SACE ONE

ACCOUNTING

WORKBOOK
FIRST EDITION

ANNA FUSCO

Essentials education

ADELAIDE TUITION CENTRE

THE AUTHOR

Anna Fusco

Anna began her career teaching at a business college in Adelaide after graduating from University of SA with a Bachelor of Secondary Education. She then moved into the private sector where she worked in computer technology sales for GE IT Solutions, which was at the time, one of the largest companies in the world. Anna made the leap back into education again in 2004. Since then, she has worked at several independent schools in South Australia as a teacher of Legal Studies, Business, Economics and Accounting. Anna has also worked at the SACE Board where she was the SACE Officer for Accounting, Economics and the Research Project. She was involved in curriculum development, moderation and marking as well as exam development. Anna currently works at Immanuel College where she has a leadership role as well as a teaching role. Anna has also previously co-authored Essentials books for Business and Enterprise.

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PUBLISHING INFORMATION

This Workbook is part of the Essentials series, designed to support the teaching of SACE Stage 1 and 2 subjects in South Australia. It is specially designed to meet the requirements of the SACE Stage 1a Accounting.

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Contents

Note to Teachers

Thank you for purchasing the Stage 1 Accounting Workbook for use with your students. This Workbook provides content and activities in line with the revised SACE Stage 1 Accounting course. Stage 1 Accounting can be completed as a semester course or as a whole year course. The content covered in this Workbook is presented in a logical sequence based on the **accounting process** and not in the sequence a teacher would necessarily teach this content.

This allows the teacher flexibility to choose which sections of the Accounting course to cover each semester, or, if only offered as a semester course at your school, in one semester.

Additionally, this Workbook is not designed to be the sole resource teachers use in the teaching of this subject. Teachers are encouraged to use this Workbook to tailor the delivery of content to their students with the assistance of their own, and other, resources.

As a guide for new teachers, the following structure is suggested if your school offers Stage 1 Accounting over two semesters:

Semester 1

- Chapter 1 – Understanding Accounting (Sections 1.1-1.3)
- Chapter 2 – Accounting Principles and Practice
- Chapter 4 – Financial Reports
- Chapter 5 – Ratios and Decision-making.

Semester 2

- Chapter 1 – Understanding Accounting (Sections 1.1, 1.3 and 1.4)
- Chapter 2 – Accounting Principles and Practice (Section 2.3)
- Chapter 3 – Double-entry Accounting
- Chapter 4 – Financial Reports (use part of this chapter as revision)
- Chapter 5 – Ratios and Decision-making (use part of this chapter as revision).

A significant part of the new SACE Stage 1 Accounting course is the section, Accounting Advice. This Workbook attempts to introduce students to the concept of giving accounting advice throughout the book, in incremental stages by interpreting data and explaining how this impacts a business. Students initially can find this aspect of the course challenging so this Workbook has been designed with simple advice activities in the early chapters and then building to the case study at the end of Chapter 5, where more complex advice is sought.

I hope you will find this Workbook a useful resource for you and your Stage 1 Accounting students in 2022.

Chapter 1 – Understanding Accounting

Glossary of Terms

- Accounting
- Business/firm/organisation/entity/company
- Stakeholders
- Shareholders
- Customers
- Management
- Suppliers/creditors
- Expenses
- Profit
- Financial statements/reports
- Government
- Quantitative data
- Qualitative information
- Internal user
- External user
- Budgeting/forecasting
- governance

1.1 What is Accounting?

Accounting affects our personal lives daily even though we may not always be aware of it. Every day we **make decisions** about how we will spend our money; we calculate how much we have earned from working or what we have saved, and we determine what we need to spend to cover our everyday expenses such as food, metro-card, petrol, gym membership and so on.

Most people need some simple form of accounting to deal with their personal finances. For example, knowing how to budget, how much tax to pay or whether they can afford a personal loan.

Similarly, businesses need an accounting system to enable them to operate efficiently. For example, they need to record the sales they make every day and what expenses they must pay, to ensure they can meet those financial commitments. **Accounting provides business owners with a process to keep *accurate* financial records for their business**.

Keeping accurate records of business transactions is vital for the success of any business. If a business owner does not keep adequate records, then there is a real risk that their business will fail. In fact, data from the Australian Bureau of Statistics (ABS) consistently shows that approximately 32% of small businesses in Australia will fail in the first 5 years, predominantly due to not managing their finances properly. *(ABS, 2015) https://www.aph.gov.au/About_Parliament/Parliamentary_Departments/Parliamentary_Library/pubs/rp/rp1516/Count*

Governments also need accounting systems to keep account of the very large amounts of money they receive and spend. If you think about it, every person who has a job pays personal tax to the Australian Tax Office on their earnings. The Government collects this tax (known as income for the Government) and this money is spent on many things including community needs and wants. For example, to build more public schools and improve infrastructure like roads. Every 12 months, the Federal Government releases their budget so we can see where they have decided to spend the money they have received.

As you can see, accounting is important for individuals, for businesses and for governments. For the purposes of this course, however, we are mainly concerned with the use of accounting by businesses.

Figure 1.1.1: The Federal Budget is released each year in May.

Activity

Helpful online resources

Watch this video called "***Three Unexpected Benefits of Learning Accounting***" which explains the benefits of learning Accounting:

https://tinyurl.com/3j8vawjy

Definition of Accounting

For a business to be successful, owners need to have more than a detailed knowledge of their product or service. They also need to know how to ***manage*** – people, customers, stock, suppliers, and, importantly, ***cash***. To do this, they need up-to-date, accurate information to make decisions. This is why accounting is important – it provides business owners with information to help them make decisions about their business, with a view to improving performance, and their business' long-term success.

One useful definition of accounting is:

Accounting is a system used for recording and processing financial information and producing reports for interested parties so they can make informed decisions about the future of the business.

Accounting involves the **collection of information**. This information is classified as either **quantitative data** or **qualitative information**.

When making decisions, a business owner will consider **both** of these.

Quantitative Data:

This is information expressed in **numerical** form and which is **measureable**. It is referred to as **objective** information meaning it **can be proven and verified**.

Qualitative Information:

This is all **other** information which is considered **subjective** information because it is biased, opinion-based or personal. It is guessing why something has occurred. This **cannot be measured or given a value**.

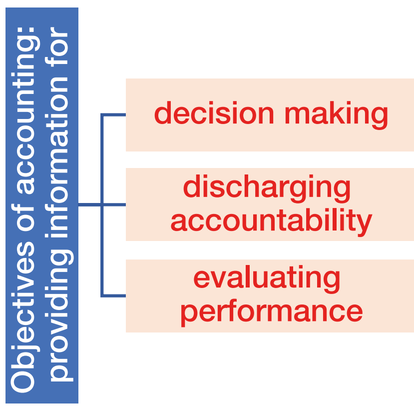
Objectives of Accounting

The main aim of accounting is to assist in the **governance** of a business. Accounting communicates business and economic information to various interested parties. These interested parties who wish to use accounting information can be classified into two groups:

Internal users: all levels of management and employees of a business

External users: investors, government (Tax Office), suppliers, society.

Accounting plays an important role in the legal obligations of businesses. For example, businesses have a legal obligation to ensure that their financial records are accurate so that they pay the appropriate tax to the Government. Therefore, **an important objective of accounting is the accurate governance of a business**. Accounting communicates business and economic information to various interested parties. This information is used to make informed decisions about the business, such as whether to expand/grow the business in the future. Therefore, **an important objective of accounting is to provide interested parties with accurate and reliable information**.



There are three key reasons why accountants must provide accurate and reliable information, as shown in the following graph.

Each objective is essential to the accurate governance of a business for the following reasons:

Information for decision making

Decisions concerning the **sustainability** of a business are usually determined by the information an accountant provides to a business owner. It is important that information is provided at regular intervals so that the business owner can make **timely decisions**. Relevant, reliable, cost-efficient and timely information will allow better decisions to be made at the time they need to be made.

For example, a business may have a small window of opportunity to purchase a building to expand their business. To do this, the business owner will rely on the accountant to assess whether this is an appropriate financial decision.

Discharging accountability

Accountability in general means being **held responsible** to another (usually higher) authority for actions carried out. For accountants, this means they have a **responsibility** to provide information to enable users to make **informed judgements** about the performance, financial position, investment activities and compliance of the reporting (business) entity.

Evaluating performance

General purpose reports are prepared by an accountant on a regular basis, usually every 6-12 months. These reports include the Balance Sheet, the Income Statement and the Statement of Cashflows. The information from these reports enable business owners to **evaluate the performance** of their business during a given period (e.g. in a financial year). This allows the business owner to make decisions about **how to use resources** more effectively, **earn more profits** or achieve **financially stability**.

Management and Financial Accounting

Accounting information is used in two ways in business. Firstly, to provide financial information to managers/ business owners so they can make decisions and secondly, to provide financial information to external users (such as banks) to help them make informed decisions about the financial position of the entity.

Management accounting is therefore defined as the area of accounting concerned with providing financial and other information to managers/business owners to assist them in their planning, controlling and decision-making responsibilities. For example, an accountant will use financial information to give advice on budget forecasts. Accountants who provide this information are referred to as management accountants.

Financial accounting is concerned with reporting information to users outside the entity in order to help them make economic decisions about the entity's performance and financial position. The financial accountant is involved in ensuring the entity is complying with requirements of the law, and that their financial reports are accurate. A financial accountant must make sure that they discharge their responsibilities, so they do not break any laws.

Activity

Can You See It?

Look at the two accounting reports below. At this stage you do not need to have an understanding of accounting to complete this task. You are simply required to read and extract information from the reports provided and answer the questions that follow.

Annie's Trading Store

Income Statement

for the period ending 31 December 2020

Revenue	$	$	$	$
Sales				
- Homewares			37,000	
- Gifts			31,000	
- Bathroom accessories			15,000	83,000
***Less* Cost of Goods Sold**				
Opening Stock		35,000		
Purchases	18,500			
Less Purchase Returns	(600)	17,900	52,900	
Less Closing Stock			(18,000)	34,900
GROSS PROFIT				**48,100**
***Less* Expenses**				
Wages			43,000	
Electricity			1,400	
Petrol			1,700	
Delivery			3,800	49,900
PROFIT/LOSS				**(1,800)**

Annie's Trading Store

Balance Sheet

as at 31 December 2020

ASSETS	**$**	**$**	**EQUITIES**	**$**	**$**
Current Assets			**Current Liabilities**		
Cash	22,000		Creditors	33,000	
Debtors	11,000		Loan to Bank (due 31.3.21)	3,000	36,000
Stock	18,000	51,000			
Non-current Assets			**Non-current Liabilities**		
Vehicles	53,000		Loan to Bank (due 2023)	21,600	
Office Equipment	68,000		Mortgage	110,000	131,600
Land	70,000				
Buildings	102,000	293,000	**Owner's Equity**		
			Capital (A Valley)	183,200	
			Less Drawings	5,000	
				178,200	
			Less Net Loss	(1,800)	176,400
TOTAL ASSETS		344,000	TOTAL EQUITIES		344,000

1. What is the name of the business?

2. Who owns the business?

3. What are the titles of the two reports?

4. What are the dates of the two reports?

5. How does the information in the Income Statement differ from that in the Balance Sheet? Provide at least two examples in your response.

6. What does the business sell?

7. List 3 items in the Balance Sheet that represent ***items of value*** to the business.

8. What do you think the term ***expenses*** means?

9. (a) Who might be interested in the two financial reports?

   (b) Why would they be interested?

   (c) What ***two*** items appear in both the Income Statement and in the Balance Sheet?

   (d) Which words in these two statements are unfamiliar to you?

Users of Information in a Business

Who uses accounting information?

Accounting information is usually prepared for the benefit of the business owner. There are, however, other parties that are interested in the financial information that is generated as well. These interested parties may be classified as either *internal* or *external* users of this information:

Internal users: management and employees of a business

External users: investors, customers, government (e.g. Australian Taxation Office), suppliers, society.

These groups are also commonly known as **stakeholders**. Stakeholders will be discussed in more detail in Chapter 1.2. They are defined below:

Internal users:

include all levels of management and other governing bodies of an organisation e.g. owners and managers, executives and board of directors. Internal stakeholders make decisions on various aspects of the operation of the organisation, such as financing, personnel, production and marketing.

External users:

(a) ***Investors*** – These are people who have invested financially in a business. They are concerned with the level of risk in investing in a particular business and whether they will receive a return on their investment. They need information to help them determine whether they should buy, hold, or sell. Shareholders are also interested in information which enables them to assess the ability of the entity to pay dividends.

(b) ***Suppliers/creditors***–Suppliers and other creditors are interested in information that enables them to determine whether amounts owing to them will be paid when due.

(c) ***Customers***–Customers have an interest in information about the continuance of an entity, especially when they have a long-term involvement with, or are dependent on, the entity.

(d) ***Employees and trade unions***–Employees and their representative groups are interested in information about the stability and profitability of their employers. They are also interested in information which enables them to assess the ability of the entity to provide remuneration, retirement benefits and employment opportunities.

(e) ***Public***–Entities affect members of the public in a variety of ways. For example, entities may make a substantial contribution to the local economy such as by employing people and using local suppliers.

(f) ***Governments and their agencies***–Governments and their agencies are interested in the allocation of resources and, therefore, the activities of entities. They also require information to regulate the activities of entities to determine the appropriate taxation payable.

(h) ***Lenders***–Lenders are interested in information that enables them to determine whether their loans, and the interest attaching to them, will be paid when due.

Examples of **users** and the information they require to make decisions can be seen below:

Stakeholders	Examples of decisions
INTERNAL STAKEHOLDERS	
Shareholders/potential investors	To buy, sell or hold shares. To decide whether to invest in an organisation.
Managers	To change pricing policies, to control customers' accounts, to determine expansion policies, to borrow, to repay loans.
EXTERNAL STAKEHOLDERS	
Lenders/creditors	To be satisfied that the business can afford to pay their outstanding debts
Employees	To claim salary increases or to be satisfied that their job is secure
Government	To raise tax, or to be satisfied that businesses are paying the necessary tax
Customers	To remain loyal to businesses and to buy products
General public	To assess the economic and social impact of an organisation and whether to continue to support these businesses.

The type of communication that will take place will depend on the information that is needed and the user of the information.

