

COMMERCE PRESENTATIONS AND PUBLICATIONS



VCE ACCOUNTING 3/4

CPAP Practice Examination No 1 2019

SUGGESTED SOLUTIONS & ADVICE

Question 1 – Rashida’s Roller Skates (6 marks)

- a. Referring to the definition of an asset, distinguish between the asset of inventory and equipment.

2 marks

Advice: The VCE Accounting Study Design for the accreditation period 2019 to 2023 defines a current asset as cash and other types of assets held primarily for the purpose of sale or trading, or are reasonably expected to be converted to cash, sold or consumed by a business within 12 months after the end of the reporting period. Similarly, non-current assets are defined as assets expected to be used by the business entity for a number of years and are not held for resale.

A key skill of Unit 3 Outcome 1 is to distinguish between current and non-current assets and current and non-current liabilities. Students not only need to commit to memory the definitions of all of the accounting elements, but they need to apply key parts of each definition to the item they are explaining rather than providing the entire definition. For example, accounts receivable outstanding balances would be classified as a current asset as they are reasonably expected to be converted to cash within 12 months after the end of the reporting period. In contrast, a prepayment for annual rent would also be classified as a current asset as it is reasonably expected to be consumed by the business within 12 months after the end of the report period.

Sample Answer: Inventory is a current asset as it is held primarily for the purpose of sale or trading by the business within 12 months. (1 mark)

Whereas, Equipment is a non-current asset as it is expected to be used by the business for a number of years and is not held for resale. (1 mark)

- b. Justify, with the use of one example, how the Balance Sheet satisfies the accrual basis assumption.

2 marks

Advice: Another set of definitions that students need to commit to memory are the four accounting assumptions and the six qualitative characteristics outlined in the Study Design. This is an example of a question where students are provided with an assumption or a characteristic and are required to apply their knowledge of the assumption or characteristic to an item included in an accounting report.

Sample Answer: Under the accrual basis assumption, expenses are recognised when they are incurred. (1 mark)

The Accrued Advertising expense is reported on the Balance Sheet as it was an expense incurred during the period ended 31 December 2019 even though it remains unpaid. (1 mark)

- c. Prepare the two transfer entries required in the General Journal on 31 December 2019.

Narrations are not required.

2 marks

General Journal

Date	Details	Debit	Credit
31/12	Capital	4 090	
	Profit and Loss Summary		4 090
	Capital	2 500	
	Drawings		2 500

1 mark – Capital and Profit and Loss Summary entries

1 mark – Capital and Drawings entries

Advice: The words 'two' and 'transfer' are the key terms in helping students determine what is required by this question. Revenue and expense accounts are required to be closed at the end of the period. Whereas, the result determined in the Profit and Loss Summary account and the balance of Drawings are required to be transferred to the Capital account.

Question 2 – Foley's Flags (9 marks)

a. Define the term net realisable value and state one reason why the net realisable value of the 6 'Winx' flags has fallen below their original cost price.

2 marks

Advice: This question has been designed to test students in a number of ways. The first way was to test whether the student is able to provide a definition of the term net realisable value. The second way was to test student's knowledge of an applicable reason as to why the 6 flags net realisable value has fallen below their original cost price. As the items in question are flags, it would be inappropriate for a student to state that the flags have become technologically obsolete or that they have been superseded by the release of a new model. Students need to be careful not to provide the first reason that comes to mind, but rather provide the best reason that applies to the unit of inventory in question.

***Sample Answer:** The term net realisable value is the estimated selling price (excluding GST) less any costs incurred in the marketing, selling and distribution of the item. (1 mark) A reason why the net realisable value of the 6 'Winx' flags has fallen below their original cost price as they could have been damaged or it is a deliberate marketing strategy to attract customers. (1 mark)*

b. Calculate the Adjusted Gross Profit from the sale of the 'Winx' flag for January 2019.

