Van was on the showroom floor with a price of \$36 000, Tara negotiated the following price with the dealer who prepared the van to meet her needs. The details of invoice 212 issued by MC Ford are listed below:

|                        |                  |
|------------------------|------------------|
| Van                    | \$28 000         |
| Modifications          | \$2 000          |
| Delivery Fee           | \$1 000          |
| 12 Months Registration | \$500            |
| Annual Insurance       | \$400            |
| GST                    | <u>\$3 190</u>   |
| <b>TOTAL</b>           | <b>\$ 35 090</b> |

**Required**

**1.2.1 Calculate** the cost of the van to be reported in the Balance Sheet of Coates Clothing.

**Solution 1.2.1**

|                                                     |                  |
|-----------------------------------------------------|------------------|
| <b>Calculation</b><br>$28\,000 + 2\,000 + 1\,000 =$ |                  |
| <b>Cost</b>                                         | <b>\$ 31 000</b> |

2 marks

**Mark allocation**

- 2 marks for correct response
- 1 mark subtracted for including either Registration or Insurance or both
- 1 mark subtracted for including GST

**1.2.2** Referring to your answer in 1.2.1, **explain** your treatment of the delivery fee.

**Solution 1.2.2**

|                                                                                                            |
|------------------------------------------------------------------------------------------------------------|
| <b>Explanation</b> <i>It is included in the cost of the asset as it is necessary to bring the van into</i> |
| <i>a condition and location ready for use, and will bring a benefit over its useful life.</i>              |
|                                                                                                            |
|                                                                                                            |

2 marks

**Mark allocation**

- 1 mark for 'condition and location ready for use'
- 1 mark for 'benefit over the life of the asset'

**Tips**

- *A student who has not included the delivery fees in the cost of the asset would have already lost marks in 1.2.1, therefore they can be awarded full marks here for explaining it in the negative.*

**1.2.3** **Record** the purchase of the van into the General Journal. (Narration is **not** required).

**Solution 1.2.3**

**GENERAL JOURNAL**

| Date<br>2008 | Particulars               | General Ledger |           | Subsidiary Ledger |           |
|--------------|---------------------------|----------------|-----------|-------------------|-----------|
|              |                           | Debit \$       | Credit \$ | Debit \$          | Credit \$ |
| July 1       | Van                       | 31 000         |           |                   |           |
|              | Prepaid Registration      | 500            |           |                   |           |
|              | Prepaid Insurance         | 400            |           |                   |           |
|              | GST Clearing              | 3 190          |           |                   |           |
|              | Sundry Creditor – MC Ford |                | 35 090    |                   |           |
|              |                           |                |           |                   |           |

5 marks

**Mark allocation**

- 1 mark for each line (all titles must be correct)

- 1.3** The van had an estimated useful life of 2 years and a scrap value of \$19 000. On 31 October Tara received an offer from MC Ford on a bigger and better van that she decided to accept. She traded the current van for \$28 000 which was deducted off the invoice price of the new van of \$50 000 plus GST \$5 000.

**Required**

- 1.3.1** Show how the Van and Disposal of Van accounts would appear in the General Ledger after the Trade in has occurred. (Balancing and the closing of accounts are **not** required).

**Solution 1.3.1**

**VAN**

| <b>Date<br/>2008</b> | <b>Cross Reference</b>           | <b>\$</b>     | <b>Date<br/>2008</b> | <b>Cross Reference</b> | <b>\$</b>     |
|----------------------|----------------------------------|---------------|----------------------|------------------------|---------------|
| <i>July 1</i>        | <i>Sundry Creditor – MC Ford</i> | <i>31 000</i> | <i>Oct 31</i>        | <i>Disposal of Van</i> | <i>31 000</i> |
| <i>Oct 31</i>        | <i>Sundry Creditor – MC Ford</i> | <i>50 000</i> |                      |                        |               |
|                      |                                  |               |                      |                        |               |
|                      |                                  |               |                      |                        |               |