Internal users may receive emails, informal reports, dashboards or more formal reports such as Income Statements and Balance Sheets. External users usually receive formal accounting reports, typically in the form of Income Statements, Balance Sheets and Statements of Cash Flow. These are referred to as **general purpose financial reports**.

Most accounting reports are comprised of monetary figures and equations organised in columns. However, accountants now usually add written sections, to help explain the information in the reports to the end user. **Interpreting reports requires knowledge of accounting and business** and this is a key role of today's accountant.

The information accountants provide aim to:

- Provide information for decision making
- To assist in discharging responsibility
- Help evaluate the business' performance
- Make judgements on the efficient acquisition and allocation of economic resources
- Help forecast the business' position in the near future
- Recommendations on how to grow/expand the business
- Help the business' compliance with legislation and government regulations.

The Accounting Process

The **Accounting Process** refers to the steps taken at different stages of the accounting period. It begins with the recording of transactions and ends with the production of the financial reports. The steps in the accounting process include: **Recording, Reporting, Interpreting and Analysing and Budgeting/Forecasting**.

Each step is explained in detail below:

RECORDING

This first step of the accounting process involves the collection of raw data from business transactions. The **raw data** is evidence that a transaction has occurred. Raw data is also known as **source documents**. Some examples include:

- Receipts
- Invoices
- Purchase orders
- Cheque butts.

The raw data is then **summarised** and **processed** into **useable information** in an accurate and systematic manner. This information is generally kept in:

- Journals
- Ledgers.

REPORTING

This step involves reporting the financial information (from the recording process) to interested parties (stakeholders – internal and external users) on the financial state of the business.

Reporting helps to evaluate the performance of the business in an accounting period, through the preparation of financial reports/statements. These include:

- Balance Sheet
- Statement of Changes in Owner's Equity
- Income Statement
- Statement of Cash Flows.

INTERPRETING & ANALYSING

This step involves the interpretation and analysis of the business' transactions and financial reports to help the owners, management and other interested parties make decisions. The types of questions they may consider are:

- *Should we employ more people?*
- *Is this the right time to expand/grow the business?*
- *How can we improve profit and return on investment for shareholders?*
- *How do we improve sales?*

BUDGETING/FORECASTING

Budgetary control involves management setting targets for the future of the business and supervising these targets in an effort to ensure that they are met. Some examples of budgetary control are:

- Cash Budgets
- Forecasts.

Helpful online resources

This video, titled "Accounting Basics: A Guide to Almost Everything" explains the steps involved in the Accounting Process:

https://youtu.be/yYX4bvQSqbo

1

Activity

The Accounting Process

Complete the table below. In the spaces provided, provide an example of the type of data/information used at each step.

Accounting Process	Type of data/information used
RECORDING	
REPORTING	
INTERPRETING & ANALYSING	
BUDGETING	

Review Questions

1. Define Accounting.

2. How is accounting relevant to our everyday lives?

3. What is one example of an accounting process that occurs in business?

4. Give an example of an external stakeholder and a decision he/she would need to make.

5. Give an example of an internal stakeholder and a decision he/she would need to make.

6. Why are managers considered to be internal stakeholders?

7. Why is it important for accountants to prepare accurate and reliable financial information?

8. Write your own paragraph describing the role of a bookkeeper and comparing them to an accountant.

9. Complete the following Find-a-Word.

Accounting Basics

D	E	L	B	A	I	L	E	R	Z	R	E	X	K	M	Y	A	B	H	H	O	N	H	V	L
C	S	Y	V	K	H	N	B	Z	W	B	R	E	N	W	O	Z	L	D	M	B	R	Y	N	I
P	O	Q	R	N	D	G	O	W	Z	Q	E	H	A	Y	G	I	C	H	N	K	A	R	O	R
A	P	X	Y	U	L	C	O	A	N	C	X	Z	J	N	O	D	R	N	I	P	G	M	K	F
D	C	U	Z	W	R	X	K	V	P	U	T	K	X	D	K	K	E	T	A	R	U	C	C	A
U	E	S	X	I	X	Z	K	R	E	T	E	V	Y	B	X	Z	R	W	E	N	E	S	X	G
Q	Z	W	L	K	H	H	E	R	W	R	R	U	J	W	W	O	U	C	D	S	B	R	T	U
T	M	C	E	S	V	O	E	G	A	L	N	N	Q	Q	Q	T	J	H	C	F	K	Y	B	I
V	Y	H	N	R	W	I	P	I	S	E	A	M	K	E	K	S	Q	K	Y	D	N	A	O	L
S	J	V	Q	L	L	I	E	C	X	E	L	H	E	E	Y	O	L	P	M	E	D	O	P	F
H	H	F	D	P	D	V	R	A	A	C	C	O	U	N	T	A	B	I	L	I	T	Y	H	X
I	V	S	P	W	K	A	U	K	F	C	J	P	E	U	T	X	Z	L	K	S	C	Y	K	K
K	I	U	B	X	Q	Z	K	H	G	L	E	J	Y	L	P	J	K	I	E	Y	H	A	S	E
T	S	K	I	J	M	A	N	A	G	E	R	X	X	E	E	Q	S	D	U	W	C	Q	P	R
C	P	W	G	C	X	O	Z	O	F	O	B	I	L	X	R	R	F	C	N	C	X	Y	X	X
E	P	G	F	X	I	J	H	Y	E	H	P	D	P	N	F	I	L	T	O	Q	D	K	E	P
E	B	J	K	T	R	L	L	K	Q	Y	X	T	Z	L	O	J	A	U	Y	C	I	U	K	Y
T	T	G	A	R	E	D	L	O	H	E	K	A	T	S	R	Z	N	E	V	T	Z	U	G	Z
L	C	X	K	Z	S	Z	R	Z	X	T	P	G	X	E	M	T	R	Y	Z	P	P	H	J	L
J	A	X	M	N	U	J	D	C	X	M	C	H	R	L	A	J	E	H	M	S	C	H	W	R
T	S	E	Z	S	H	V	M	T	M	Y	Q	T	H	N	N	F	T	F	H	G	I	I	L	A
I	F	E	V	B	T	T	G	I	K	U	I	I	T	X	C	I	N	R	S	P	E	F	H	H
E	Q	Q	E	B	K	S	Z	C	R	M	H	J	K	H	E	S	I	R	J	D	H	V	Q	Q
B	D	Y	J	N	Z	P	F	R	E	C	H	Z	E	O	V	N	E	E	W	O	W	J	I	Y
S	G	G	N	X	W	W	S	G	A	C	C	O	U	N	T	I	N	G	J	X	W	Z	M	B

ACCOUNTING	TAXATION	BOOKKEEPER	USER	MANAGER
ACCOUNTANT	PERFORMANCE	INTERNAL	STAKEHOLDER	
OWNER	RELIABLE	ACCURATE	ACCOUNTABILITY	
EMPLOYEE	SUPPLIER	GOVERNMENT	EXTERNAL	

10. Fill in the missing words:

Today's accountant is more of a .... partner than a .... Business .... rely on an accountant to provide them with .... and .... financial information. Accountants .... financial data from reports such as the .... and the .... to determine whether the business is financially .... They then provide accounting .... to assist the business owners to make decisions about the .... of their business. For example, they might decide to .... or .... more staff.

owners advice expand accurate sustainable bookkeeper employ Income Statement usiness interpret reliable Balance Sheet future

OPTIONAL – Clickview

Watch "Day to Day Business in a Café" on:

https://online.clickview.com.au/playlists/27393560/videos/3715469

and complete the worksheet attached. Share with the class:

- what you learnt that you did not know about operating a business, and
- whether you think this business will be successful in the long-term and why.

1.2 Stakeholders

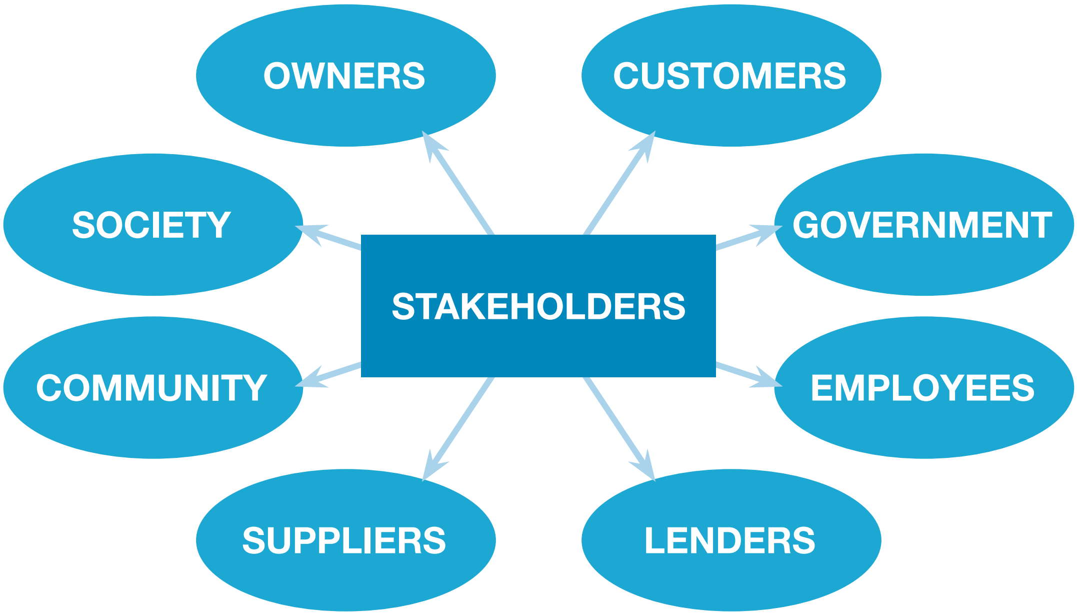


Figure 1.2.1: Stakeholders of a business.

A **stakeholder** is a person or group that has an **interest** in a business and who is **affected** by the decisions made by that business. Stakeholders include people within the business such as the **owner**, **shareholders** and **employees**. Stakeholders are also **customers**, lending institutions such as **banks**, **suppliers** the **government**, and **society** in general. Stakeholders are impacted either **directly or indirectly** by the decisions made by a business. For example, employees will be concerned about whether the business is profitable and able to provide them with stable and secure, long-term employment. Additionally, suppliers may be concerned about whether the business is able to pay their debts on time and society may be concerned about whether this business is ethical and cares about the community that supports them.

Stakeholders are vital to the success of any business and they play an integral role in the **sustainability** of a business. Business owners and shareholders will be keen for the business to make a profit so that they can earn a **return on their investment** (ROI). To make a profit, the business owner will need to ensure they are making adequate sales and that their expenses are low in comparison. If the business is not financially viable, then stakeholders may become concerned and decide to take their business elsewhere. For example, customers might look for an alternative business to purchase these products.

Stakeholders will be very interested in the financial position of a business. For example, banks will want to make sure the business is able to repay their loan and so they may ask to see the financial reports of the business.

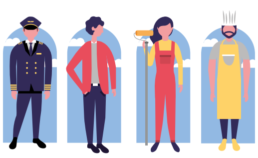
Therefore, for a business to be successful, the business owners need to have more than a detailed knowledge of their product or service. They also need to know how to ***manage*** – people, customers, stock, suppliers, and, most importantly, *cash*. To do this, they need up-to-date, accurate information to make **decisions**. This is why accounting is important – it provides business owners with **information** to help them make decisions about their business, with a view to **improving performance**, and therefore, the success of their business.

Accounting provides stakeholders with financial information so that informed judgments and decisions about the business can be made.

Classifying Stakeholders

Stakeholders can be classified as either ***internal*** or ***external*** users. They use information provided by the business for different reasons.

External users include:

Stakeholder	Who are they?	Type of interest
Shareholders/Investors		
	Shareholders invest financially in the business. They may provide the capital needed for the business to begin. They are therefore concerned with the risk in investing in this business and the return provided by their investment.	They need information to help them determine whether they should buy, hold or sell their interest in the business. Shareholders are also interested in information which enables them to assess the ability of the business to pay dividends (a share of profits).
Suppliers/Creditors		
	Suppliers provide products to the business and are interested in ensuring the business pays the money that is owed to them.	They are interested in how trustworthy the business is so they can determine whether to continue to have them as a customer. Suppliers must make sure that businesses they sell to are able to pay them promptly.
Customers		
	Customers are essential to any successful business. Customers buy the business' products and help create a positive reputation in the community about the business.	Customers are interested in the ability of the business to provide safe and reliable products and whether the business will continue long-term (are they dependable?).
Employees and trade unions		
	Employees and unions are interested in information about the stability and profitability of the business long term.	They are interested in information which enables them to assess the ability of the business to provide them with a salary, good working conditions and continuing employment.
Society		
	Businesses affect members of the public in a variety of ways. For example, businesses may make a substantial contribution to the local economy in many ways including the number of people they employ and using local suppliers.	The community will support businesses that are good corporate citizens and 'give back' to the community that supports them. Ethical practices and caring for the environment are also factors that determine whether a community accepts a business.
Government and other agencies		
	Governments and their agencies are interested in the allocation of resources and, therefore, the activities of businesses. They will want to ensure that businesses are operating within required regulations.	They require information in order to regulate the activities of businesses, determine taxation policies and ensure businesses are operating within the law.
Lenders/Banks		
	Lenders/banks provide businesses with loans so they can start or grow their business.	Lenders are interested in information that enables them to determine whether their loans, and the interest attached to them, will be paid when due.

Internal users include:

Stakeholder	Who are they?	Type of interest
Owners		
	Owners need to assess how well their business is performing. Financial statements provide information to owners about the **profitability** of the overall business.	Accounting information helps owners assess the stability of the business. This information helps owners to decide if they should invest any further in the business.
Managers		
	Managers need accounting information to plan, monitor and make business decisions on the daily operations of the business. Managers need to make decisions about the financial, human and capital resources that the business needs to operate efficiently.	Managers rely on accounting data to make decisions such as investment, financing and pricing decisions. Managers require accounting information to monitor the performance of business in order to make forecasts and prepare budgets.
Employees		
	Employees want to make sure the business is financially stable and that it can provide them with continuing employment.	Employees are interested in knowing how well a business is performing as it could have implications for their job security and ability to earn an income.

Helpful online resources

Watch the video called "***Stakeholders and their Influence***" to check your understanding of this concept.

https://online.clickview.com.au/share?sharecode=43400927

Complete the Comprehension Questions and Case Study available from Clickview.