5 marks

Sales	\$500	(1 mark)
Less: Sales Returns	\$150	(1 mark)
Less: Cost of Sales	\$108	(1 mark)
Plus: Inventory Gain	\$20	(1 mark)
Less: Inventory Write Down	\$78	(1 mark)
Adjusted Gross Profit	\$184	

Advice: Student knowledge of Accounting Report templates are crucial for exam success. Students are encouraged to label all calculations and show their workings to maximise the allocation of marks should their Adjusted Gross Profit figure not equal \$184.

c. Explain the benefit of reporting an Adjusted Gross Profit in an Income Statement.

2 marks

Advice: Not only do students need to know how to record various transactions and prepare Accounting Reports, they need to be able to explain or provide reasons as to why accountants do or not do certain things.

***Sample Answer:** The benefit of reporting an Adjusted Gross Profit in an Income Statement is that it allows the management of inventory to be assessed from one period to the next. (1 mark)*

The Income Statement will highlight the result of a physical inventory count and allow corrective action to be taken to reduce the likelihood of inventory losses or gains and inventory write downs. (1 mark)

Question 3 – Winona’s Warehouse (27 marks)

a. Record the transactions from 15 February and 16 February in the General Journal of Winona’s Warehouse.

Narrations are not required.

6 marks

General Journal

Date	Details	Debit	Credit
15/02	Bank	30 000	
	Loan – MNC Bank		30 000
16/02	Forklift	26 400	
	Prepaid Service Agreement	600	
	GST Clearing	2 700	
	Bank		29 700

1 mark – per line entry

Advice: A key knowledge dot point in Unit 4 Outcome 1 is the purchase of non-current depreciable assets for cash and financed by a loan. This question requires students to record both of these transactions. The initial borrowing of the funds as identified by the Bank Statement and the invoice provided by the supplier of the forklift. The recording of a purchase of a non-current depreciable asset generally requires one additional amount to be included in the cost of the asset, such as the \$500 delivery fee, whilst another additional amount, such as the 12-month service agreement, is required to be reported as a Current Asset and labelled ‘Prepaid’.

b. Referring to your answer in part a., explain your treatment of the 12-month service agreement in determining the cost price of the forklift.

2 marks

Advice: As outlined above, the purchase of a non-current depreciable asset generally requires one additional amount to be included in the cost of the asset and another additional amount excluded entirely. One error students make when explaining how they determined the cost price of a non-current depreciable asset relates to the way they incorporate the language used to describe *product costing* and *period costing*. These terms relate to determining the cost price of an inventory item and NOT determining the cost price of a non-current depreciable asset.

Sample Answer: *As the 12-month service agreement is not a cost incurred in getting the Van into a condition or location ready for use that will provide a benefit for the life of the asset, it is not included in the cost of the Van. (1 mark)*

Rather, the 12-month service agreement was recorded separately and reported as a Prepaid Service Agreement under the heading Current Assets on the Balance Sheet. (1 mark)

- c. **State one advantage and one disadvantage of Winona's Warehouse only having a small amount of inventory on hand at any point in time.**

2 marks

Advice: The 2019 VCAA Sample exam (accessible here:

<https://www.vcaa.vic.edu.au/Documents/exams/account/2019/2019acct-w.pdf>) required students to state two advantages and two disadvantages of reducing inventory on hand for a total of four marks. This was an unusual approach as students are generally required to discuss whether a business should reduce inventory on hand. Accordingly, students should be prepared to discuss both the advantages and disadvantages of reducing inventory.

Advantage

- reduced storage costs
- reduced likelihood of inventory write downs

Disadvantage

- loss of potential sales
- increased cartage inwards costs

1 mark – one advantage

1 mark – one disadvantage

- d. **Record receipt 2387 in the General Journal of Winona's Warehouse.**

A narration is not required.

2 marks

General Journal

Date	Details	Debit	Credit
18/02	Bank	1 100	
	Unearned Sales Revenue		1 100

1 mark – per line entry

- e. **Explain how internal controls can be used to improve the accounting process of Winona's Warehouse. Use a specific example in your response.**

2 marks

Advice: A key knowledge dot point for Unit 3 Outcome 1 is internal control procedures to safeguard resources against theft and fraud. Interestingly, the same dot point appears in Unit 1 Outcome 1. The inclusion of bank statements in the documents for a business in the Study Design suggests that bank statements can be referred to as an appropriate method for internal control.