**DISPOSAL OF VAN**

| <b>Date<br/>2008</b> | <b>Cross Reference</b> | <b>\$</b>     | <b>Date<br/>2008</b> | <b>Cross Reference</b>           | <b>\$</b>     |
|----------------------|------------------------|---------------|----------------------|----------------------------------|---------------|
| <i>Oct 31</i>        | <i>Van</i>             | <i>31 000</i> | <i>Oct 31</i>        | <i>Acc Depn – Van</i>            | <i>2 000</i>  |
|                      |                        |               |                      | <i>Sundry Creditor – MC Ford</i> | <i>28 000</i> |
|                      |                        |               |                      | <i>Loss on Disposal Van</i>      | <i>1 000</i>  |
|                      |                        |               |                      |                                  |               |

7 marks

Total 45 marks

**END OF QUESTION 1**

## Question 2

For the purpose of Question 2 you are not required to consider GST.

### Ellis Electrical

Coen Ellis is starting his own small business on 1 July 2008, Ellis Electrical, selling electrical equipment to Schools and clubs. Coen's accountant will maintain a double-entry accrual accounting system. The business will use a perpetual stock recording system with the FIFO cost assignment method. Control accounts will be used for Creditors, Debtors and Stock.

- 2.1** During the first month of his new business Coen hopes to generate total sales of \$60 000 with cash sales making up 80% of total sales. He has estimated the debtors balance at the end of the first month to be approximately \$1 000. It is expected that bad debts will be 2% of credit sales. He will offer a 2% discount for prompt payment and he expects that this will cost him about \$500.

Most purchases of stock will be made on credit with only \$2 000 being cash. Coen estimates that the cost of sales will be 50% of the total sales and that the stock on hand at end will be \$8 000. He should earn \$1 000 in discounts for prompt payment of his accounts. At the end of the first month creditors are expected to be owed \$4 000. Coen is anticipating a stock loss of 1% of cost of sales.

### Required

- 2.1.1** Reconstruct the Debtors Control accounts in order to calculate budgeted receipts from Debtors for the month of July 2008.

### Solution 2.1.1

#### DEBTORS CONTROL

| Date<br>2008 | Cross Reference | \$            | Date<br>2008 | Cross Reference | \$            |
|--------------|-----------------|---------------|--------------|-----------------|---------------|
| July31       | Credit Sales    | 12 000        | July31       | Bad Debts       | 240           |
|              |                 |               |              | Discount Exp    | 500           |
|              |                 |               |              | Bank            | 10 260        |
|              |                 | _____         |              | Balance         | <u>1 000</u>  |
|              |                 | <u>12 000</u> |              |                 | <u>12 000</u> |

**Receipts from Debtors \$ 10 260**

4 marks

### Mark allocation

- 4 marks for the correct response in the Receipts from Debtors box
- If not correct then instead award 1 mark for each correct entry in the table (ignoring Bank)
- Maximum 1 mark subtracted for alien entries

**2.1.2 Reconstruct** the Stock Control Account and the Creditors Control Account to **calculate** budgeted payments to creditors for the month of July 2008.

**Solution 2.1.2**

**STOCK CONTROL**

| <b>Date<br/>2008</b> | <b>Cross Reference</b> | <b>\$</b>     | <b>Date<br/>2008</b> | <b>Cross Reference</b> | <b>\$</b>     |
|----------------------|------------------------|---------------|----------------------|------------------------|---------------|
| July31               | Creditors Control      | 36 300        | July31               | Cost of Sales          | 30 000        |
|                      | Bank                   | 2 000         |                      | Stock Loss             | 300           |
|                      |                        | _____         |                      | Balance                | <u>8 000</u>  |
|                      |                        | <u>38 300</u> |                      |                        | <u>38 300</u> |

**CREDITORS CONTROL**

| <b>Date<br/>2008</b> | <b>Cross Reference</b> | <b>\$</b>     | <b>Date<br/>2008</b> | <b>Cross Reference</b> | <b>\$</b>     |
|----------------------|------------------------|---------------|----------------------|------------------------|---------------|
| July31               | Discount Revenue       | 1 000         | July31               | Stock Control          | 36 300        |
|                      | Bank                   | 31 300        |                      |                        |               |
|                      | Balance                | <u>4 000</u>  |                      |                        | _____         |
|                      |                        | <u>36 300</u> |                      |                        | <u>36 300</u> |

