

FREE SAMPLE: THE FIRST 3 QUESTIONS

ANSWER ALL THREE QUESTIONS

36 marks in all

Answer ALL questions. Show the calculation for every measure. Use the formulae given. Where a question asks you to explain, say what the measure means, what changed, why it changed (use the information about the business), and what the owner should do.

Formula sheet

Percentage change = $(\text{this year's figure} - \text{last year's figure}) \div \text{last year's figure} \times 100$. Gross profit % = $\text{gross profit} \div \text{sales} \times 100$. Net profit % = $\text{profit for the year} \div \text{sales} \times 100$. Expense % = $\text{expense} \div \text{sales} \times 100$. Return on equity % = $\text{profit for the year} \div \text{average equity} \times 100$. Rate of return on total assets % = $(\text{profit for the year} + \text{interest}) \div \text{average total assets} \times 100$. Current ratio = $\text{current assets} \div \text{current liabilities}$. Liquid ratio = $(\text{current assets} - (\text{inventory} + \text{prepayments})) \div (\text{current liabilities} - \text{secured overdraft})$. Equity ratio = $\text{equity} \div \text{total assets}$ (written as x:1). Inventory turnover = $\text{cost of goods sold} \div \text{average inventory}$. Age of accounts receivable (days) = $\text{average accounts receivable} \div (\text{credit sales} \times 1.15) \times 365$. Average = $(\text{opening} + \text{closing}) \div 2$.

Question One (12 marks)

(a) Information about Anika's Surf Shop: this year the business ran a large advertising campaign.

Calculate the percentage change in sales, the gross profit % for each year and the net profit % for each year, and the advertising % of sales for each year. Then explain how the change in the business affected its profitability, and give the meaning of the net profit % for this year.

Income Statement extract (\$)	Last year	This year
Sales	310 000	341 000
Cost of goods sold	186 000	204 600
Wages	49 600	51 088
Advertising	6 200	9 920
Rent	21 000	21 000
Other expenses	9 300	10 230
Interest on loan	1 000	1 000
Profit for the year	36 900	43 162

[7 marks]

THE WORKED ANSWERS TO THOSE 3 QUESTIONS

Question 2 (12 marks) [Liquidity and financial stability]

(a) This year Anika's Surf Shop bought extra inventory for the busy season and paid for it from the bank. Calculate the current ratio and the liquid ratio for each year, using the formulae on the formula sheet (as x:1, to two decimal places). Then explain what happened to the business's ability to pay its short-term debts, and make one recommendation.

(a) Answer: Current ratio 4.14:1 → 4.62:1; liquid ratio 2.55:1 → 2.26:1

- Evidence level: Excellence (calculates both ratios with the NZQA formulae and explains the change using the figures).
- Current assets last year = \$18 000 + \$42 000 + \$1 400 + \$36 000 = \$97 400; this year = \$108 462.
- Current liabilities last year = \$19 000 + \$4 500 + \$0 = \$23 500; this year = \$23 500.
- Current ratio = current assets ÷ current liabilities: last year $97\,400 \div 23\,500 = 4.14:1$; this year $108\,462 \div 23\,500 = 4.62:1$.
- Liquid ratio = (current assets – (inventory + prepayments)) ÷ (current liabilities – secured overdraft): last year $(97\,400 - 37\,400) \div (23\,500 - 0) = 2.55:1$; this year $(108\,462 - 55\,400) \div (23\,500 - 0) = 2.26:1$.
- Achievement: The current ratio increased from 4.14:1 to 4.62:1: this year the business has \$4.62 of current assets for every \$1 of current liabilities. The liquid ratio decreased from 2.55:1 to 2.26:1.
- Merit: The current ratio increased from 4.14:1 to 4.62:1: this year the business has \$4.62 of current assets for every \$1 of current liabilities. The liquid ratio decreased from 2.55:1 to 2.26:1. The business bought extra inventory for the busy season and paid for it from the bank: bank decreased from \$18 000 to \$11 062, accounts receivable stayed at \$42 000, inventory increased from \$36 000 to \$54 000.
- Excellence: The current ratio increased from 4.14:1 to 4.62:1: this year the business has \$4.62 of current assets for every \$1 of current liabilities. The liquid ratio decreased from 2.55:1 to 2.26:1. The business bought extra inventory for the busy season and paid for it from the bank: bank decreased from \$18 000 to \$11 062, accounts receivable stayed at \$42 000, inventory increased from \$36 000 to \$54 000. The liquid ratio decreased because bank plus accounts receivable decreased from \$60 000 to \$53 062 while accounts payable plus other current liabilities stayed at \$23 500, so the business's ability to pay its short-term debts got worse. The liquid ratio is the stricter test because it leaves out inventory and prepayments, which cannot be turned into cash quickly. Recommendation: sell the extra inventory quickly, because it ties up cash that is needed to pay bills.

KEY TAKEAWAY

Liquidity: the liquid ratio leaves inventory and prepayments out of current assets and the secured overdraft out of current liabilities; compare both ratios with 1:1 and explain the change using what the business did.

(b) Information about Anika's Surf Shop: this year the business had larger drawings taken by the owner. Using the formulae on the formula sheet, calculate the equity ratio (as x:1, to two decimal places), the return on equity % and the rate of return on total assets % for each year. Explain the change in financial stability and in the returns, and make one recommendation.