Sample Answer: Internal control refers to the procedures and strategies used to protect a business' assets from theft, damage and misuse. **(1 mark)**

Examples of Internal Control **(1 mark)**

- payments should not be made directly from the cash register / cash in registers should be verified against the cash register roll

- cash should not be kept on the premises / takings should be banked at least daily
- accurate and up-to-date cash records must be kept / regular bank reconciliations should be made
- physical protection of assets
- separation of duties / rotation of duties
- security measures to protect inventory such as employees, video monitors and security tags

f. Record invoice 1017 in the General Journal of Winona's Warehouse.

2 marks

General Journal

Date	Details	Debit	Credit
20/02	Inventory	5 000	
	GST Clearing	500	
	Accounts Payable – Vandelay Industries		5 500

1 mark – Inventory and GST Clearing entries

1 mark – Accounts Payable – Vandelay Industries entry

g. Explain why Winona's Warehouse would be better suited using the First In, First Out cost assignment method instead of the Identified cost assignment method.

2 marks

Advice: The addition of the Identified cost assignment method to the Study Design raises the potential for many comparison questions. Students need to be prepared to explain which method should or could be adopted by businesses selling different types of inventory items.

Sample Answer: *Winona's Warehouse would be better suited using the First In, First Out cost assignment method given the quantity of units they purchase as this method allocates the cost prices of the items sold in the order they are purchased. (1 mark)*

Whereas using the identified cost assignment method, Winona's Warehouse is required to code each unit of inventory with its original cost price which is a timely and expensive process and may be impractical or impossible to accurately do so. (1 mark)

h. Record invoice 183 in the General Journal of Winona's Warehouse.

5 marks

General Journal

Date	Details	Debit	Credit
24/02	Sales		4 800
	GST Clearing		480
	Unearned Sales Revenue	1 100	
	Accounts Receivable – Harbour View Hotel	4 180	
	Cost of Sales	2 380	
	Inventory		2 380

1 mark – per line entry (except Cost of Sales and Inventory entries allocated 1 mark in total)

Advice: If students are presented with an invoice and asked to record it in the General Journal they would list the five accounts effected. However, the inclusion of a deposit complicates the amounts to be recorded and adds the Unearned Sales Revenue account to the five accounts normally used to record an Invoice. A complication to this question is that instead of the sales details being provided and the deposit being deducted, it is the amount of the deposit and the final amount owing on the invoice that are provided. These two amounts are required to be added together to get the sales including GST amount. Again, students should be prepared for these types of complications in the exam.

i. Explain why the value of the 'Early Riser' alarm clock reported in the Balance Sheet may be higher using the First In, First Out cost assignment method compared to the Identified cost assignment method.

2 marks

Advice: As outlined previously, the addition of the Identified cost assignment method to the Study Design raises the potential for many comparison questions. Not only do students need to be able to explain what each of the methods are and why they are better suited to specific types of trading businesses, they need to be able to explain how the use of the two methods can effect the reports. The 2019 VCAA Sample Exam presents students with a visual representation of a comparison between the two methods. It is important to note that, when asked to explain the effect on a Balance Sheet, students should always address the two-fold effect on the accounting equation.

Sample Answer: *As the supplier's prices are rising, under the First In, First Out cost assignment method, the older, cheaper unit costs are allocated as an expense in the order they are purchased. (1 mark)*

This results in the most recent, more expensive unit costs being reported on the Balance Sheet using FIFO. In comparison, the specific cost prices under the Identified Cost assignment method remain on hand at the end of the period which could be a combination of the cheaper and most recent cost prices resulting in a lower overall inventory valuation on the balance sheet. (1 mark)

j. Explain one ethical issue Winona should consider before making her final decision.

2 marks

Advice: The Study Design introduces the concept of ethical considerations and outlines that business decisions made by the owner will not only be influenced by financial considerations, but also includes those which are social and environmental in nature. Further to this, dot points throughout Units 3 and 4 make reference to ethical considerations when making business decisions in relation to operating a trading business, recording and reporting accounting information and strategies used to improve business performance. It is recommended that any response to a question involving an ethical consideration begins with an attempt to demonstrate an understanding of the concept (e.g. via the provision of a definition) before addressing the key requirements of the question (i.e. explain the possible or potential impact on society and the environment).