Financial Data vs Financial Information

As stated above, accounting is concerned with the supply of financial information in order for internal and external users to make decisions. This information, however, must come from a source, and begins as **raw data** (source documents), before being transformed into **financial information** (financial reports). It is therefore necessary to distinguish between ***financial data*** and ***financial information***.

- **Data** – is the raw facts and figures upon which financial information is based.

  Examples include:

- **Information –** when financial data is summarised or rearranged in a structured fashion.

  Examples include:

Stakeholder decision-making process

Stakeholders require financial information to make decisions for their business. This type of information can be defined as quantitative data and qualitative data. **Quantitative data** includes what can be **measured** such as revenue, expenses, profits, assets, and liabilities. By analysing this financial data, a business owner can determine whether their business is performing well or not. Understanding expenses, and how much to sell products for, helps a business owner determine whether the business will be profitable.

Qualitative data on the other hand, refers to the **intangible** aspects of the business. For example, excellent customer service will ensure customers return to the business which can lead to more sales. Customer service is not measurable in the same way that profits are but is just as important to understand. Another way to look at it is that good customer service will ensure customers come back but poor customer service will do the opposite. A business owner cannot put an exact figure on the value of customer service to their business, but they do know it is valuable, and therefore, it cannot be discarded as having an impact.

Financial statements that business owners produce such as the Balance Sheet and the Income Statement, provide a mixture of both qualitative and quantitative data which help them make decisions about their business.

Below are some examples of the **typical types of decisions** which may be faced by a business:

- How much should be produced?
- What price should be charged?
- Should we purchase a new fleet of vehicles?
- How should the new fleet be financed?
- How can sales be expanded?
- How can the wages expense be reduced?

Review Questions

1. Create a **Stakeholders mind-map** to include both internal and external groups. Include a description of each stakeholder. Go one step further and add the reasons why this stakeholder has an interest in the business. Provide an example for each stakeholder.

2. Explain the difference between a *stakeholder* and a *shareholder*.

3. **Stakeholders do not always have the same interests**. Using an example of two stakeholders, explain how one stakeholder's interests might **conflict** with another stakeholder's interests.

   (a) Compare the following:

   - Employees and customers
   - Shareholders and employees
   - Business owners and customers.

   (b) Assume you are the business owner. How would you resolve the above conflicts? Decide which stakeholder you would give priority to in each situation. For example, are the needs of customers more important than employees? For each case, make sure you justify your decision.

4. Identify of the following are **internal** or **external** users? Add your response in the table below.

Manager		Society	
Supplier		Employee	
Australian Tax Office		Bank	
Local Council		Customer	
ASIC		Shareholder	
Business owner		Board of Directors	

Case Study

5. Ultra Violette

Read the case study on Ultra Violette

Meet the founders of Ultra Violette, a multimillion-dollar Aussie sunscreen label that's found a cult following

ELOISE KEATING

OCTOBER 21, 2020

After 'bunkering down' when the coronavirus pandemic first took hold in Australia, the passionate duo being cult SPF brand Ultra Violette is ready to take the next, international, steps to grow their business. Bec Jefferd and Ava Matthews spent more than two years developing their products, which look, and feel, much more like cosmetics than traditional sunscreens.

The first of the Ultra Violette products launched via an online pre-sale event in December 2018, with more following soon after at the end of January 2019. Despite its products only being available for fewer than two years, the business has developed a loyal following and has a revenue run rate for the 2020 calendar year of more than $2.5 million.

The Ultra Violette team has also grown. Jefferd and Matthews now have three employees, two of whom were hired right as national lockdowns came into effect in March. Jefferd recalls that moment "when we started to take this seriously" and says survival mode kicked in. "We took an approach of, 'we've just got to survive this'," she tells *SmartCompany*. "We pulled back on expenses, bunkered down and tried to keep as lean as we can."

The Ultra Violette team was already working remotely, and the founders say they were fortunate not to have an office lease or other "big-fixed costs". Despite the initial concerns, Jefferd says sales have grown, particularly in recent months. "Surprisingly, skincare consumers, beauty consumers have been very resilient during 2020 and they continued to invest in products," Jefferd says. That is because these products fall into the "self-care bucket", say the founders. "We represent a consistent part of someone's day; they put sunscreen on and go for a walk."

Ultra Violette recorded its biggest sales months ever in August and September, with the team doing "little things" to put a smile on their customers' faces, from including personal messages and free samples in orders, to offering free shipping for. "We kept things fun and light, hopefully bringing a little joy to someone's day," Jefferd says.

The brand saw growth in its own direct-to-consumer sales, as well as through Adore Beauty and Sephora, which means it's now in a strong cash position heading into summer when more people think about wearing sun protection. "Revenue has been incredibly strong. We've kept expenses tight, and we're now looking at what are some smart ways to invest."

While the business did have "grand expansions" planned for the UK and some parts of Asia this year, Matthews says it now has international plans ready to go "as soon as the clock strikes for 2021". The goal is to be in the UK, Europe and Southeast Asia next year, with the founders having learnt a lot from their venture into Hong Kong. "In hindsight, it has been a good thing we've had the extra year to get ready," Jefferd says. It's been an opportunity to sharpen operating systems and implement an inventory management system, because "what else can you do when locked at home", she adds.

From side-hustle to full-fledged business

Jefferd and Matthews were both working in the private label department of beauty retailer Mecca when the seed was planted for them to create their own brand. That meant finding jobs that would allow them to work on something of their own, in their own time. “Obviously, we realised if we were to do this brand, we needed to get out of any potential conflict of interest,” Matthews explains. Matthews moved to Rationale Skincare where she headed up the brand’s marketing, while Jefferd took on the role of general manager at Toms’ Organics.

The pair worked on their brand on the weekends until, a month out from launch, Matthews quit her job and focused on Ultra Violette, while also doing some consulting work. Meanwhile, Jefferd dropped back her days at Toms’. “For me personally, I guess as soon as we launched, we kind of knew there was some magic there,” Matthews says.

“Obviously we weren’t paying ourselves a salary at that point, so I kind of needed to earn as much money as I could in as little hours, and spend the bulk of the time getting up and running.” After six months, the founders knew it was time to “give this a big solid crack” and go all in. “We needed to really dedicate ourselves full-time to this, and not be distracted by growing other people’s brands for them,” Matthews says.

It was a “really terrifying moment”, Jefferd says, but once they made the switch from having a business on the side, to a full-time focus, it “felt completely different”. “It was difficult to navigate that stage, to put everything into a business that wasn’t paying us,” she says. Paying themselves a salary was, therefore, a way to justify the amount of work they were putting in. “The more effort you put in, the better the business does, and it does return that salary,” Jefferd says.

Building an audience online

When Jefferd and Matthews first released some of their products out to the world in December 2018 — at the behest of friends and family who were begging to buy some — they sold out within a day. It was a sign of things to come, with social media and word-of-mouth recommendations playing a key role in the brand’s growth to date. Today, most of Ultra Violette’s sales come via Instagram, with the brand boasting more than 42,000 followers on the platform.

Early media coverage also helped, say Jefferd and Matthews, as did getting a “really important tick of approval” from Adore Beauty. Getting shelf space in Sephora stores added another dimension to the brand’s growth strategy, as it allowed customers to test products before they bought them.

Ultra Violette’s approach to its customers hasn’t really changed since day one, Matthews says, with education and community-building remaining front-of-mind, even while it invests more in marketing through those channels. “Obviously as you grow, your audience grows and the amount of people interested in you grows,” she says. “Keeping that kind of authentic brand voice, and education, and the pillars we care about, is going to be harder, but that’s something we will focus on; it’s always top of mind for me.”

‘Your time is your greatest asset’

Ultra Violette’s growth may have been swift to this point, but Matthews says entrepreneurs can’t underestimate the value of time. “I would say to really invest your time wisely,” she says when asked about advice for other new business owners.

“Don’t bother learning how to code a website if you don’t know how to do it; hire experts in their fields that you’re not equipped in,” she says. “You’re not going to be all things to everyone. “Your time is basically your greatest asset. Invest in what your strengths are … you can only do so many things.”

Another important piece in the puzzle, Jefferd says, is to “have an eye on the profitability of your business from the beginning”. This means having a plan for how, and when, you’re going to make a profit. “The plan might be that you won’t make a profit for 12 months, but you need to understand what the bottom line of your business means,” she says.

Source: www.smartcompany.com.au

Answer the questions below:

(a) Identify at least 3 stakeholders of this business.

(b) What challenges did this business face when they first began?

(c) How did the business overcome these challenges?

(d) Why was working from home during COVID-19 restrictions beneficial for this business?

(e) What did this business do to improve customer relations?

(f) Using an example from this case study, explain why ensuring customers are satisfied is important to the financial success of a new business.

(g) Explain what is meant by “having your eye on profitability”.

(h) What have you learnt about starting a business from this case study? Choose one example to discuss.

1.3 Ownership Structures

Understanding accounting and legal entities

Every business has an **ownership structure**. This refers to how the business was structured when it commenced and how it may have changed over time as it grew and developed. For example, when a person decides to start their own business and be the only worker in the business, they would generally start their business as a **sole trader**. However, should they decide to start a business with another person, they will be structured as a **partnership**.

Accounting entities

In Accounting, each business is referred to as an **accounting entity**. This does not refer to their ownership structure but to the fact that **accounting records** are kept, and **accounting reports** prepared for the business (separate to the owner). Each business is seen as **separate and distinct** from its owner for **accounting purposes** and only a business can be referred to as an accounting entity.

Legal entities

A legal entity refers to a business that is seen as separate from the owner in the eyes of the law. In other words, a legal entity can be sued. When a business owner starts a business, they will need to decide on the ownership structure, and this will determine how the business is viewed in the eyes of the law. Some businesses are separate legal entities from the owners and others are not. This is because of the **ownership structure** in place.

The following table explains the **ownership structures** available to businesses. Pay particular attention to the difference between unincorporated businesses that have **UNLIMITED LIABILITY** and incorporated business that have **LIMITED LIABILITY**.

Unincorporated businesses	Incorporated businesses
Not registered as a company and has unlimited liability	Registered as a company and has limited liability
Sole Trader Partnership	Private Company Public Company

Ownership Structures Explained

Description	Definition of Legal Entity
Sole Trader	
• A sole trader is a business which has one owner • The owner contributes most of the money and other resources needed to begin a business • The owner takes on all of the risks and stands to make all of the profit • The owner makes all the decisions and has full responsibility of the daily operations of the business • Sole traders are commonly involved in owning small to medium sized businesses. Although they own the business, they may employ others to help them in the business. • Sole traders may engage in a wide variety of business operations e.g. rural, professionals, factories and retail stores. They are very common for service industries such as hairdressers. • A sole trader can operate under a business name that is different to their own name. However, this name must be registered at the Australian Securities and Investment Commission (ASIC). For example, Jenny's Flowers rather than Jenny Smith, Florist.	• One owner • Must be registered for ABN, business name and for tax purposes • Unlimited liability applies – this means that the business and the owner are seen as the same (i.e., in the eyes of the law the business and the owner are not separated). • Unlimited liability means that the business owner is responsible for all the debts of the business and can be sued personally.

Description	Definition of Legal Entity
Partnerships	
• A partnership consists of two or more persons who co-own a business with a view to making a profit. • Each partner contributes capital (funds) to start/buy into the business. Each owner therefore takes the risk and responsibility of the business to the value of their investment. • Each partner is involved in decision-making and is entitled to a share of the profits. • A partnership is not a separate legal entity, so while the partnership requires its own ABN and must lodge its own tax return, the partnership itself is not taxed. • Any profits are shared between the partners and these are added to any other income of each individual partner and taxed at the appropriate personal tax rates.	• More than one owner but less than 20 • Must be registered for ABN, business name and for tax purposes • Unlimited liability applies – this means that the business and the owners are the **same**. • Unlimited liability means that the business owners are responsible for all the debts of the business and can be sued personally.
Companies	
• Companies are incorporated bodies formed to overcome the disadvantages of the sole trader and partnership forms of business organisation. • A company is a business registered under the Corporations Act. • The shareholders are entitled to a return on their money, called a dividend. • There are two types of companies–private companies and public companies. Both public and private companies have **limited liability:** • *The greatest amount investors can lose is the cost of their shares. They do not lose personal assets beyond the cost of these shares. If the shares are fully paid for, they have no further liability.* **Common Features** • Investors who buy shares in the business are called shareholders. • They are part owners of the business • They are paid a share of the profits called dividends • Managers/Executives may be employed to carry out the real day-to-day business of the company. • Directors and Secretaries are appointed to plan the overall strategic direction of the business. **Private companies** • Are usually family concerns and their membership is limited to between one and fifty members. • They are distinguished by the words Proprietary Limited (Pty Ltd) after their name. • Must have a minimum of one director • The general public cannot invest in these companies. Shareholders are usually restricted to families or small groups of people, and new shareholders must be invited by existing shareholders. **Public companies** • Invite ownership from members of the public. • They may elect to be listed on the Australian Stock Exchange and be subject to the various regulations required by them. • They must have a minimum of five shareholders and there is no maximum limit. • They have the word Limited (Ltd) after their name. • There are certain legal requirements that these companies must meet. The Corporations Act sets these out.	• Limited liability applies – this means that the owners/ shareholders and the business are **separate** legal entities • The company has perpetual succession, i.e. it continues to exist even if the shareholders change. • The company is a legal entity (a legal person) and it can be sued. It can sue other people or firms. The shareholders cannot be sued individually for something the company has done. • Between 1-50 members • Minimum of 5 members

Activity

Create a table showing the **main features** of each of these ownership structures as well as the **advantages and disadvantages of each**. Aim to include as many advantages and disadvantages as you can find. You may need to do some of your own research in order to complete this table. Refer to the sample table below for how to format your table.

Helpful online resources

This link may help you get started with learning more about ownership structures:

https://www.business.gov.au/planning/business-structures-and-types/business-structures

Ownership Structure	Key Features	Advantages	Disadvantages
Sole Trader			
Partnership			
Company			

In addition to the above ownership structures, there are also other, more informal, organisations that you may know about. Incorporated and unincorporated associations are entities that are not-for-profit. The following descriptions provide some of the key features of these entities.

