



**YOU BE THE ASSESSOR: UNIT 3 AREAS OF STUDY 2**

**Question 1 (2018 VCAA June Exam Question 5 modified)**

**SAMPLE ANSWER A**

Using the information provided, prepare the General Journal entry to close expense accounts.

Narrations are not required.

**2 / 3 marks**

**General Journal**

Date	Details	Debit	Credit
31/07	Profit and Loss Summary		194 000 ✗
	Advertising	4 000 ✓	
	Cost of Sales	109 000 ✓	
	Rent Expense	13 000 ✓	
	Wages	68 000 ✓	

This student has unfortunately swapped all the entries around! There should be a debit of \$194 000 to the Profit and Loss Summary account and each expense account needs to be credited in the General Journal. If this entry was posted back into the General Ledger the expense account balances would be doubled and not returned to zero in readiness for the next period.

**SAMPLE ANSWER B**

Narrations are not required.

**3 / 3 marks**

**General Journal**

Date	Details	Debit	Credit
31/07	Profit and Loss Summary	194 000 ✓	
	Advertising		4 000 ✓
	Cost of Sales		109 000 ✓
	Rent Expense		13 000 ✓
	Wages		68 000 ✓

Show how the Profit and Loss Summary account and the Capital account would appear in the General Ledger after the closing entries were posted. No additional capital was contributed during the period.

You are not required to balance the accounts.

SAMPLE ANSWER A

3 / 6 marks

This student has not added the \$2 000 of Discount Revenue to the \$285 000 of Sales. But as the Expense Accounts entry has been recorded correctly, the subsequent calculation of profit is correct. However, it is the label 'Profit' which is deemed to be incorrect. The correct cross-reference is Capital.

**Profit and Loss Summary**

Date	Cross-reference	Amount	Date	Cross-reference	Amount
31/07	Expense Accounts	194 000 ✓	31/07	Revenue Accounts	285 000 ✗
31/07	Profit ✗	91 000 ✓			
		285 000			285 000

**Capital**

Date	Cross-reference	Amount	Date	Cross-reference	Amount
31/07	Drawings	38 000 ✓	01/07	Balance	297 000 ✗
			31/07	Profit and Loss Summary	91 000 ✓

This student has seen Capital of \$350 000 in the question and thought that the closing balance of Capital is \$350 000. However, the balance of Capital in the question is the opening balance, not the closing balance.

SAMPLE ANSWER B.

6 / 6 marks

**Profit and Loss Summary**

Date	Cross-reference	Amount	Date	Cross-reference	Amount
31/07	Expense Accounts	194 000 ✓	31/07	Revenue Accounts	287 000 ✓
31/07	Capital	93 000 ✓			
		287 000			287 000

**Capital**

Date	Cross-reference	Amount	Date	Cross-reference	Amount
31/07	Drawings	38 000 ✓	01/07	Balance	350 000 ✓
			31/07	Profit and Loss Summary	93 000 ✓

## Question 2

Using the information and data provided above, discuss the owner's belief that the business is now operating satisfactorily.

### SAMPLE ANSWER A

**2 / 6 marks**

D&B Traders has seen a decrease in their Net Cash from Operating Activities as the cash outflows relating to the day-to-day trading activities were greater than the cash inflows relating to the day-to-day trading activities.

D&B Traders has seen an increase in their Net Cash from Investing Activities as the cash inflows relating to the disposal of non-current assets were greater than the cash purchases of non-current assets. This would have been due to non-current assets being sold.

D&B Traders has seen an increase in their Net Cash from Financing Activities as the cash inflows relating to changes in their financial structure were greater than the cash outflows relating to changes in the financial structure. This would have been due to both the owner's \$60 000 capital contribution and the further loan borrowings.

Each of the above three sections simply outline the movement of cash for each of three sections of the Cash Flow Statement and provide a definition of what each section represents. In order to achieve further marks, the student needed to address the term 'discuss' in the question. Not only does this expect the student to describe each movement of cash, but an explanation of the positive and negative aspects as well. A better response would also include an explanation of any possible links between each of the three sections of the Cash Flow Statement.

As D&B Traders have a large positive cash balance and are reporting an increase in sales and a small profit, the business is operating satisfactorily now as the business' revenues earned are greater than the expenses incurred.

The final sentence is a satisfactory comment about the positive outcome of a Net Increase in Cash and the reporting of a small Net Profit. But what the student has failed to address is what it means for a business to be operating satisfactorily. This is a 'cash versus profit' question in disguise. A comment about whether an increase in cash translates into a satisfactory operating result was warranted.

### SAMPLE ANSWER B.

**6 / 6 marks**

The introduction of credit to customers resulting in an increase in sales and a small profit is a positive indication of the business' improved trading performance, especially after successive losses.

However, the owner believes that the improved cash position is the indicator that the business is now operating satisfactorily. But what the owner needs to understand is that just because there has been an increase in cash does not necessarily mean that the business is now operating satisfactorily. The owner would not only need to see an increase in profit, but report profits for at least two consecutive periods.