Sample Answer: *Ethical considerations refer to the impact choices made by the business have on society and the environment. (1 mark)*

By choosing to introduce self-service barcode checkouts in her warehouse, this would most likely result in employee redundancies which would have a negative impact on her local community both emotionally and economically. (1 mark)

Question 4 – Gurveen’s Garments (15 marks)

a. Calculate the depreciable value of the Van.

1 mark

\$40 000

Advice: This question has been entirely based on the inclusion of the term ‘non-current depreciable non-current asset’ in the Study Design. It is a reasonable expectation that any term included in the Study Design can be examined. Therefore, the depreciable value of the Van is the cost of the asset excluding GST less its estimated residual value.

b. Justify why Gurveen should have chosen Option 2.

2 marks

Advice: While it is clear that students need to calculate depreciation expense using both depreciation methods, it is important that students are in a position to justify why certain depreciation methods are suited to certain types of assets. Typically, students believe that whether or not an asset has moving parts is the determining factor in deciding which depreciation method is to be used. However, students need to appreciate that it is the *expected revenue earning pattern* of the asset that should be used as the basis for justifying the choice of depreciation method.

Sample Answer: As the Van is expected to be more productive in its earlier years and therefore generate more revenue in those periods, **(1 mark)** Gurveen should have adopted the reducing balance method.

The reducing balance method allocates more of the depreciable amount in the earlier years and less in the Van’s later years, when it is less productive and therefore matches the Van’s revenue earning pattern with the allocation of the expense. **(1 mark)**

- c. Prepare all the necessary General Journal entries required on 30 June 2021 in relation to the Van.

Closing entries and narrations are not required.

10 marks

General Journal

Date	Details	Debit	Credit
30/06	Depreciation – Van	10 000	
	Accumulated Depreciation - Van		10 000
	Van	50 000	
	Disposal of Van		50 000
	Accumulated Depreciation – Van	30 000	
	Disposal of Van		30 000
	Bank	25 000	
	Disposal of Van		25 000
	Disposal of Van	5 000	
	Profit on Disposal - Van		5 000

1 mark – per line entry

Advice: When recording the disposal of a non-current asset, the asset needs to be depreciated up until the date of disposal. However, when students are asked to record the General Journal entries relating to the purchase and disposal of a non-current asset, it is recommended that students sketch the necessary General Ledger accounts, namely the Disposal of Van account. This can facilitate an easier identification of the entries requiring a debit entry and those requiring a credit entry.

- d. Referring to your answer in part c., explain why a profit or loss from the sale of the Van occurred.

2 marks

Advice: A common and predictable question that follows when an asset is sold (or traded-in) is whether or not the business made a profit or a loss. Students need to tailor their responses to the profit or loss calculated previously in the question. If the business made a profit, then the response needs to explain why the business made a profit (e.g. the asset was depreciated by too much). In contrast, if the business made a loss then the response needs to explain why the business made a loss (e.g. the asset was not depreciated by enough).

Sample Answer: A profit on disposal of the Van occurred as the proceeds received from the sale of the Van was more than it's carrying value. (1 mark)

This was due to over-depreciating the Van due to under-estimating the Van's useful life or residual value. (1 mark)

Question 5 – Bailey’s Books (7 marks)

a. State the trend in the Inventory Turnover.

1 mark

Advice: On page 10 of the Study Design refers to each of the *financial indicators* that can be used to measure business performance in relation to profitability, liquidity and stability. The Study Design prescribes both the way that each of the *financial indicators*, should be expressed, as well as how the change or trend in each of the indicators are to be described. Students are advised to use the descriptions (increase, decrease, faster or slower) appropriately. As illustration, the 2019 VCAA Sample Exam requires students to describe and state the trends of the Inventory Turnover, Accounts Receivable Turnover and Accounts Payable Turnover indicators.

b. Discuss one strategy to improve the Accounts Receivable Turnover.