**Payments to Creditors \$ 31 300**

5 marks

**Mark allocation**

- 5 marks for the correct response in the Payments to Creditors box
- If not correct, then instead award marks for the following correct entries in the table: 1 mark for Cost of Sales, 1 mark for Stock Loss, 1 mark for Discount Revenue, 1 mark for Balances in both accounts, 1 mark for 36 300 in both accounts
- Maximum 1 mark subtracted for alien entries

**2.1.3 State** two reasons why the suppliers of Ellis Electrical would offer him a discount for prompt payment of his accounts.

**Solution 2.1.3**

|                                                                        |
|------------------------------------------------------------------------|
| <b>Reason 1</b> <i>Access the cash for alternative purposes</i>        |
| <i>Decrease administration costs associated with outstanding debts</i> |
| <b>Reason 2</b> <i>Decrease likelihood of Bad debts</i>                |
|                                                                        |

2 marks

**Mark allocation**

- 1 mark per correct response

**Tips**

- *As the question only asks you to 'State', there is no need for detailed responses.*

**2.1.4 Explain** one negative effect on the profitability of Ellis Electrical offering a discount for prompt payment of accounts.

**Solution 2.1.4**

|                                                                                                       |
|-------------------------------------------------------------------------------------------------------|
| <b>Explanation</b> <i>Discount expense is a reduction in inflows to the entity and therefore will</i> |
| <i>reduce the net profit of the business</i>                                                          |
|                                                                                                       |
|                                                                                                       |

2 marks

**Mark allocation**

- 1 mark for expense
- 1 mark for reduce net profit

**2.2** In addition to the above information Ellis Electrical also provided the following information regarding expectations for July.

- Wages are estimated to be \$800 of which half will be paid in July and half in August.
- Annual insurance will be paid on 3 July \$1 800.
- Rent for July is \$400. This is payable in August.

**Required**

**2.2.1 Prepare** the Budgeted Profit and Loss Statement for the month ended 31 July 2008.

**Solution 2.2.1**

**ELLIS ELECTRICAL**  
**BUDGETED PROFIT AND LOSS STATEMENT**  
**FOR THE MONTH ENDED 31 JULY 2008**

| <b>Expected Revenue</b>        | <b>\$</b>  | <b>\$</b>            |
|--------------------------------|------------|----------------------|
| <i>Sales</i>                   |            | <i>60 000</i>        |
| <i>Less Cost of Goods Sold</i> |            |                      |
| <i>Cost Of Sales</i>           |            | <u><i>30 000</i></u> |
| <i>GROSS PROFIT</i>            |            | <i>30 000</i>        |
| <i>Less Stock Loss</i>         |            | <u><i>300</i></u>    |
| <i>ADJUSTED GROSS PROFIT</i>   |            | <i>29 700</i>        |
| <i>Add other Revenue</i>       |            |                      |
| <i>Discount Revenue</i>        |            | <u><i>1 000</i></u>  |
|                                |            | <i>30 700</i>        |
| <i>Less other Expenses</i>     |            |                      |
| <i>Bad Debts</i>               | <i>240</i> |                      |
| <i>Discount Expense</i>        | <i>500</i> |                      |
| <i>Wages</i>                   | <i>800</i> |                      |
| <i>Insurance</i>               | <i>150</i> |                      |
| <i>Rent</i>                    | <i>400</i> | <u><i>2 090</i></u>  |
| <i>NET PROFIT</i>              |            | <u><i>28 610</i></u> |
|                                |            |                      |

7 marks

**Mark allocation**

- 1 mark for Sales and Less Cost of Goods Sold title (No abbreviations as it is a report)
- 1 mark for Cost of Sales and Gross Profit
- 1 mark for Less Stock Loss and Adjusted Gross Profit
- 1 mark for Add other Revenue and Discount Revenue with the subtotal
- 1 mark for Bad debts and Discount Expense
- 1 mark for Wages and Rent
- 1 mark for Insurance
- 1 mark subtracted if the report is not finished off correctly and net profit calculated.
- 1 mark subtracted for alien entries

**2.2.2 Prepare** an extract from the Budgeted Statement of Cash Flows to show the Cash Flow from Operations for the month ended 31 July 2008.