(b) Answer: Equity ratio 0.70:1 → 0.72:1; ROE 34.6% → 36.1%; return on total assets 24.5% → 26.3%

- Evidence level: Excellence (calculates the three measures with averages and explains stability and the returns).
- Equity ratio = equity ÷ total assets: last year $113\,900 \div 162\,400 = 0.70:1$; this year $124\,962 \div 173\,462 = 0.72:1$.
- Return on equity % = profit ÷ average equity × 100: last year $36\,900 \div 106\,500 = 34.6\%$; this year $43\,162 \div 119\,431 = 36.1\%$.
- Rate of return on total assets % = (profit + interest) ÷ average total assets × 100: last year $(36\,900 + 1\,000) \div 155\,000 = 24.5\%$; this year $(43\,162 + 1\,000) \div 167\,931 = 26.3\%$.
- Achievement: The equity ratio increased from 0.70:1 to 0.72:1: the owner finances 72 cents of every \$1 of assets this year. The return on equity increased from 34.6% to 36.1% and the rate of return on total assets increased from 24.5% to 26.3%.
- Merit: The equity ratio increased from 0.70:1 to 0.72:1: the owner finances 72 cents of every \$1 of assets this year. The return on equity increased from 34.6% to 36.1% and the rate of return on total assets increased from 24.5% to 26.3%. Reasons: total assets increased from \$162 400 to \$173 462; equity increased from \$113 900 to \$124 962 (profit \$43 162 less drawings \$32 100). The return on equity increased because profit changed by 17.0% while average equity changed by 12.1%; the rate of return on total assets increased because profit plus interest changed by 16.5% while average total assets changed by 8.3%.
- Excellence: The equity ratio increased from 0.70:1 to 0.72:1: the owner finances 72 cents of every \$1 of assets this year. The return on equity increased from 34.6% to 36.1% and the rate of return on total assets increased from 24.5% to 26.3%. Reasons: total assets increased from \$162 400 to \$173 462; equity increased from \$113 900 to \$124 962 (profit \$43 162 less drawings \$32 100). The return on equity increased because profit changed by 17.0% while average equity changed by 12.1%; the rate of return on total assets increased because profit plus interest changed by 16.5% while average total assets changed by 8.3%. Recommendation: limit drawings so the business keeps enough equity and cash.

KEY TAKEAWAY

Stability = how much of the assets the owner pays for (equity ratio); returns use average equity or assets over the year; compare profit growth with the growth in equity and in assets to explain each return.

LOS: Liquidity and financial stability (91177)

Question 3 (12 marks) [Management effectiveness and recommendations]

(a) This year Anika's Surf Shop ran a large advertising campaign and also bought extra inventory for the busy season and paid for it from the bank. Using the formulae on the formula sheet, calculate the age of accounts receivable (in days, to one decimal place) and the inventory turnover (times, to one decimal place) for each year. Explain how the changes affected the business's management of accounts receivable and of inventory, and make a recommendation.

(a) Answer: Age of accounts receivable 42.0 → 39.1 days; inventory turnover 5.0 → 4.5 times

- Evidence level: Excellence (calculates both measures with averages and explains the change for receivables and for inventory).
- Age of accounts receivable = average accounts receivable ÷ (credit sales × 1.15) × 365 (accounts receivable include GST): last year $41\,000 \div 356\,500 \times 365 = 42.0$ days; this year $42\,000 \div 392\,150 \times 365 = 39.1$ days.
- Inventory turnover = cost of goods sold ÷ average inventory: last year $186\,000 \div 37\,000 = 5.0$ times; this year $204\,600 \div 45\,000 = 4.5$ times.
- Achievement: The age of accounts receivable decreased from 42.0 to 39.1 days and inventory turnover decreased from 5.0 to 4.5 times.
- Merit: The age of accounts receivable decreased from 42.0 to 39.1 days and inventory turnover decreased from 5.0 to 4.5 times. Accounts receivable stayed at \$42 000 (average 41 000 to 42 000) while sales increased from \$310 000 to \$341 000, so customers take fewer days to pay, and the business collects its cash sooner. Cost of goods sold increased from \$186 000 to \$204 600 and inventory increased from \$36 000 to \$54 000 (average 37 000 to 45 000), so the stock turned over more slowly and so more money is tied up in inventory.
- Excellence: The age of accounts receivable decreased from 42.0 to 39.1 days and inventory turnover decreased from 5.0 to 4.5 times. Accounts receivable stayed at \$42 000 (average 41 000 to 42 000) while sales increased from \$310 000 to \$341 000, so customers take fewer days to pay, and the business collects its cash sooner. Cost of goods sold increased from \$186 000 to \$204 600 and inventory increased from \$36 000 to \$54 000 (average 37 000 to 45 000), so the stock turned over more slowly and so more money is tied up in inventory. Because the business ran a large advertising campaign and also bought extra inventory for the busy season and paid for it from the bank, a recommendation is to stop buying extra inventory and discount slow-moving lines to free up cash.

KEY TAKEAWAY

Management effectiveness: a lower age of accounts receivable means faster collection; a higher inventory turnover means inventory sells faster; explain each measure separately using the figures and what the business did.

(b) The owner of Anika's Surf Shop compares this year's results with the industry average. In your answer, explain what each result shows about the business, and recommend ONE action for each, justifying it.

(b) Answer: The business earns 12.7% of each sales dollar as profit compared with 15.2% for similar businesses, a gap of 2.5 percentage points. Inventory turns over 4.5 times compared with 5.7 for similar businesses, so goods stay on the shelves longer and money is tied up.

- Evidence level: Excellence (compares each measure with the industry, explains the gap and recommends justified actions).
- Compare each result with the industry average and describe the size of the gap.
- Achievement: The business earns 12.7% of each sales dollar as profit compared with 15.2% for similar businesses, a gap of 2.5 percentage points. Inventory turns over 4.5 times compared with 5.7 for similar businesses, so goods stay on the shelves longer and money is tied up.
- Merit: The business earns 12.7% of each sales dollar as profit compared with 15.2% for similar

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