3 marks

Suggested Approach

1 mark – identification of strategy

1 mark – advantage of strategy

1 mark – disadvantage of strategy

Sample Answer:

One strategy Bailey could introduce to improve the Accounts Receivable Turnover would be to increase the discount for prompt payment. (1 mark)

An advantage of increasing the discount for prompt payment is that it is likely that more Accounts Receivable balances will be repaid faster. (1 mark)

However, a disadvantage of increasing the discount offered for prompt payment is that it is likely that it would result in an increase in Discount Expense which would decrease the profit. (1 mark)

c. Explain the effect of the trend in the Accounts Payable Turnover on the liquidity of the business.

2 marks

Sample Answer: The trend in the Accounts Payable Turnover indicates that the liquidity of Bailey’s Books is improving as the outstanding Accounts Payable balances are being paid faster. (1 mark)

However, this may also have a negative impact on liquidity as the Accounts Payable balances are being paid well within the credit terms of 21 days without taking advantage of the discount terms which may make it difficult to repay other short-term debts as they fall due. (1 mark)

d. State one other benchmark Bailey could use to assess the liquidity of his business.

1 mark

Advice: The purpose of this question is to test student’s knowledge of the difference between an indicator and a benchmark. Some students may provide the Working Capital Ratio or the Quick Asset Ratio as their response. However, these are likely to be marked as incorrect, as these are indicators of liquidity and not a benchmark. The other key word in this question is ‘other’. Students are required to provide another benchmark not specified in the question. As the question provides dates from 2017 to 2019, a student who provides ‘previous reporting periods’ are also likely to be penalised.

Sample Answer:

- Industry Averages or other Similar Businesses
- Budget Estimates or Predicted Results

Question 6 – Kimberley’s Kettles (21 marks)

- a. Reconstruct the Accounts Receivable ledger in order to calculate budgeted Receipts from Accounts Receivable for the year ended 30 June 2020.**

3 marks**Accounts Receivable**

Date	Cross-reference	Amount	Date	Cross-reference	Amount
	Balance	12 650		Bank	224 250
	Credit Sales	210 000		Sales Returns	4 000
	GST Clearing	21 000		GST Clearing	400
				Balance	15 000
		243 650			243 650

1 mark – Opening Balance and Closing Balance

1 mark – Credit Sales and GST Clearing

1 mark – Sales Returns and GST Clearing

- b. Reconstruct the Accounts Payable ledger in order to calculate budgeted Payments to Accounts Payable for the year ended 30 June 2020.**

3 marks**Accounts Payable**

Date	Cross-reference	Amount	Date	Cross-reference	Amount
	Bank	186 300		Balance	19 800
	Discount Revenue	5 000		Inventory	165 000
	Balance	10 000		GST Clearing	16 500
		201 300			201 300

1 mark – Opening Balance and Closing Balance

1 mark – Inventory and GST Clearing

1 mark – Discount Revenue

Advice: Templates! Templates! Templates! These are common exam questions that require the careful reading of questions during reading time, where difficult concepts need to be identified and applied to the scenario presented. Only a careful reading of the examination question(s) will ensure that full marks are awarded for these types of reconstruction questions.

c. Prepare the Budgeted Cash Flow Statement for the year ended 30 June 2020.

13 marks

Kimberley's Kettles

Budgeted Cash Flow Statement for the year ended 30 June 2020

	\$	\$
Cash Flow from Operating Activities		
Cash Sales	90 000	
GST Collected	9 000	
Unearned Sales Revenue	3 000	
Receipts from Accounts Receivable	224 250	
Payments to Accounts Payable	(186 300)	
Advertising	(18 000)	
General Expenses	(25 000)	
Interest Paid	(2 000)	
Prepaid Rent Expense	(31 680)	
Wages	(38 000)	
GST Settlements	(3 292)	
GST Paid	(9 468)	
Net Cash from Operations		12 510
Cash Flow from Investing Activities		
Purchase of Equipment	(20 000)	
Net Cash from Investing Activities		(20 000)
Cash Flow from Financing Activities		
Capital	15 000	
Drawings	(30 000)	
Loan Repayments – MNC Bank	(8 000)	
Net Cash from Financing Activities		(23 000)
Net Increase (Decrease) in Cash		(30 490)
Bank Balance – 1 July 2019		38 650
Bank Balance – 30 June 2020		8 160