Incorporated Associations

- Established for purposes such as to operate a small professional society, sporting club or a social club, usually on a non-profit basis.
- Act of incorporation sets it up as a **separate legal entity** and enables the members to be protected from any debts incurred by the organization.
- Profit may not be the main motivation but generally income needs to exceed expenses to ensure their survival
- Accounting information is kept with a member usually appointed to the role of Treasurer.

Unincorporated Associations

These are the same form of organisation but they are **not a separate legal entity** and the members of the association are personally liable for any debts of the association.

Activity

Use the table below to identify the **key features and differences** between incorporated and unincorporated associations.

Helpful online resources

You can find more information about associations here:

https://www.sa.gov.au/topics/family-and-community/community-organisations/types/incorporated-associations

Incorporated	Unincorporated	Differences

Helpful online resources

Watch "Starting Up" – Clickview program:

https://clickv.ie/w/Bk1n

This program explains what is involved in starting a small business – from legal requirements through to financial record keeping

Review Questions

1. What is the difference between a sole trader and a partnership?

2. What is meant by unlimited liability?

3. What is meant by limited liability?

4. What factors would an ***electrician*** need to consider before deciding on a legal structure for their new business?

5. Identify ***three*** benefits of operating as a sole trader.

6. What are **three** challenges of operating as a sole trader?

7. Identify possible circumstances which may lead to a change in ownership structure.

8. Refer to the Glossary on page 1. Create a Glossary of your own and add definitions for the terms you have learnt so far.

1.4 Sources of Finance

A key decision that needs to be made when a person decides to begin a new business or purchase an existing business, is how to finance such a venture. There are several options available. However, the implications are significant so caution must be exercised when making this important decision.

It is highly recommended that independent financial advice, preferably from an accountant, is sought. Every business has different financial needs. However, it is fair to say that all businesses require funds to function. Some businesses require 'start-up capital' at the establishment phase, whilst others may require finance to extend, expand or reinvigorate their business during growth, maturity or post-maturity phase. Many businessses need access to finance to assist them to manage cash flow to meet expenses when sales fluctuate or receipt of revenue is delayed.

Sourcing seed funding for start-up ventures can be difficult, so it is likely that entrepreneurs will need to explore several different avenues to obtain finance.

There are two types of lender categories available to businesses:

(a) ***Equity Financing*** – refers to the investment of funds from within the business (i.e. from the owners, partners, family or friends). This is also known as internal finance and is a common source of finance at the establishment phase for many small business owners. Equity finance includes retained profits from the business. Internal financing comes from the business. It is a type of self-sufficient funding.

(b) ***Debt Financing*** – refers to the borrowing of funds from outside the business (i.e. from financial institution such as bank). This is also known as external finance.

The main difference between internal and external sources of finance is origin. External financing comes from outsider investor, which can include shareholders or lenders, who may expect either a percentage of the ownership of the business or interest paid, in exchange for the funds they provide. Internal finance comes from within the business, such as the owner contributing funds to start the business.

Equity Financing

Equity financing differs from debt financing in that the investors are frequently also the owners of the business. The sole proprietor may use their own savings to start their business, or invite family members, business partners or friends to invest in the business for a portion of ownership. Many small businesses, in particular use equity finance to establish their business as it does not need to be repaid like a loan from a bank would. Equity finance means selling a 'stake' in a business in return for funds. In other words, a person who invests in a business, now owns a share of it and can receive a portion of the profits earned. This can be a significant advantage in the early stage of a business's life cycle when sales are low and expenses are high.

Equity finance is also common with small businesses when they are considering expansion. Capital can be raised by altering the business's legal structure and accepting new partners into the business. Each new partner can then 'buy into' the business and these funds may be used to expand the business without needing to seek a loan from an external source.

Another alternative is to apply to ASIC to change the legal structure to an incorporated private company and ask interested parties to become shareholders. Shareholders are the owners of the company who will receive a share of the profit referred to as a dividend. Existing private companies may choose to increase the number of shareholders up to a maximum of 50.

Or, on a larger scale if the Australian Stock Exchange (ASX) criteria can be satisfied, a business may decide to 'float' the company on the ASX and invite the public to buy shares by issuing a Prospectus. This is a formal document that offers shares to the public and contains background and future information about the company. ASX Regulations and The Corporations Act, 2001 have strict requirements that must be followed to allow the potential investor to make an informed decision about buying shares in the company. Public companies must release audited financial accounts. They have no limit on the number of shareholders they have, and thus the equity fund-raising capacity is increased dramatically under this structure.

Aussie GoFundMe donations up 30% for 2020, with $2 million raised for small businesses

The COVID-19 crisis has seen more than $2 million donated through GoFundMe campaigns in 2020 to help small businesses cover their overheads. In Australia, some 1.3 million donations were made in total — 30% more than in 2019.

Helpful online resources

Among the most successful campaigns was *Lentil As Anything's campaign* to keep its 20-year-old, pay-as-you-feel, community-focused kitchen alive

https://www.smartcompany.com.au/industries/hospitality/lentil-as-anything-gofundme/

The campaign set out to raise $150,000 to bring the restaurant back from the brink of closure. It ultimately raised just shy of $375,000.

"We had no idea that the support was so strong," Lentil As Anything founder Shanaka Fernando told *SmartCompany* in September. "There's goodwill over 20 years."

This was all part of a broader trend that saw more Aussies dishing out cash to support people, businesses and workers in need during a particularly trying year.

"This year saw more Australians turn to crowdfunding for needs that fall outside of traditional government or charitable support, from stranded travellers covering quarantine fees to return home, to bushfire-impacted farmers in need of fencing and PPE for frontline medical professionals."

Donations to causes focused on Indigenous rights were also up a massive 221%.

The biggest Aussie fundraiser was a campaign to help save koalas and other wildlife following the bushfires on Kangaroo Island, which raised $2.69 million.

"At the heart of the response is community," Britton said. "Community means something different for each and every Australian, we have seen community generosity in ways not witnessed before," she added.

Debt Financing

When a business borrows money, it is commonly referred to as a debt or a loan. Banks are the most likely source for a loan as most people recognise banks as a safe option and they also are likely to have an existing relationship with one for their personal finances. Any loan sought from a bank will incur charges to establish and service the loan. Additionally, ongoing interest is payable for the term of the loan. However, the expense, interest on a loan, will reduce the profit of a business and thus the resulting tax that must be paid.

It should also be noted that often a general condition for a loan to a NEW business owner is that they personally guarantee the loan. This means that the owner/s must offer personal assets as security. These may be seized in the event the owner/s cannot repay their loan (loan default) regardless of what type of legal structure the business has.

Review Questions

1. Define the term *debt*.

2. Distinguish between debt and equity financing.

3. List the different sources of equity finance available to businesses.

4. Identify the main advantages to a business owner who uses equity rather than debt to finance the establishment of their business.

5. Analyse the level of risk entrepreneurs undertake when starting a new business with a high level of debt.

6. Go to: https://www.smartcompany.com.au/finance/funding/

   Choose a story about a business that sought funding through GoFundMe. Briefly outline the reason(s) why this business sought to raise finance this way and identify what the advantages and disadvantages of this type of funding are for small businesses.

7. Why is it difficult for entrepreneurs to secure seed capital for a start-up venture even if they have a good idea for their business venture?

Chapter 2 – Accounting Principles and Conventions

2.1 Accounting Elements

What is an account?

In Accounting terms, an **account** is used to describe where information (transaction) is 'stored' to be used at a later date. For example, "Cash at Bank" is a **common account** in accounting.

Cash at Bank is an **account** that stores all transactions that involve cash receipts and cash payments. All cash receipts are recorded as increases in "Cash at Bank" and all payments are recorded as deductions in the same account.

Another example of an account is "Building". Suppose a business purchases a building and pays for it in cash. That transaction would be recorded in the "Building" account for the acquisition of the building as well as in the "Cash at Bank" account for the payment to buy the building.

The Accounting Cycle

The diagram below shows us what happens from the time a business makes a transaction. The accounting cycle, also commonly referred to as the **accounting process**, is a series of procedures in the collection, processing, and communication of financial information.

As explained in earlier lessons, accounting involves recording, classifying, summarizing, and interpreting financial information. This cycle shows the order in which this occurs. We will be focusing on **Step 2: Analysing each transaction** to classify them into accounting elements**.**

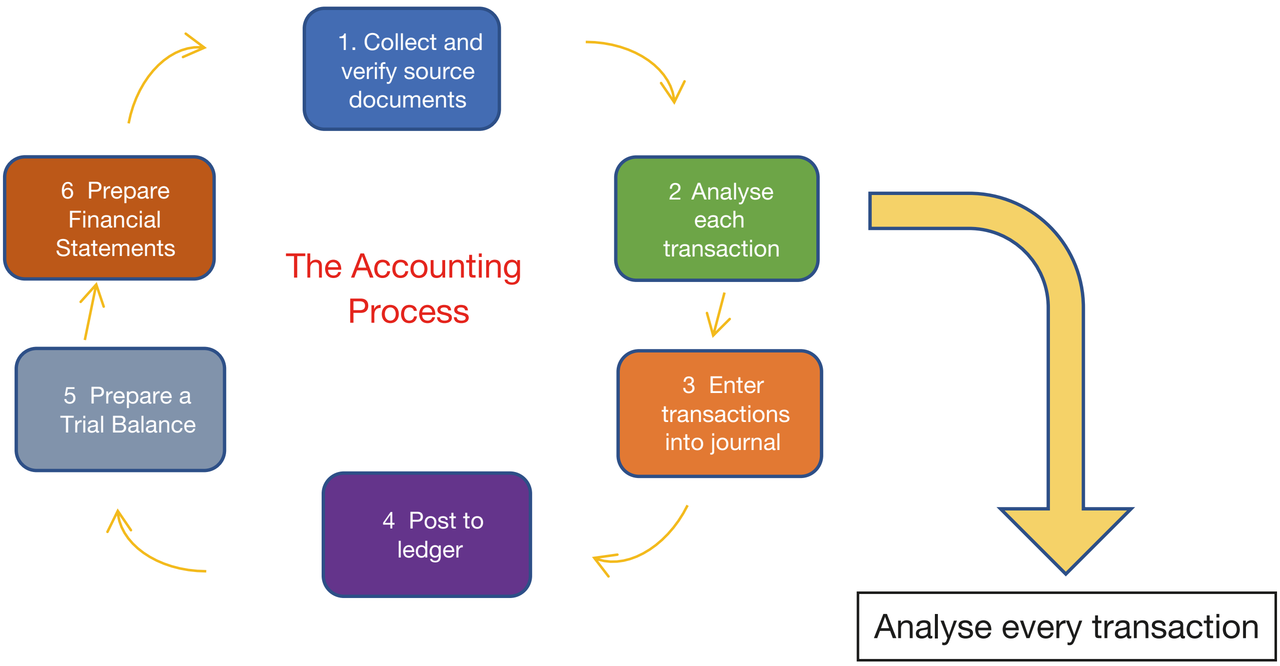


Figure 2.1.1: The Accounting Process

The Accounting Elements

The five accounting elements are: ***Asset, Expense, Liability, Revenue and Owner's Equity.*** They are defined as:

ASSET	Assets are resources that are **owned** and/or controlled by the business and will provide a future economic benefit. Assets are divided into ***Current Assets*** and ***Non-current Assets***. Current Assets – these refer to items of value that the business owns but which can be converted into cash quickly. Every business has current assets. These include items such as debtors, cash at bank and stock which are all **liquid** in nature, meaning they can be converted to cash easily. Non-current Assets – these are also items of value that the business owns. Examples include such things as motor vehicles, furniture, or land that are purchased by a business to be kept long-term. They are essential to the operations of the business and are not intended to be sold for the foreseeable date future. In other words, they are **not as liquid** in nature.
EXPENSE	An expense in accounting terms is the **money spent** or the **cost incurred** in a business's efforts to generate revenue. In other words, these are costs incurred by the business as part of their daily operations. For example, a business that rents premises, will need to play their rent regularly (usually monthly). Therefore, this is an expense for the business. If they do not pay their rent, they will be evicted. Some other examples of expenses include advertising, insurance and wages; these are all incurred by the business in their efforts to sell goods to make a profit.
LIABILITY	Liabilities are defined as a business's legal financial debts or obligations that arise during the course of business operations. Liabilities are something that a business ***owes***. Liabilities can be short-term, known as Current Liabilities or long-term, known as Non-current Liabilities. Current Liabilities are debts that are due to be **repaid within 12 months**. Examples include creditors, bank overdraft and short-term loans (of less than 12 months). Non-current Liabilities are debts that are repaid over a **longer period of time** (i.e. longer than 12 months). Examples include mortgages and long-term loans (e.g. 5 years).
REVENUE	Revenue is the amount of money that a business **receives**, predominantly from the **sale of goods or services,** during a specific period. Revenue could include money coming in through sale of goods and providing services. Other examples include commission/interest received.
OWNER'S EQUITY	Owner's equity refers to the owner's investment in the business. From the business' point of view, this investment is a debt owed to the owner. At times, the owner may withdraw funds from the business for personal use. This is referred to as Drawings and it is deducted from the capital investment by the owner. Profit earned by the business is owed to the owner. This will also appear in the Owner's Equity account. The Accounting Equation is generally shown as: A – L = OE In the Balance Sheet it is usual to show: Capital + Net Profit – Drawings.

Activities

1. Classify the following as either an Asset (A), Expense, Liability (L), Revenue, or Owner's Equity (OE)

Account	A, E, L, R or OE
Bank – money in bank account	
Cash – loose cash, sometimes called Bank	
Salary – paid to employees in exchange of the service provided	
Debtors – money owed by people to the business, generally from credit sales	
Creditors – money the business owes to other people, generally from credit purchases	
Sales – sale of goods	
Inventory/ Stock – goods the business sells to earn revenue	
Mortgage – long term secured loan to purchase Land/Buildings	
Accounts Receivable – same as debtors	
Accounts Payable – same as creditors	
Loan – borrowings of money from a financial institution	
Commission received – commission received by business	
Drawings – owner withdrawing assets from the business for personal use	
Inventory – same as stock	
Buildings	
Insurance expenses	
Capital – owner's injection of assets into the business	
Land	
Machinery	
Stationery expenses	
Bank Overdraft – short term loan, overdrawing the business account	
Furniture	
Fixtures & fittings – shelving, light fixtures, electrical fixtures	
Electricity Bill Owing	
Motor Vehicle	
Advertising	
Office equipment	

2. List the five accounting elements.

3. Classify the following accounts into the elements of accounting.

Building	
Debtor	
Loan	
Plant & Machinery	
Salaries	
Electricity expense	
Sales	
Interest received	
Commission received	
Insurance expense	
Drawings	
Bank overdraft (this is a short-term term)	
Motor Vehicle	
Stationery expense	
Net Profit	
Capital	
Inventory	
Advertising	
Creditor	

4. The following table shows what has occurred in the month of May for Wilson's Grocery Store and Bencher's Cabinet Making. In each case, identify the business item and classify this as either an asset (current and non-current), liability (current and non-current) or owner's equity.