This student has raised the issue of what it means for a business to operate satisfactorily. They have identified that there is a difference between a satisfactory trading performance and an increase in cash.

From a cash flow perspective, a worrying result is the negative net cash from operations. Initially, the business would have difficulty expanding by purchasing additional non-current assets or providing the owner with drawings without taking out additional loans or further capital contributions. The owner would need to identify the contributing factors as to why the business has reported a negative net cash from operations. This may simply be a timing issue of Receipts from Accounts Receivable being delayed due to the credit terms offered to customers. Further to this, the business may have purchased a significant quantity of inventory in bulk at a cheaper unit price or invested in an advertising campaign which is expected to improve both the trading performance and cash position of the business in future periods.

This student has correctly applied the concept of 'discuss' to their response. They have explained both the negative and positive aspects of the decrease in Net Cash from Operations.

A misleading factor that the owner may view as a positive indicator of an improved trading performance is the increase in cash position. The only reason why the business was able to report an increase in cash was due to the positive cash from Financing Activities. As the owner had not taken any Drawings during the period and had made a capital contribution of \$60 000, the remainder of the cash inflow would have come from loan borrowings. This increase in loan borrowings could have a negative impact on the future profitability, liquidity and stability of the business. Further to this, the business has sold non-current assets. This could also have a detrimental effect on the trading performance of the business as their ability to generate revenue could be diminished.

This student has now addressed the negative aspects of the positive cash inflows from Investing and Financing activities. The owner may incorrectly view these positive net cash flows from Investing and Financing as a positive and a clear indication of the improved trading performance of the business.

### Question 3

**Discuss the profitability of Aime Traders, as shown by the data above**

#### **SAMPLE ANSWER A**

**3 / 6 marks**

Aime Traders' Return on Owner's Investment and Gross Profit Margin are above the industry average. These two results are favourable as Aime Traders are retaining more Gross Profit from each dollar of sales and are providing the owner a greater amount of profit from each dollar of capital invested compared to the industry.

However, Aime Trader's Return on Assets, their Asset Turnover and Net Profit Margin are below the industry average. These three results are unfavourable as Aime Traders' Assets are generating less Sales than competitors, are generating less profit than competitors, and are retaining less Net Profit from each dollar of sales.

Most of Aime Trader's profitability indicators are below their competitors which the owner would view as being unacceptable. However, the main profitability indicator the owner is most interested in is the Return on Owner's Investment. As Aime Trader's Return on Owner's Investment is above their competitors, the owner would view this as a favourable outcome.

As in Question 2, this student has made a series of accurate observations comparing the business' profitability indicators and those of the industry averaged. They have also briefly explained what each of the indicators measure. However, what they have neglected to do is provide connections between the indicators and analyse the impact of the Debt Ratio on the profitability of the business.

**SAMPLE ANSWER B.****5 / 6 marks**

Profitability measures the ability of the business to earn a profit compared to a base figure such as Sales, Assets and Owner's Equity.

A positive indicator of a business' profitability is the return the business can generate using the owner's capital. The Return on Owner's Investment indicator demonstrates that Aime Traders is generating a greater return than their competitors. This is an indicator that an owner is most interested in.

Further to this, Aime Traders' Gross Profit Margin is larger than their competitors. This indicates that they are retaining more Gross Profit from each unit of inventory they sell. This may be due to a selling price that is above competitors and/or Aime Traders are able to source their products from a cheaper supplier.

This student's response has started off very well. There is a clear definition of the concept of profitability and explanations of the favourable profitability indicators of Return on Owner's Investment and the Gross Profit Margin.

However, there are profitability indicators which do not compare Aime Traders favourably with their competitors. Aime Traders has a poor Return on Assets indicator compared to the industry average, indicating a poor profitability as the business' assets are not being used as efficiently to generate profit as other businesses.

The same can be said of Aime Traders' Asset Turnover. Even though the business' Gross Profit Margin is higher than the industry average, this has not translated into a higher Asset Turnover. Again, Aime Traders are not using their assets efficiently to generate as much Sales as other businesses.

A further indicator that supports that Aime Traders' profitability is poor compared to their competitors is the Net Profit Margin. The Net Profit Margin indicates that the business is retaining less profit from each dollar of sales. A concerning aspect of their profitability is that their Gross Profit Margin is above the industry average yet their Net Profit Margin falls below the industry average. The concern here is that Aime Traders' expense control is poor.

This student has now identified and explained the profitability indicators that are negative in nature. However, the connection that the student has failed to make is the correlation between a higher Debt Ratio and the higher Return on Owner's Investment. Any student going into the exam should have a prepared response explaining the relationship between an increase in the Debt Ratio and an expectation that the Return on Owner's Investment will also increase. An increase in Debt Ratio indicates a greater reliance on external debt and less reliance on the owner's capital. If a business' profit remains relatively constant, when compared to the owner's capital, it would see the profit represent a larger percentage of capital.