- 1 mark** – Cash Sales and GST Collected
- 1 mark** – Unearned Sales Revenue
- 1 mark** – Receipts from Accounts Receivable and Payments to Accounts Payable
- 1 mark** – Advertising
- 1 mark** – General Expenses, GST Paid and GST Settlements
- 1 mark** – Interest Paid
- 1 mark** – Prepaid Rent Expense
- 1 mark** – Wages
- 1 mark** – Purchase of Equipment
- 1 mark** – Capital
- 1 mark** – Drawings
- 1 mark** – Loan Repayments – MNC Bank
- 1 mark** – Final 3 lines

Advice: Students should always remember that the rules of accrual accounting still apply when budgeted reports are prepared. The completion of a budgeted report, or extract, requires the same skill set for that needed to complete a report at the end of a reporting period.

d. Referring to the timeliness qualitative characteristic, explain the limitation of Kimberley using a Cash Variance Report as a basis for decision-making.

2 marks

***Sample Answer:** The qualitative characteristic of timeliness requires having information available to decision makers in time to be capable of influencing their decisions. (1 mark)*

As Kimberley prepares reports on an annual basis, given that the Cash Variance Report would only be prepared after the year ended 30 June each year, there would be a time delay in identifying problem areas and any corrective action required may be too late to rectify the issue. (1 mark)

Question 7 – Tania’s Tents (9 marks)

- a. Complete the Allowance for Doubtful Debts account in the General Ledger as at 31 December 2019.**

4 marks**Allowance for Doubtful Debts**

Date	Cross-reference	Amount	Date	Cross-reference	Amount
31/12	Accounts Receivable	900	01/07	Balance	840
	Balance	1 090	31/12	Bad debts	1 150
		1 990			1 990
			01/01	Balance	1 090

1 mark – per entry**1 mark** – balancing account

Advice: The introduction of the creation of an allowance for doubtful debts using the Income Statement approach, and the writing off of bad debts using the allowance method in the subsequent period, has provided both teachers and students alike with confusion. A recommendation to completing the Allowance for Doubtful Debts account in the General Ledger is to adopt a budgeting reconstruction approach to determine the Bad Debts amount. Record the Opening Balance first. Then write off any bad debts excluding GST by debiting the account. Then calculate what the closing balance of the Allowance for Doubtful Debts as at balance day needs to be.

- b. Calculate and explain the effect on the accounting reports of Tania’s Tents as at 31 December 2019 if the Van was depreciated using the straight-line method instead of using the reducing balance method at a rate of 30% per annum.**

5 marks

Advice: Students should expect a question relating to the use of alternative depreciation methods. As calculation details of both depreciation methods are provided in the question, students are required to refer to any differences in the amounts of depreciation expense under both methods. It is recommended that students include amounts when asked to explain the effect on a report. This is even more evident if a 'Working Space' is provided.

Sample Answer: In the Income Statement for the period ended 31 December 2019 the profit would be \$585 higher as depreciation expense would lower. (1 mark)

Under the straight-line method the depreciation expense would be \$3 750 as opposed to the \$4 335 for the period ended 31 December 2019 using the reducing balance method. (1 mark)

On the Balance Sheet as at 31 December 2019 the assets and the owner’s equity would be \$4 185 higher. (1 mark)

Under the straight-line method the carrying value of the Van would be \$28 750 as opposed to the \$24 565 reported under the reducing balance method. (1 mark)

Whereas, as depreciation does not represent a movement of cash there would be no effect on the Cash Flow Statement for the period ended 31 December 2019. (1 mark)

Workings for Income Statement

Straight-Line Method

$$\frac{\$40\,000 - \$10\,000}{4} = \$7\,500 \text{ per annum}$$

$$\frac{\$7\,500}{2} = \$3\,750 \text{ for six months ending 31 December 2019}$$

Reducing Balance Method

$$(\$40\,000 - \$11\,100) \times 30\% = \$8\,670 \text{ per annum}$$

$$\frac{\$8\,670}{2} = \$4\,335 \text{ for six months ending 31 December 2019}$$

Workings for Balance Sheet

Straight-Line Method

$$\$40\,000 - (\$7\,500 + \$3\,750) = \$28\,750$$

Reducing Balance Method

$$\$40\,000 - (\$11\,100 + \$4\,335) = \$24\,565$$

Question 8 – Eleni's Electronics (6 marks)

Discuss the effects that the trend in the Debt Ratio has had on Eleni's Electronics.