Wilson's Grocery Store

	Item	A, L, OE
(a) Amount Wilson invested to begin the business		
(b) Money in the business' bank account		
(c) Building from which the store operates		
(d) Grocery items which will be sold to make a profit for the business		
(e) Amount of money Wilson has taken out of the business for his own use		
(f) Truck used to deliver goods to customers		
(g) Shelves in the shop		
(h) Computer and other office machinery		

K & R Cabinet Making

	Item	A, L, OE
(a) Tools and machines used in the manufacture of cabinets		
(b) Money the owner has invested into the bank account of the business		
(c) Loan made by the bank to this business to purchase premises		
(d) The building purchased with the borrowed funds		
(e) Amounts owing by the business to other firms that have supplied him with materials		
(f) Amounts owing by customers who have purchased tables from the business.		
(g) Money that the owner has taken out of the business for personal use		
(h) Unsold cabinets and tables		

2.2 Accounting Conventions and Principles

Accounting conventions (or assumptions) are the basic rules of accounting which have become acceptable over time. Accounting conventions provide standards for professional bodies (such as accountants) to follow. These 'rules' ensure accounting records and reports are prepared in a similar way, regardless of the type of business or ownership structure used.

The following are a few of the accounting conventions and principles you will need to learn for this course.

Historical Cost Principle

The **historical cost principle** refers to how transactions made by a business are recorded. When an item, such as an asset, is purchased by a business, it is recorded at its ***original cost*** in the entity's accounting records. In other words, in accounting terms, the value of the asset must be recorded at the time it is purchased – this is known as its **original cost**.

For example, if a motor vehicle is purchased for $20,000, then this asset is recorded in the business' accounting records at that purchase price (its original cost).

Many business transactions are recorded at their historical cost. This concept states that an asset, liability or equity investment should be **recorded at its original acquisition cost**. The reason for this is that it makes it easy to trace the cost of an item when it was purchased, simply by looking at the source documents (receipt or invoice).

However, a disadvantage of this principle, is that it does not necessarily represent the **actual** (fair market) value of an asset over time, as this is likely to change. For example, the motor vehicle that was purchased in the above example, for $20,000 will be worth less in 5 years' time.

It is important to note, however, that the use of the historical cost principle will require some **adjustment** to the cost of an item as time passes. This is because some assets will **depreciate** in value over time, such as a motor vehicle. If adjustments are not made, the historical price of an asset is still reliable, but it is not very **useful** in the long term. For example, an item that was purchased 20 years ago, does not provide the business owner with the current market value now. The **market value** is more useful than its historic cost. ***Adjustments to the cost of an item will be covered in more depth in the Stage 2 Accounting course.***

Helpful online resources

Watch: "The Historical Cost Principle: The Basics: This short video explains the historical cost principle. It may be useful in helping you understand this concept.

https://youtu.be/-POwfO0-sx0

Cash Basis of Accounting

The cash basis of accounting is a method of **recording all financial transactions when cash is exchanged**. This method of recording transactions is popular with small businesses that deal mainly with cash transactions. This is because it is simple to use and easy to apply.

However, the disadvantage of this method is that it is not suitable for all businesses as it does not allow income and expenses that have occurred over two different periods to be recorded at the time of the transaction – they must be recorded in the period (month) that the cash is exchanged.

For example, a sale made in the month of June is recorded when the cash is received which may not be until July. Therefore, the business owner would record the revenue (sale) in June but the payment for the surfboards (from debtors) in July. This is shown on the next page in more detail.

Example: Jacob Jonesy owns Jonesy's Surf and Ski. He sold $5,000 worth of surfboards on 28 June 2021 to various debtors. Payment for the surfboards was received in July 2021. At the end of June, Jacob prepares his financial reports.

Using the **cash** accounting method, he would record this transaction as:

	June 2021	July 2021
Sale of surfboards		$5,000
Cash received		$5,000

*This means that the **sale** is recorded in the month that the **cash** is **received**. This transaction is therefore recorded in July as that is when the debtors paid for the surfboards.*

Another example is this: a business receives an electricity bill for $800. Under the cash basis of accounting, the amount is not recorded until the bill is paid (cash is exchanged). However, under the accrual basis of accounting (explained below), the $800 is recorded as an expense in the month it is incurred.

Helpful online resources

Watch: "Cash Accounting – How it works and should you use it?": This short video explains the pros and cons of the cash basis of accounting. It may be useful in helping you understand this concept.

https://youtu.be/8t9PFHILLVI

Accrual Basis of Accounting

The accrual basis of accounting principle states that **transactions are recorded in the period when they occur**. In other words, transactions are recorded when they occur (accrued) rather than when the funds are exchanged (cash changes hands). In other words, **revenue** is recognised when it is **earned** and **expenses** are recorded when they are **paid**.

For example, a sale (revenue) made in the month of June is recognised in June even if the money is not received for this sale until July (debtor pays in 30 days). In other words, it is recorded when the sale occurs, regardless of when the cash is actually received.

Using the above example of Jacob Jonesy's Surf and Ski, the sale of surfboards would be recorded in the following way using the **accrual** accounting method:

	June 2021	July 2021
Sale of surfboards	$5,000	
Cash received		$5,000

This means that the sale is recorded in the month it is earned (June) and the cash in the month it is received (July).

This means applying the '**matching principle**' which states that revenue, and all expenses incurred to generate that revenue, need to be **recognised in the same accounting period**. The matching principle provides a mechanism for analysing results objectively so business owners can accurately measure their profit over time. A disadvantage of the accrual basis of accounting is that it does not track cash flow so this must be calculated separately.

Helpful online resources

Watch: "Accural Accounting – How it works and why it is number 1": This video explains the benefits of accrual accounting compared with cash accounting. It may be useful in helping you understand the reason most businesses use the accrual basis of accounting method.

https://youtu.be/C8UuX75ZarU

Going Concern Assumption

The going concern assumption states that a business will **continue to operate indefinitely** (i.e. more than 2 years). In other words, this principle assumes that a business will continue for the foreseeable future so that accountants can report long term assets in the Balance Sheet. Accountants prepare reports for businesses on the understanding that the business will continue to exist from one year to the next. This makes it easier for an accountant to defer payments from one period to another, knowing that the business will exist in the future to be able to make these payments.

The Prudence Concept

The prudence concept requires accountants to take **'care and concern'** when recording revenue, expenses, assets and liabilities in financial statements. It can be defined as being **conservative and cautious** in the way transactions are recorded. In other words, it is important that revenue items are not over-estimated and that assets, liabilities and expenses are not under-estimated. The prudence concept also requires that a transaction is recorded at the time it occurs and not necessarily when money is exchanged. For example, revenue should be recognised in the period when it is reasonably certain to occur. Expenses, on the other hand, should be recognised in the period they are will be paid. This ensures that transactions are recognised in the period in which they occurred.

Relevance and Faithful Representation

Relevance and **faithful representation** are fundamental characteristics of accounting information. The purpose of presenting accounting information in financial statements is to provide **relevant** information to users (such as the business owner) to make decisions. It is therefore essential, that the information provided to users is **helpful** for economic decision-making. For example, predicting future cash flow, deciding on whether to expand the business or employ more staff.

Just as important, is **faithful representation**. This means that the user of financial information is confident that it is **accurate, complete and without bias or error**. Faithful representation is closely linked to **reliability**. Accountants must provide information that can be relied upon by users to make decisions.

Review Questions

Check your understanding of the above concepts by completing these questions.

1. Which of the following is an example of an accrued expense?
   (a) Salary owed but not yet paid
   (b) Commission Fees received but not yet earned
   (c) Stock on hand
   (d) A two-year premium paid on a fire insurance policy.
2. An accrued expense can be described as an amount:
   (a) that has not been paid but is due in the current period
   (b) that has not been paid as it is due in the next accounting period
   (c) that has been paid as it was due in the current period
   (d) that has to be paid when the cash is exchanged.
3. The historical cost principle means:
   (a) items are recorded using their actual value each accounting period
   (b) assets are recorded at their original cost at the time they are acquired
   (c) assets are never recorded at their original cost but their market value
   (d) only assets are recorded at their original cost.
4. Historical cost requires:
   (a) items to be recorded at their acquisition cost each accounting period
   (b) adjustments to be made to the historical cost of an item in each subsequent year
   (c) no adjustments to be made to items in subsequent years
   (d) that assets purchased be kept on record for 5 years.

5. The method of accounting that recognises revenue when it is earned and expenses when they are incurred is called:
   (a) Income Basis
   (b) Managerial Accounting
   (c) Accrual Basis
   (d) Asset Basis.

6. The prudence concept is used to:
   (a) record transactions regardless of when they occur
   (b) over-estimate transactions to ensure that caution is taken
   (c) record transactions using the 'care and concern' principle
   (d) all of the above.

7. Using the **accrual basis of accounting**, explain how and when the transaction below will be recorded.
   (a) Jessica Sampson owns Flirty Shirts. She sells $3,000 worth of shirts to Colourful Clothing on 25 July, 2021. She has 7-day payment terms for her debtors.

   (b) Explain how the above transaction (question 3) would be recorded using the **cash basis of accounting**.

   (c) Identify one advantage and one disadvantage of the **cash basis** of accounting and the **accrual basis** of accounting.

   (d) With reference to the above comparisons, which method would you recommend Jessica Sampson uses in her business? Ensure you provide a reason for your decision.

8. Read the following transactions and decide whether they would be recorded as accrual transactions.

	Transaction	Accrual required?
1	The business pays wages on the 14th and 28th of the month.	
2	The business obtained a $6,000 loan on the 12th of the month, to be repaid within 12 months.	
3	The business sold goods to a customer on the final day of the month. The customer paid in cash.	
4	The business sold $2,000 worth of goods on the 15th of the month. They allow their debtors 30 days to pay their invoice. The business receives payment on the 3rd of the following month.	

9. **Match** the accounting conventions/assumptions in Table 1 with the situations in Table 2.

Table 1:

A	Accounting Entity assumption	**D**	Relevance
B	Going Concern assumption	**E**	Faithful Representation
C	Accrual Accounting assumption	**F**	Prudence concept

Table 2:

i	The reporting of accounting information should be free from personal bias.	
ii	As a sole trader, the owner's house and car are not recorded in the records of the business.	
iii	An expense is recorded in the year in which it occurs.	
iv	Financial reports prepared for users must be accurate and reliable.	
v	The life of a business is considered to continue indefinitely.	
vi	It is important that accountants do not over-estimate value of revenue items.	

10. Complete this Word Search puzzle using the accounting terms you have learnt so far in this course.

Accounting Theory and Conventions

O	D	G	O	I	N	G	C	O	N	C	E	R	N
W	E	T	S	C	S	W	A	S	S	E	T	S	R
N	S	S	B	A	R	E	O	S	T	T	S	D	E
O	S	S	B	I	C	E	N	L	B	E	I	E	V
I	N	A	T	S	E	T	D	L	F	E	S	B	E
T	C	A	S	H	B	A	S	I	S	H	X	I	N
A	D	J	U	S	T	M	E	N	T	S	S	T	U
I	N	S	R	O	T	B	E	D	I	E	N	A	E
C	E	S	A	L	E	S	S	B	A	C	N	S	C
E	V	A	C	C	O	U	N	T	A	N	T	L	O
R	B	U	S	I	N	E	S	S	H	A	L	V	L
P	R	I	N	C	I	P	L	E	E	L	L	E	T
E	E	X	P	E	N	S	E	S	L	A	T	C	M
D	S	A	S	E	I	T	I	L	I	B	A	I	L

ADJUSTMENT	BALANCE SHEET	REVENUE	ASSETS	BASIS
CASH FLOW	DEPRECIATION	DEBTORS	LIABILITIES	DEBIT
EXPENSES	ACCOUNTANT	PRINCIPLE	CREDIT	
GOING CONCERN	SALES	BUSINESS	CASH	

2.3 Duality Concept and The Accounting Equation

In accounting, every transaction made by a business is recorded to keep track of funds coming into the business (revenue/income/sales) and funds going out of the business (expenses/liabilities). This helps a business owner to **understand** the financial position of their business at any one time.

To do this properly, **every transaction is recorded into two accounts**. This is called **double-entry bookkeeping**. This basically means that every transaction affects the business in at least **two** ways. This **dual effect** of a transaction ensures that the **accounting equation** always balances.

To understand what effect every transaction has on the accounting equation, we must first understand how to classify **items** such as **Assets, Liabilities, Owner's Equity and Expenses and Revenue**.

Debit and Credit Rules

In accounting, there are certain **rules** that need to be followed. There is no theory or explanation behind some of the rules you will encounter in your study of Accounting, except that these rules exist by **convention**. These rules are sometimes referred to as **assumptions**.

The first assumption for you to learn is that items will be classified as either ***debits*** or ***credits***. In arriving at rules for debits and credits, an assumption is made that **assets and expenses are debit in nature** and that **liabilities, owner's equity and revenue items are credit in nature**. This is to support the **accounting equation** which requires **total debits** to **equal total credits** for it to balance.

Once you have **classified** an item as per the above assumption, you will need to determine whether that item is ***increasing*** or ***decreasing,*** and this will depend on the transaction. Remember that every transaction has a dual effect on the accounting equation. This means that there must be a debit as well as a corresponding credit, so that the accounting equation remains in **balance**.