**Solution 2.2.2****ELLIS ELECTRICAL****EXTRACT FROM BUDGETED STATEMENT OF CASH FLOWS****FOR THE MONTH ENDED 31 JULY 2008**

| <b>Cash Flow from Operating Activities</b> | <b>\$</b>             | <b>\$</b>              |
|--------------------------------------------|-----------------------|------------------------|
| <i>Inflows – Receipts from debtors</i>     | <i>10 260</i>         |                        |
| <i>Cash Sales</i>                          | <i><u>48 000</u></i>  | <i>58 260</i>          |
| <i>Outflows – Payments to creditors</i>    | <i>(31 300)</i>       |                        |
| <i>Stock</i>                               | <i>(2 000)</i>        |                        |
| <i>Wages</i>                               | <i>(400)</i>          |                        |
| <i>Prepaid Insurance</i>                   | <i><u>(1 800)</u></i> | <i><u>(35 500)</u></i> |
| <b>NET CASH FROM OPERATING ACTIVITIES</b>  |                       | <i>22 760</i>          |
|                                            |                       |                        |

6 marks

**Mark allocation**

- 1 mark for each item
- 1 mark subtracted for not indicating inflows and outflows (either with a title, brackets or both)
- 1 mark subtracted for not completing the report with 'Net Cash from Operating Activities'
- 1 mark subtracted for alien entries

- 2.3** After asking his accountant to evaluate his plans for the first month, Coen is concerned that his Cash Flow Ratio (Net Cash Flow from Operating Activities / Average Current Liabilities) of 10 times per month may not be satisfactory for his business.

### Required

- 2.3.1** **Explain** what is meant by 'liquidity' and **explain** how the Cash Flow Ratio is an indicator of liquidity.

#### Solution 2.3.1

|                                                                                                                                                                                                                                                           |
|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Explanation</b> <i>Liquidity refers to the ability of a business to meet short term financial commitments when they fall due.</i>                                                                                                                      |
| <i>The CFR indicates the number of times in a period the Net Cash Flow from Operations is able to cover average current liabilities. If it can generate sufficient cash then it will not require investing or financing activities to meet its debts.</i> |
|                                                                                                                                                                                                                                                           |

3 marks

### Mark allocation

- 1 mark for 'short term debts'
- 1 mark for 'when they fall due'
- 1 mark for explanation of the ratio

- 2.3.2** Other than the Working Capital Ratio, **state** two other **liquidity ratios** that Coen may be able to refer to in order to assess his liquidity.

#### Solution 2.3.2

|                                                |
|------------------------------------------------|
| <b>Liquidity Ratio 1</b> <i>Quick Asset</i>    |
| <b>Liquidity Ratio 2</b> <i>Interest Cover</i> |

2 marks

### Tips

- *Given the limitations of the study design these are the only answers covered by the course.*

- 2.4** After 2 months of rapid growth Ellis Electrical was able to present the following information in order to evaluate the profitability of the business for July and August 2008.

|                             | July     | August   |
|-----------------------------|----------|----------|
| Sales                       | \$50 000 | \$80 000 |
| Gross Profit                | \$30 000 | \$50 000 |
| Net Profit                  | \$20 000 | \$36 100 |
| Average Total Assets        | \$50 000 | \$95 000 |
| Return On Assets (NP/Av TA) | 40%      | 38%      |
| Net Profit Ratio (NP/Sales) | 40%      | 45%      |

**Required**

**2.4.1 Explain** what the Return on Assets ratio measures and **discuss** the trend in the ratio from July to August.

**Solution 2.4.1**

|                                                                                                      |
|------------------------------------------------------------------------------------------------------|
| <b>Explanation</b> <i>This ratio indicates that the business generated 38cents of net profit for</i> |
| <i>every dollar invested in average total assets during the month. This shows the</i>                |
| <i>business is less profitable as they are using their assets less effectively</i>                   |
|                                                                                                      |