Advice: Although this is the first year of the new Study Design, statistics from previous VCAA Assessor Reports highlight the difficulty that students have experienced in their attempts to achieve full marks for questions relating to the *Debt Ratio*. A recent trend in VCAA exams is to provide students with multiple financial indicators and ask students to explain the potential relationships or causes and effects between the indicators provided. As the current question requires students to explain *the effects that the increase in the Debt Ratio has had* on three other financial indicators, students could reasonably break the question up into the following 2 mark questions:

1. Discuss the relationship between an increase in the Debt Ratio and a decrease in the Cash Flow Cover.
2. Discuss the relationship between an increase in the Debt Ratio and an increase in the Return on Assets.
3. Discuss the relationship between an increase in the Debt Ratio and an increase in the Asset Turnover.

This approach can help to provide students with a framework to structure their responses. A model approach would also include an explanation of what each of the indicators measures, whether the trend is favourable or unfavourable, followed by discussion of the impact on the business.

- Teachers should firstly assess student responses based on their understanding of each of the indicators provided.
- In order to be allocated further marks, students must be able to explain the consequences of the change in the Debt Ratio and the impact on each of the other three indicators.

Suggested Response: *The Debt Ratio has increased between 2018 and 2019 as a larger percentage of the business' assets are financed by liabilities. In 2019, for every one dollar of assets, the business owed \$0.70 in liabilities. This has increased from \$0.50 of liabilities in 2018.*

The trend in the Cash Flow Cover is unfavourable as the business is only able to generate Net Cash Flows from Operations to cover Current Liabilities 9 times in 2019 compared to 15 times in 2018.

A higher Debt Ratio means the business has a greater reliance on borrowed funds. From a liquidity perspective, the increase in the Debt Ratio has seen a decline in the Cash Flow Cover. Due to the increase in borrowings, a larger proportion of the Net Cash Flows from Operations is being used to repay current liabilities, as reflected in the decrease in the Cash Flow Cover from 2018 to 2019. This can be due to a combination of an increase in interest paid on the borrowings reducing the Net Cash Flows from Operations and the increase in loan repayments increasing the Current Liabilities. This would make it more difficult for the business to meet other short-term debts such as payments to suppliers as they fall due. The Debt Ratio can also be used as a guide to assess the stability of a business. The increase in the Debt Ratio worsens the stability of the business as the business is viewed as being at risk of not being able to meet its debts and continue its operations in the long-term due to the cash flow pressures of loan and interest repayments.

The Asset Turnover profitability indicator is used to measure how productively the business has used its Assets to earn Sales. In 2019, 250% of the value of average assets have been generated as Sales. This is favourable when compared to the previous reporting period of 2018 when only 175% of the value of average assets have been generated as Sales. This improvement in the Asset Turnover may have been an indirect benefit of the increase in the Debt Ratio. The borrowings may have been used to purchase new more efficient revenue generating non-current assets, as reflected in the Asset Turnover result of 2019, meaning that Sales have increased by a greater percentage than the percentage increase in Assets.

The Return on Assets profitability indicator is used to measure how productively the business has used its Assets to earn Profit. In 2019, for every one dollar of average assets, the business has generated \$0.20 of Profit. This is favourable when compared to the previous reporting period of 2018 when, for every one dollar of average assets, the business generated \$0.175 of Profit. This improvement of the Return on Assets may have been as a result of the net profit increasing by a greater percentage than the percentage increase in average assets. Even though there has been an increase in interest expense, it is the increase in the Asset Turnover that resulted in an improved Net Profit Margin and an improved Return on Assets.

100 marks

END OF SOLUTIONS