Refer to the table below about the rules for increasing and decreasing debit and credit items:

Item	Nature of Account	Increase	Decrease
Assets and Expenses	Debit in nature	Debit to increase	Credit to decrease
Liabilities, Owner's Equity and Revenue	Credit in nature	Credit to increase	Debit to decrease

MEMORY AID – PALER

This memory aid may be useful to remember how to classify items such as Owner's Equity (commonly referred to as **P**roprietorship), **A**ssets, **L**iabilities which belong to the **Balance Sheet**, and **E**xpenses and **R**evenue which belong to the **Income Statement.** The **acronym** is **PALER**. ***PAL*** represents items in the Balance Sheet while ***ER*** represents items shown in the Income Statement.

With this acronym in place, you can then practise recalling which of these items are **debit in nature** and which are **credit in nature**. The table below shows how you can differentiate between them:

Item	Nature of the Account	Increase in Value	Decrease in Value
P **(proprietorship)** **Owner's Equity**	Cr	Cr	Dr
A **Assets**	Dr	Dr	Cr
L **Liabilities**	Cr	Cr	Dr
E **Expenses**	Dr	Dr	Cr
R **Revenue**	Cr	Cr	Dr

The example below may also be helpful to demonstrate how to classify items.

Scenario:

If a business purchases a motor vehicle on credit, then this transaction will have two effects. Firstly, the **assets** of the business have **increased** as a result of the purchase of the **vehicle** (an asset), and they may now also have a loan (**liability**) as they have borrowed funds to buy the vehicle which means their liabilities have also **increased**.

The **dual aspect** of financial transactions affects the accounting equation, which is:

ASSETS = LIABILITIES + OWNER'S EQUITY

Every transaction has a two-sided effect on the accounting equation. This is because the accounting equation needs to remain constant (balance).

The accounting equation **should balance** after every transaction.

Therefore, in the above transaction regarding the purchase of a motor vehicle, we can analyse it like this:

Item	Action	Why	Impact on Accounting Equation
Motor Vehicle	***Debit***	Asset is increasing	**Accounting equation is equal as assets = liabilities**
Loan for Vehicle	***Credit***	Liability is increasing	

Helpful online resources

Watch: "The Accounting Equation for Beginners" will help you understand what duality is and why the accounting equation must always balance.

https://tinyurl.com/3pzrjf5s

Activity

1. Refer to the accounting equation below. **Calculate** the **missing values** to ensure the equation balances.

Assets	**=**	**Liabilities**	**+**	**Owner's Equity**
______		2,000		5,000
23,000		______		10,000
75,900		53,800		______
46,000		______		38,990
______		11,000		2,500
134,900		65,630		______
93,800		______		23,100
______		9,400		300,000
117,000		25,800		______
592,000		______		321,500
______		78,500		95,000

2. Classify the following as an **Asset (A), Liability (L) or Owner's Equity (OE)** and whether the item is **DEBIT or CREDIT in nature.**

Some definitions of terms have been provided, for understanding. Record your answers below.

Account	A, L or OE	Debit or Credit
Bank – money in a bank account		
Cash – sometimes called Cash at Bank		
Debtors – money owed by people to the business, generally from credit sales		
Creditors – money the business owes to other people, generally from credit purchases		
Stock – goods the business sells to earn revenue		
Mortgage – long term secured loan to purchase Land/Buildings		
Accounts Receivable – same as debtors		
Accounts Payable – same as creditors		
Loan – borrowings of money from a financial institution		
Drawings – owner withdrawing assets from the business for personal use		
Inventory – same as stock		
Buildings		
Capital – owner's investment into the business		
Land		
Machinery		
Bank Overdraft – short term loan, overdrawing the business account		
Furniture		
Electricity Bill Owing		
Motor Vehicle		
Plant – same as machinery		

3. For each of the following transactions, indicate whether the accounts affected are an ***asset, a liability, owner's equity, an income or expense***. Then indicate whether the accounts are ***increasing or decreasing***.

Example: *Paid wages*.

The two accounts affected are: Cash at Bank and Wages Expense. Increase an expense (debit), decrease an asset (credit).

(a) Owner provided capital to start the business.
(b) Paid electricity.
(c) Purchased supplies on credit.
(d) Received cash from a debtor.
(e) Invoiced a customer for services provided.
(f) Owner withdrew funds for personal use.
(g) Paid for advertising.
(h) Borrowed money from the bank to purchase a building.
(i) Bought furniture using cash.

Transaction	Accounts Affected	Account Type	Nature of Item	Increase	Decrease
Example: *Paid electricity*	*Cash at Bank* *Electricity*	*Asset* *Expense*	*Debit* *Debit*	 *X*	*X*

2

The Accounting Equation

The accounting equation (A = L + OE) represents the financial position of a business. As with any mathematical equation, if one element changes in value then there must be a corresponding change to maintain the balance in the equation.

The Accounting Equation is the relationship between Total Assets and Total Equities (ie total assets, liabilities and owner's equity) shown in the Balance Sheet.

This relationship is **always in balance**:

Assets = Liabilities + Owner's Equity

The equation is usually expressed as A = L + OE but can also be expressed as:

Liabilities = Assets – Owner's Equity

or as:

Owner's Equity = Assets – Liabilities

Remember: the accounting equation **should balance after every transaction**. Try the following activities to check your understanding.

Review Questions

1. Using the accounting equation, calculate the owner's equity for each business below:

   (a) **Harry's Hardware Store**

   Motor Vehicles $12,000; Land $25,000; Cash at Bank $4,000

   OE = ..

   (b) **MoMo's Music Shop**

   Inventory $11,200; Motor Vehicles $32,000; Debtors $1,500; Creditors $4,300

   OE = ..

   (c) **Newton Bay Newsagency**

   Cash in Hand $600; Furniture $1400; Inventory on Shelves $1250; Loan from K White $300; Debtors $1200; Creditors $1150; Bank Overdraft $320.

   OE = ..

   (d) **Walkabout Shoes**

   Inventory $44000; Bank Overdraft $2700; Vehicles $13000; Creditors $3250; Debtors $1350; Loan to G Brown $140; Equipment $700.

   OE = ..

2. You are provided with a series of **effects on the accounting equation** below. For each of these, describe a transaction that would have caused this effect on the accounting equation. *The first one is done for you*.

   (a) Increase an asset and increase a liability.

   Example Answer: Purchased stock on credit.

   Try and provide more detail such as: The effect on the accounting equation is–Stock is an asset increasing and Suppliers is a Liability increasing.

   (b) Decrease one asset and increase another asset.

   (c) Decrease an asset and decrease equity.

(d) Increase an asset an increase equity.

(e) Decrease a liability and decrease an asset.

3. Calculate the missing amounts for each situation in the table below:

	Total Assets	Total Liabilities	Equity
A	$95,000	$35,000	
B	$120,000		$81,000
C		$17,000	$48,000
D	$82,000		$45,000
E		$23,000	$135,000

2

Duality Concept

Remember that the duality concept refers to the fact that **every transaction has at least two effects on the accounting equation** and that the accounting equation must always balance.

Activity

Analysing transactions

The activity below gives you an opportunity to practise balancing the accounting equation. Refer to the two examples to show you how to complete this task.

Example 1: **Transaction: The business buys a $25,000 motor vehicle with cash.**

Motor Vehicle (Asset) increases by $25,000 *as the business has a new vehicle*

Cash at Bank (Asset) decreases by $25,000 *as the money is taken out of the bank to pay for the vehicle.*

Assets	=	Liabilities	+	Owner's Equity
+$25,000 - $25,000	=	no effect	+	no effect

Example 2: **The business gets a $15,000 loan from the bank**.

Cash at Bank (Asset) increases by $15,000 *as the business receives this amount from the bank.*

Loan from bank (Liability) increases by $15,000 *as the business now owes this amount to be repaid at a future point in time.*

Assets	=	Liabilities	+	Owner's Equity
+$15,000	=	+ $15,000	+	no effect

Practice

Complete the following table listing the **two effects** on the accounting equation for each transaction.

(a) **Buy equipment with cash for $35 000**

Assets	=	Liabilities	+	Owner's Equity
	=		+	

(b) **Buy furniture on credit from Taylor's Office Furniture for $55,000**

Assets	=	Liabilities	+	Owner's Equity
	=		+	

(c) **Owner injects $70,000 cash into the business**

Assets	=	Liabilities	+	Owner's Equity
	=		+	

(d) **Debtor pays his account $1,250**

Assets	=	Liabilities	+	Owner's Equity
	=		+	

(e) **Business repays loan of $15,000**

Assets	=	Liabilities	+	Owner's Equity
	=		+	

(f) **Owner withdraws $1,700 for personal use**

Assets	=	Liabilities	+	Owner's Equity
	=		+	

The Balance Sheet and the Accounting Equation

The Balance Sheet is a **financial statement** that shows the relationship between Assets and Equities, i.e., it is a report which shows how the accounting equation balances.

The relationship between assets, liabilities and owner's equity, as described by the accounting equation, is at the heart of the Balance Sheet and can be seen in the example below:

Annie's Trading Store

Balance Sheet

as at 31 December 2020

ASSETS	**$**	**$**	**EQUITIES**	**$**	**$**
Current Assets			**Current Liabilities**		
Cash	22,000		Creditors	33,000	
Debtors	11,000		Loan to Bank (due 31.3.21)	3,000	36,000
Stock	18,000	51,000			
Non-current Assets			**Non-current Liabilities**		
Vehicles	53,000		Loan to Bank (due 2023)	21,600	
Office Equipment	68,000		Mortgage	110,000	131,600
Land	70,000				
Buildings	102,000	293,000	**Owner's Equity**		
			Capital (A Valley)	183,200	
			Less Drawings	5,000	
				178,200	
			Less Net Loss	(1,800)	176,400
TOTAL ASSETS		344,000	TOTAL EQUITIES		344,000

The accounting equation in this Balance Sheet is:

Assets $344,000 = **Liabilities** $167,600 + **Owner's Equity** $176,400.

Activity

1. Fill in the blank spaces.

   (a) The accounting equation can be expressed in the following ways:

   Owner's Equity = ...

   Liabilities = ...

   Assets = ...

   (b) Every business transaction has a .... effect on the ....

   ....

   (c) In order for the accounting equation to be equal, ... sides of the .... must balance.

   (d) It is important to remember that every .... has at least .... effects on the accounting equation.

2. Complete the following for S Wilson's business:

   (a) Show the **effect of the transactions** listed below on the accounting equation.

   (b) **Total up** the assets, liabilities and owner's equity of the business at the end of first month.

June 2021

1 S Wilson commenced business with supplies $800 and cash $10,000.

2 Bought furniture worth $1000 from Furniture Land Co, paying a deposit of $400 and agreeing to pay the balance within a month.

6 Borrowed $3,000 from the bank towards meeting some future purchases.

7 Bought land for $10,000 from Finance Co Ltd.

10 Paid Furniture Land Co $200.

11 Purchased supplies for $300 cash.

Date	Name of account	Asset	Liability	Owner's Equity
	Total			

3. Identify the **two** accounts involved, classify them as A, E, L, OE, R and indicate the effect on the accounts involved.

e.g.: Paid Wages		
Account	**Classification**	**Effect**
Wages	Expense	increasing (Debit)
Cash at Bank	Asset	decreasing (Credit)
Purchased Fixtures and Fittings from ABC Equipment		
Account	**Classification**	**Effect**
Received payment from Debtors		
Account	**Classification**	**Effect**
Secured a loan from XYZ Bank		
Account	**Classification**	**Effect**
Paid Electricity		
Account	**Classification**	**Effect**
Sold goods to J Small		
Account	**Classification**	**Effect**

2

Distinguishing between Current and Non-current Assets and Liabilities

The accounting elements (Assets and Liabilities) are further classified into **CURRENT** and **NON-CURRENT** items in the **Balance Sheet**. This is to **make information more useful** to users of this financial report.

Current assets are cash and other types of assets that are more **liquid** (i.e. easily converted into cash) within a accounting period. Items that can be converted into cash within a 12 month period, are therefore classified as Current Assets. Some examples include: cash, inventory, and debtors.

Non-current assets are items of value that the business **cannot easily convert into cash**. These are items that the business is **expected to use over a number of years** and are therefore not for sale. Some examples include: buildings, furniture, investments, motor vehicles and land. As you can see, these items are not usually purchased by a business to resell. They are purchased to help the business operate.

Current liabilities are obligations the business has to pay for debts they have incurred which are **due to be settled within a 12 month period**. Some examples include: creditors and short-term loans.

Non-current liabilities are obligations the business has to pay for debts they have incurred that require **payment over a longer term** (i.e. over 12 months). Some examples include: mortgage and long-term loans (e.g. 3 year term).

Activity

4. Classify the following items as assets, liabilities (current/non-current) or owner's equity:

Transaction	Classification	Transaction	Classification
Creditors		Loan to J Jones	
Loan from bank (due in 1 year)		Loan secured by mortgage	
Owner's interest in the business		Motor vehicle	
Bank overdraft		Debtors	
Furniture		Inventories	
Loan from J Green		Premises	
Cash at bank		Land	

5. R Rogers' business has the following assets and liabilities: Cash at bank $6,000; Motor vehicles $21,000; Debtors $4,000; Inventory $15,000 and Creditors $3,000.

   (a) What is R Rogers' equity in the business? *Circle the correct response*.

   i) $49,000 ii) $43,000 iii) $41,000 iv) $31,000.

   (b) If debtors repaid $3,500 of the $4,000 currently outstanding, which TWO accounts would be affected?

   ....

   (c) What would be the new balances to the above TWO accounts?

   ....

Case Study

Read the case study below:

New casual employment rules kick in next week: Here's what you need to know

STEPHANIE PALMER-DERRIEN

SEPTEMBER 23, 2021

New laws are set to kick in next week for employers of casual workers, meaning any casual who has been with the business for 12 months or more must be issued a written offer to convert to permanent employment.

First introduced in 2020 and passed in March this year, the new rules give casual employees the right to convert to permanent employment, either on a part-time or full-time basis.

The new rules come into effect from Monday, 27 September, 2021. For some employers, there may be actions needed before then.

Casual conversion rules: What do businesses need to do?

With the exception of small business employers, as defined by the Fair Work Ombudsman, businesses must make a written offer to convert a casual employee to a permanent staff member within 21 days of their 12-month anniversary with the business.

If the employee has effectively been working full-time hours for at least six months, the employer must offer them a full-time, permanent position. If they have been working less than full-time hours, the employer must offer them part-time employment.

Employees must respond to the offer within 21 days. If they don't respond, employers can assume they have declined the offer. However, from 28 September, eligible casual employees can make a request to convert to permanent employment once every six months, or earlier if they become eligible.