2 marks

**Mark allocation**

- 1 mark for the explanation of the ROA ratio
- 1 mark for identifying decrease in profitability

**2.4.2 Explain** why the Return on Assets is decreasing given that the Net Profit Ratio is increasing.

**Solution 2.4.2**

|                                                                                            |
|--------------------------------------------------------------------------------------------|
| <b>Explanation</b> <i>Because the average total assets is increasing at a greater rate</i> |
| <i>proportional to the Net Profit</i>                                                      |
|                                                                                            |
|                                                                                            |

2 marks

**Mark allocation**

- 1 mark for ATO is increasing
- 1 mark for identifying that it is at a greater rate than Net Profit.

**2.4.3 State** one strategy that Ellis Electrical could adopt in order to improve the Return on Assets without changing its Net Profit Ratio.

**Solution 2.4.3**

|                                                                                                    |
|----------------------------------------------------------------------------------------------------|
| <b>Strategy</b> <i>Sell inefficient assets, generate more sales with the assets on hand or buy</i> |
| <i>more efficient assets</i>                                                                       |

1 mark

**Mark allocation**

- 1 mark for any of the above

**2.4.4 State** two strategies Coen could adopt to improve his Net Profit Ratio.

**Solution 2.4.4**

|                                                                    |
|--------------------------------------------------------------------|
| <b>Strategy 1</b> <i>Increase GPR via increase mark up</i>         |
| <b>Strategy 2</b> <i>Increase expense control to cut out waste</i> |

2 marks

**Mark allocation**

- 1 mark for each strategy

**Tips**

- *Students are required to state more than just ‘increase Gross Profit’ or ‘decrease expenses’.*

**2.4.5 Complete** the (extract of) Profit and Loss Variance report in the answer booklet.

**Solution 2.4.5**

|             | <b>Actual</b> | <b>Budget</b> | <b>Variance</b> | <b>F/U</b> |
|-------------|---------------|---------------|-----------------|------------|
| Sales       | 80 000        | 75 000        | 5 000           | F          |
| Advertising | 3 000         | 4 000         | 1 000           | F          |

2 marks

**Mark allocation**

- 1 mark per line

**2.5** Although Coen has been advised that his profitability for each month is excellent, he is not happy with the return he is receiving from the business.

**Required**

**2.5.1 Explain** one possible reason why Coen may be unhappy with the profitability of the business.

**Solution 2.5.1**

|                                                                                             |
|---------------------------------------------------------------------------------------------|
| <b>Explanation</b> <i>The hours worked to generate these returns may be very long and</i>   |
| <i>unsustainable. He may need to employ another staff member which will decrease his</i>    |
| <i>Profitability and perhaps further complicate the business.</i>                           |
| <i>The growth may be unsustainable as the market gets flooded by himself or competition</i> |

2 marks

**Tips**

- *A sound explanation will gain two marks, however, it should be recognized that these ratios are for one month and are likely to represent a very high return for the year. Therefore reference to alternative investments will require significant explanation.*
- *Sometimes a question may not have a clearly correct answer. These are often the questions students should spend a little more time on.*

**2.5.2 State** three items of non financial information that could be used by Ellis Electrical to assess their relationship with customers.

**Solution 2.5.2**

|                                                    |                              |
|----------------------------------------------------|------------------------------|
| <b>Item 1</b> <i>Number of repeat customers</i>    | <i>Customer surveys</i>      |
| <b>Item 2</b> <i>Number of Sales Returns</i>       | <i>Attitude of customers</i> |
| <b>Item 3</b> <i>Number of Customer complaints</i> |                              |

3 marks

**Mark allocation**

- 1 mark per item (must not refer to amount, therefore, to just state ‘Sales Returns’ would be incorrect as this could be assumed to be the dollar amount)

**Tips**

- *It is hoped that by asking for three items, students who understand this area will be able to respond with ease, whereas students hoping to memorize possible answers may be caught out.*

Total 45 marks

**END OF SOLUTIONS**