What penalties are in place?

Employers cannot change or reduce an employee's hours, or terminate employment, in order to avoid having to make a conversion offer. Businesses that fail to make an offer could reportedly face penalties of $66,000 or more, while individuals could be fined $13,000.

What are the rules for converting existing casual employees?

For businesses with casual employees who started before 27 March, 2021, employers must assess whether their casual staff members are eligible for conversion to permanent employment. More detail on eligibility below.

Within 21 days of making the assessment, they must make a written offer of conversion to all eligible casual employees. For ineligible employees, or if they are not planning on making an offer to convert, they must write to employees explaining the reasons why. Crucially, these letters must be sent before 27 September, 2021.

Do casual employment changes apply to small businesses?

Businesses with fewer than 15 employees do not have to offer casual conversion. However, from 28 September, eligible casual workers within these businesses can request to convert to permanent employment at any time on or after their 12-month anniversary with the business.

In this case, the employer can only refuse the request if they have consulted with the employee and have reasonable grounds to do so. Reasonable grounds could be that the position is likely not to exist within 12 months' time; that the employees' hours would significantly reduce; or that the days and times of work would change significantly.

Which employees are eligible for casual conversion?

In order to be eligible, casual employees must have been working with the business for 12 months, and have been working a regular pattern of hours on an ongoing basis for at least six months.

The rules apply if the employee can reasonably continue working those hours as a full- or part-time employee, without making any significant changes.

Source: www.smartcompany.com.au

Scenario:

A friend of yours who owns a small business – Jay's Trades and Swaps – has read the above article and has come to you for advice as he knows you are studying Accounting. Jay employs 12 people, most of whom are employed on a casual basis. He has the following questions for you. Read the article carefully and then prepare clear and helpful responses to Jay's questions:

(a) Who are the stakeholders in this situation?

(b) Does this new change to rules affect small business owners? How do you know this?

(c) What does 'casual conversion rule' actually mean?

(d) What is the difference between a casual worker and a permanent worker?

(e) Jay admits that 3 of his staff work regular casual hours each week. Advise Jay on whether he will now have to consider changing their employment to permanent. In your response, include what conditions apply and what penalties are in place if Jay does not adhere to the new rules.

Chapter 3 – Double-entry Accounting

3.1 General Journal

Glossary of Terms

ledger	journal	Cost of Goods Sold
revenue	purchases	inventory
debit	credit	income
equity	Gross Profit	goodwill
balance	transaction	narration

As you learnt in Chapter 2.3, every transaction made by a business must be **recorded** to keep track of funds coming into and going out of the business. To do this properly, every transaction is recorded into two accounts. This is known as **double-entry accounting**. This basically means that every transaction affects the business in at least two ways. This **dual effect** of a transaction ensures that the **accounting equation** always balances.

In a typical manual accounting system, a transaction is analysed and recorded in a book known as a **General Journal *before*** the effects of the transaction are entered into individual accounts in the **General Ledger**. In this chapter, you will learn how to enter transactions into the General Journal. This is **Step 3** of the Accounting Process you learnt about in Chapter 2.1.

The General Journal refers to a book of original entries that is used by bookkeepers and accountants to record business transactions. These transactions are recorded in chronological order (date order). **A General Journal is the first place where financial data is recorded.**

Some businesses keep specialized journals, such as Purchase Journals or Sales Journals that only record specific types of transactions. We will only be focusing on the General Journal for the purposes of this course.

Once a transaction is recorded in a General Journal, the amounts are then posted to the appropriate General Ledger accounts, such as Accounts Receivable, Equipment, and Cash at Bank. *We will cover this in more detail in the next chapter.*

Journal Entry Format

Transactions are recorded in the General Journal in a debit and credit format, by date, with the earliest entries being recorded first. These entries are called **journal entries** (since they are entries into journals). Each journal entry includes the date, the amount of the debit and credit, the titles of the accounts, and whether the account is being debited or credited, as well as a short **narration**. It's important to remember that **total debits must equal total credits.**

General Journal Example

An example of a transaction that would be recorded in the General Journal is "Paid wages in cash". This would be recorded in the following way:

Debit account goes first

Amounts must be equal

General Journal

Date	Account	Debit	Credit
30 June	Wages	5,500	
	Cash at Bank		5,500
	To record wages expense for the month of June .		

Indent the credit account

Include a narration to explain the transaction

The above General Journal entry shows the date of the transaction, the two accounts which are affected by this transaction and the relevant debit and credit. Finally, a short narration is included to remind us as to the nature of this transaction.

In summary, an accounting transaction is recorded into a journal, and then the information in the journal is posted into the accounts which are stored in the General Ledger. The General Journal is the place transactions are stored if they are not recorded in a specialty journal.

Other Issues

The General Journal was more important in the days of manual record-keeping. With the majority of small businesses now using accounting software to record their accounting transactions, the General Journal is not so visible. Instead, the software makes it appear as though all transactions centre around the General Ledger, with no specialty journals used at all. However, in order to understand what is happening 'behind the scenes', it is important for you to learn how to record transactions in the General Journal.

The table below shows some of the advantages of each system:

Advantages of Manual Record-keeping	Advantages of Accounting Software
Less expensive to set up	More efficient way to record transactions
Simple to use	Easy to generate reports whenever they are needed
Easier to correct errors in entries	Able to automate many processes such as sending invoices
Data loss is less of a risk	Easy to backup records for safekeeping

Helpful online resources

Watch: "How General Journal Entries work in Accounting". This video explains the purpose of a General Journal and how to enter transactions. It is useful in reviewing what you have learnt so far.

https://youtu.be/Y-_Q3rANyxU

Activity

1. Practice entering transactions

(a) You are required to complete the following transactions for **Razzle Catering** who had the following transactions for the month of August. (*The first one is done for you. Note that next to the account name, e.g. Purchases, the nature of the account is included [Expense] as well as whether it has increased or decreased. You may also take the option of showing the effect of each transaction on the accounting equation).*

Date	Transaction	Account to Debit	Dr	Account to Credit	Cr
1	Purchased stock from Fresh Food Bazaar $1500	Purchases *(Expense increasing)*	1,500	Fresh Food Bazaar *(Liability increasing)*	1,500
3	Returned stock to Fresh Food Bazaar $250				
4	Sold stock $570				
4	Paid electricity $350				
4	Paid wages $550				
5	Sold stock to B Smithson on credit $650				
6	Owner withdrew cash $1,500 for school fees				
6	B Smithson returned goods $50				
6	Cash Sales $450				
7	Paid Fresh Food Bazaar $250				
7	Paid petrol and oil $85				

Date	Transaction	Account to Debit	Dr	Account to Credit	Cr
8	Owner injects $2 500				
8	Cash Sales $250				
8	Sold Stock to M Grincer $200				
11	M Grincer paid $50 of their account				
12	Paid wages $550				
12	Cash Purchases $750				
12	Purchased stock from Fresh Food Bazaar $320				
14	B Smithson paid his account in full				
15	Paid Fresh Food Bazaar $300				
21	Owner withdrew stock $150				

(b) **Circle** the word that makes these statement true:

(i) Asset and Expense accounts are of a *debit/credit* nature.

(ii) Liability, Revenue and Owner's Equity accounts are of a *debit/credit* nature.

(iii) Sales are *revenue/asset* accounts.

(iv) Purchases are *liability/expense* accounts.

(v) Drawings *reduce/increase* owner's equity accounts.

(vi) Discount received is a negative *revenue/expense* account.

(vii) Discount allowed is a negative *revenue/expense* account.

(c) **Complete** the sentences below:

(i) The Purchase of stock is called ....

(ii) The Sale of stock is called ....

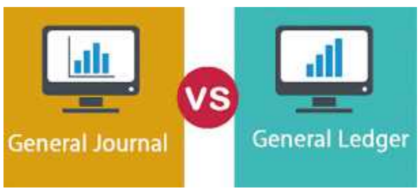
(iii) The return of goods bought on credit is called ....

(iv) The return of goods sold to a debtor is called ....

(v) Drawings of stock is called ....

Why Use a General Journal?

The General Journal shows the account names and is a **cross-check** of the transactions you are entering. In learning this process, you are given a chance to think through each transaction, to understand what effect this is going to have on the accounting equation. It is important to ensure that the transaction has both a debit and a credit.



When entering a transaction into the General Journal, **debit entries are listed first** and then the **credit entries which are indented**. Do not forget to add a **narration** at the end of each transaction.

Activity

1. Complete the General Journal for Razzle Catering

General Journal of Razzle Catering

Date	Account	Dr /Cr	Debit $	Credit $
Feb 1	Purchases Food Bazaar *Purchased stock on credit.*	Dr Cr	1,500	 1,500

Date	Account	Dr /Cr	Debit $	Credit $

2. You are required to prepare the General Journal of Definitely Maybe using the information provided below:

   The following transactions occurred in the month of June for new business, "Definitely Maybe".

   June 1 Owner N. Smith starts business by injecting $10,000

   June 3 Bought Stock from XYZ Supplies $16,000

   June 4 Paid Rent $1,000

   June 6 Sold goods to M Shah $500

   June 9 Cash sales $1,300

   June 13 Received loan from TRB Bank $5,000

   June 17 Bought Furniture $3,500 from All4Furniture store.

Definitely Maybe

General Journal

Date	Account	Dr /Cr	Debit $	Credit $

3. Revision – Double Entry Accounting

Show the **effect on the accounting equation** for the following transactions:

(a) Business brings in furniture $5,000, stock $500 and cash $12,000 as capital.

(b) Purchased equipment worth $450 from XYZ Trading Co. for cash.

Date	Name of account	Asset	Liability	Owner's Equity
i				
ii				

4. Fill in the missing values:

Asset	Liabilities	Owner's Equity
	2 750	3 000
13 500		8 340

5. Classify the following in A, E, L, OE, R

Bank Balance		Fixtures & Fittings		Drawings	
Accounts Payable		Fees		Commission received	
Net Profit		Mortgage		Land and Building	

6. Complete the entries in the General Journal for the following transactions:

Nov 3 Sold old delivery van for $5 000.

5 Purchased goods worth $1 000.

General Journal

Date	Account	Dr /Cr	Debit $	Credit $

7. Post the following transactions to the Bank a/c and formally balance it. *Hint: only post transactions that involve cash.*

Mar 1	Deposited $2,500 in the business's bank account to commence business
2	Purchased goods worth $5,000 from East West Suppliers and paid half in cash
3	Borrowed a loan of $3,000 from State City Bank
4	Purchased equipment worth $750
10	Sold stock worth $500 to Justin and $300 for cash
16	Paid wages to assistant $220
21	Sold goods worth $250
27	Repaid $1,000 of bank loan
30	Cash Sales $100

Dr **Bank** Cr

Date	**Particulars**	**Amount**	**Date**	**Particulars**	**Amount**

Bank balance at the end of March: ______________________

8. Explain the stages of the accounting process in detail.

3.2 General Ledger

As you have already learnt, every transaction has at least **two effects on the accounting equation** – known as the ***Duality Concept***. An ***account*** is a financial record where all changes to a particular item within an entity are kept.

So far you have learnt to post **transactions** to the **General Journal**. Each transaction you have posted has had **two effects on the accounting equation**. You have shown this by posting the transaction in the General Journal. For example, Cash Sales of $1,000 on 1 June 2021, would look like this in the General Journal:

June 1	Cash at Bank	$1,000	
	Sales		$1,000
	Cash sales.		

Step 4 in the accounting process (see below), is to post this General Journal entry to the relevant **ledger**. A ***ledger*** is a collection of all the accounts of an **entity** (business).

Accounting Process

Collecting → Recording → Reporting → Analysing → Budgeting

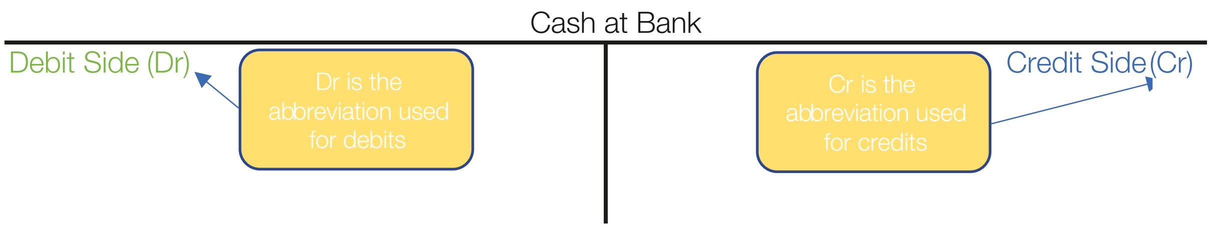
Separate ledger accounts are kept for each account a business uses. Some of the more common accounts appear below:

Ledgers	**Assets**	**Liabilities**	**Owner's Equity**	**Revenue**	**Expenses**
Accounts	Cash at Bank	Creditors	Capital	Sales	Wages
	Debtors	Loans	Drawings	Fees Received	Rent
	Land	Bank Overdraft		Interest Received	Telephone

Any **change** to a particular asset, liability, owner's equity, revenue and expense is recorded in their respective **account**.

What do General Ledger accounts look like?

The traditional form of an account is called a **"T" account** *(because it looks like a T)* where all movements, both ***increases*** and ***decreases***, are recorded. An example of a T account can be seen below. Cash at Bank is a commonly used Ledger Account. It looks like this:



How to make entries into a Ledger Account:

Before you start making entries into a Ledger Account, you must remember to use the **principles of double entry accounting**. These are:

1. For every ***debit*** entry there must be a corresponding ***credit*** entry
2. For every transaction, ***total debits*** must equal ***total credits*** – see example below:

Total Debits \$ (Dr) = Total Credits \$ (Cr)

3. **Increases** to accounts are recorded on the **same side** as the **nature** of the account
4. **Decreases** to accounts are recorded on the **opposite side** to the **nature** of the account.

Let's take the earlier example of the Cash Sales transaction, which was posted to the **General Journal**:

June 1	Cash at Bank	\$1,000	
	Sales		\$1,000
	Cash sales.		

We are now ready to post this to the General Ledger account using the principles of double entry accounting, explained above.

Step 1: For every debit there must be a corresponding credit entry.

In this case, we received cash for the sales we made. We have our **debit** (Cash) which is **increasing** because we received cash, and our **credit** (Sales) which is also **increasing**. Remember, **Cash is DEBIT in nature as it is an Asset and Sales is CREDIT in nature as it is Revenue**. This is shown in the table below:

Accounts	Type of Account	Nature of Account	Action Taken
Cash at Bank	Asset	Debit	Increasing so we debit
Sales	Revenue	Credit	Increasing so we credit
Total Debits \$1,000 = Total Credits \$1,000			

Therefore, the General Journal entry would be:

June 1	Cash at Bank	\$1,000	
	Sales		\$1,000
	Cash sales.		

Step 2: Post the General Journal entry into the relevant Ledger accounts.

In this step, we will do **exactly** what the General Journal entry tells us to do. That is, we will **DEBIT** Cash and **CREDIT** Sales, thereby keeping the **accounting equation balanced**. This is shown below:

Cash at Bank

Date	*Particulars*	*Amount*	*Date*	*Particulars*	*Amount*
June 1	Sales	\$1,000			

This shows which account has the corresponding **credit**

Sales

Date	*Particulars*	*Amount*	*Date*	*Particulars*	*Amount*
			June 1	Cash at Bank	\$1,000

This shows which account has the corresponding **debit**

General Ledger Accounts – Posting to the General Ledger

Posting to the ledger is straightforward once the General Journal entries have been made. Posting to the ledger involves doing ***exactly*** what the transaction in the General Journal tells you to do.

This is shown in the above example. The transaction in the General Journal tells us to Debit Cash at Bank and to Credit Sales. In this example, **total debits equal total credits** so we are in **balance**.

Review of Debits and Credits

The ledger account below shows you examples of common items and where they would appear in the ledger (based on the nature of that account). For example, Cash is on the DEBIT side of the ledger because it is DEBIT in nature.

DEBIT (Dr) Name of Account CREDIT (Cr)

DEBIT (Dr)	CREDIT (Cr)
Assets	**Liabilities**
Cash	Creditors
Debtors	Loans
Land	Bank overdraft
Expenses	**Owner's Equity**
Wages	Capital
Rent	
Telephone	**Revenue**
	Sales
Drawings	Fees received
	Interest received

Once transactions have been analysed, they are then placed into their respective ledger accounts. The procedure for entering details into a ledger account is called "***posting***".

To post to a ledger account in "T" format, you will need to do the following:

1. **Identify** the account, and **open** (create) an account if one does not exist.
2. **Identify** whether the account is to be ***Debited (Dr)*** or ***Credited (Cr).***
3. Show the **date** of the transaction.
4. Fill in the **name** of the ***other account*** affected under **Particulars**
5. Place the relevant amount in the **$** column.

Example

The table below shows the transactions for **Ropes and Ladders**, owned by Johnny Climb. These transactions need to be posted to the Subsidiary Ledger accounts.

Date	Transaction	Accounts	Type	Nature	Inc/Dec	Dr	Cr
June 1	Owner introduced	Cash at Bank	A	Dr	Inc	30,000	
	$30 000 into the business	Capital	OE	Cr	Inc		30,000
June 15	Bought Motor Vehicle	Motor Vehicle	A	Dr	Inc	15,000	
	Cash deposit $5,000	Cash at Bank	A	Cr	Dec		5,000
	Balance on loan	Loan	L	Cr	Inc		10,000

Posting to the ledger would occur as follows:

Dr — Cash at Bank — *Cr*

Date	***Particulars***	***Amount***	***Date***	***Particulars***	***Amount***
June 1	Capital	$30,000	June	15 Motor Vehicle	$5,000

Dr — Capital — *Cr*

Date	***Particulars***	***Amount***	***Date***	***Particulars***	***Amount***
			June 1	Cash	$30,000

Dr — Motor Vehicle — *Cr*

Date	***Particulars***	***Amount***	***Date***	***Particulars***	***Amount***
June 15	Cash	5,000			
	Loan	10,000			

Dr — Loan — *Cr*

Date	***Particulars***	***Amount***	***Date***	***Particulars***	***Amount***
			June 15	Motor Vehicle	$10,000

Review Questions

Posting transactions

Use the General Journal entries below to post the transactions to the General Ledger.

General Journal

Date	Account	Dr/Cr	Debit $	Credit $
1 Jan	*Cash at Bank*	Dr	8000	
	Capital	Cr		8000
	(Owner invested capital)			
2 Jan	*Rent*	Dr	1500	
	Cash at Bank	Cr		1500
	(paid rent)			
3 Jan	*Purchases*	Dr	500	
	Richard Z	Cr		500
	(purchased goods on credit)			
5 Jan	*Richard Z*	Dr	50	
	Purchase Returns	Cr		50
	(returned faulty goods to creditor)			
7 Jan	*Richard Z*	Dr	450	
	Cash at Bank	Cr		450
	(made full payment to Richard Z)			

Dr Bank *Cr*

Date	***Particulars***	***Amount***	***Date***	***Particulars***	***Amount***

Dr Capital *Cr*

Date	***Particulars***	***Amount***	***Date***	***Particulars***	***Amount***

Dr Rent *Cr*

Date	***Particulars***	***Amount***	***Date***	***Particulars***	***Amount***

3

Dr Purchases Cr

Date	Particulars	Amount	Date	Particulars	Amount

Dr Richard Z Cr

Date	Particulars	Amount	Date	Particulars	Amount

Dr Purchases Returns Cr

Date	Particulars	Amount	Date	Particulars	Amount

Closing General Ledger Accounts

At the end of each accounting period, individual ledger accounts need to be closed in preparation for the next account period. The closing process requires balancing both sides of the ledger account and transferring the remaining amount to the correct side of the ledger in readiness for the next accounting period.

This is shown briefly for you below but please note, your teacher will take you through this process more carefully and in more detail in class.

We will use the Cash at Bank account from the above business transactions for Ropes and Ladders to show you how to close an account. It is important that both sides of the ledger balance and that closing balances are shown where appropriate. See the example below:

Dr Cash at Bank Cr

Date	Particulars	Amount	Date	Particulars	Amount
June 1	Capital	$30,000	June 15	Motor Vehicle	$5,000
			30	Bal c/d	$25,000
		$30,000			$30,000
July 1	Bal b/f	$25,000			

Add Balance brought forward at beginning of next month to show starting balance

Both sides of ledger must balance at the end of the month/period

Add a Balance carried down amount on smaller side of ledger so account will balance

Trial Balance

The double-entry accounting system requires a debit and corresponding credit for every transaction. This means that dollar amounts must be equal for debits as well as credits. Therefore, if you have a transaction where you receive cash for the sale of goods for $2,000, you will need to debit Cash for $2,000, credit Sales for $2,000. **The dollar amounts must be equal**.

To ensure that at the end of the accounting period, before Financial Statements are prepared, that debit and credit amounts are equal, a **Trial Balance** is prepared. The Trial Balance helps to **verify** that the ledger accounts are properly balanced. This is a final check that all transactions have been correctly entered so that the Financial Statements are accurate. For example, you might uncover that an amount has been incorrectly recorded from the ledger account to the Trial Balance – Cash at Bank was recorded as $1,251 but in the Trial Balance it was recorded as $2,151.

A Trial Balance consists of a list of all of the accounts of the business for that accounting period. The accounts are listed in the order they appear in the General Ledger with their current balances. The dollar amounts of accounts with a **debit balance are listed in one column** and the **dollar amounts of accounts with a credit balance are listed in a second column**. The totals of the two columns should be equal. When this occurs, the ledger is said to be 'in balance'.

Below is an example of what a Trial Balance looks like once all the accounts and balances have been entered:

Learn to Ride Bicycles
Trial Balance
as at 30 June 202X

Account	Debit	Credit
Cash at Bank	$50,000	
Accounts Receivable	$12,600	
Office Equipment	$45,000	
Land	$105,000	
Accounts Payable		$13,400
Loan from S Swift (due Dec 202X)		$5,600
Mortgage		$125,000
Owner's Equity		$68,600
	$212,600	$212,600

Activity

1. Complete the Trial Balance for **Ropes and Ladders** using the balances from the ledger accounts you prepared above.

Ropes and Ladders **Trial Balance** **as at ....**		
Account	**Debit**	**Credit**

2. What is a Trial Balance?

....

....

3. What is the purpose of preparing a Trial Balance?

....

....

....

4. Why can a Trial Balance be in equilibrium (i.e. balance), and still be incorrect?

....

....

....

5. Provide ONE reason why the Trial Balance may not balance.

....

....

....

3.3 Trial Balance

The double-entry accounting system requires a debit and corresponding credit for every transaction. This means that dollar amounts must be equal for debits as well as credits. Therefore, if you have a transaction where you receive cash for the sale of goods for $2,000, you will need to debit Cash for $2,000, credit Sales for $2,000. **The dollar amounts must be equal**.

To ensure that at the end of the accounting period, before Financial Statements are prepared, that debit and credit amounts are equal, a **Trial Balance** is prepared. The Trial Balance helps to **verify** that the ledger accounts are properly balanced. This is a final check that all transactions have been correctly entered so that the Financial Statements are accurately prepared.

A Trial Balance consists of a list of all the accounts of the business for that accounting period. The accounts are listed in the order they appear in the General Ledger with their current balances. The dollar amounts of accounts with a **debit balance are listed in one column** and the **dollar amounts of accounts with a credit balance are listed in a second column**. The totals of the two columns should be equal. When this occurs, the ledger is said to be 'in balance'.

3

Below is an example of what a Trial Balance looks like once all the accounts and balances have been entered:

Learn to Ride Bicycles Trial Balance as at 30 June 202X		
Account	**Debit**	**Credit**
Cash at Bank	$50,000	
Accounts Receivable	$12,600	
Office Equipment	$45,000	
Land	$105,000	
Accounts Payable		$13,400
Loan from S Swift (due Dec 202X)		$5,600
Mortgage		$125,000
Owner's Equity		$68,600
	$212,600	$212,600

Activity

1. Complete the Trial Balance for **Ropes and Ladders** using the balances from the ledger accounts you prepared in the previous chapter – 3.2 General Ledger.

Ropes and Ladders **Trial Balance** **as at ....**		
Account	**Debit**	**Credit**

2. Answer the theory questions below, in order to check your understanding of Trial Balances.

   (a) What is a Trial Balance?

   (b) Why is it prepared?

   (c) Why can a Trial Balance be in equilibrium (ie balance), and still be incorrect?

   (d) Provide ONE reason why might it not balance.

Chapter 4 – Financial Reports

4.1 The Balance Sheet

Glossary of Terms

financial position	general purpose report	net worth
drawings	capital	current asset
non-current asset	current liabilities	non-current liabilities

A Balance Sheet is a **general purpose report** that shows the **financial position** of a business **at a particular point in time**, generally at the end of the financial year. A Balance Sheet summarises the **value of a business's assets** (what the business owns) and the business's **liabilities** (what the business owes). In addition, it includes details of the owner's equity (what the owner is owed by the business). In other words, it is a snapshot of a business's **net worth** at a particular point in time. This report is also commonly known as a **Statement of Financial Position**. An example of a Balance Sheet is shown below:

Annie's Trading Store
Balance Sheet
as at 31 December 2020

ASSETS	$	$	EQUITIES	$	$
Current Assets			**Current Liabilities**		
Cash	22,000		Creditors	33,000	
Debtors	11,000		Loan to Bank (due 31.3.21)	3,000	36,000
Stock	18,000	51,000			
Non-current Assets			**Non-current Liabilities**		
Vehicles	53,000		Loan to Bank (due 2023)	21,600	
Office Equipment	68,000		Mortgage	110,000	131,600
Land	70,000				
Buildings	102,000	293,000	**Owner's Equity**		
			Capital (A Valley)	163,200	
			Less Drawings	(5,000)	
				158,200	
			Add Net Profit	18,200	176,400
TOTAL ASSETS		**344,000**	**TOTAL EQUITIES**		**344,000**

There are **three different sections** in a Balance Sheet; these are shown by the following formula (known as the **accounting equation**):

Assets – Liabilities = Owner's Equity

(A – L = OE)

It is important to note that the **Balance Sheet must 'balance'**. This is achieved by ensuring that each side of the above equation is equal. In other words, Assets *minus* Liabilities (one side of the equation), must *equal* Owner's Equity (the other side of the equation).

The **accounting equation** can also be represented in a number of other ways, as shown below. Regardless of how it is represented, each side of the equation, must **ALWAYS** balance. This is referred to as the **duality concept** where **total assets are equal to total equities**.

Assets = Liabilities + Owner's Equity
A = L + OE
Liabilities = Assets – Owner's Equity
L = A – OE
Owner's Equity = Assets – Liabilities
OE = A – L

Helpful online resources

Watch this video "The Accounting Equation for Business" to learn more about the accounting equation:

https://tinyurl.com/4twacj6v

The **accounting equation** must always balance, and the Balance Sheet is a snapshot of a business's assets, liabilities and equity at a particular point in time. A Balance Sheet is an important financial statement as it provides important information about a business's financial position.

Definition of the sections of the Balance Sheet

In order to prepare a Balance Sheet, it is important to understand the meaning of each section.

Assets refers to items of value owned by the business. A more formal definition of assets is:

Assets are future economic benefits controlled by the entity as a result of past transactions or other past events.

Assets (items of value) include such things such as motor vehicles, furniture, land which are purchased by a business with a view to continuously earn revenue. They are essential to the operations of the business and are **not intended to be resold** at a foreseeable date in the future. Other assets such as debtors, cash at bank, and stock, which are **liquid** in nature, are items which can be quickly converted to cash.

Assets are further divided as follows:

Current: exist in the short term – these are items the business will not hold onto for very long and will convert into cash (usually within a year) – i.e. items the business will sell in the short term.

Some examples of Current Assets include: Cash at Bank, Accounts Receivable (Debtors) and Inventory (Stock).

Non-current: items that the business will retain for the long term – i.e. will not be sold but are needed to help earn revenue.

Some examples of Non-current Assets include: Furniture, Land and Buildings, Motor Vehicles.

Intangible: Intangible assets are those that are not visible (cannot be touched) but are important to a business and ultimately to the financial value of a business. Intangible assets include:

- **Intellectual property** – this refers to knowledge, information or processes that are specific to the business and therefore enable this business to 'stand apart' from competitors. For example, an app that has been designed to be used to record customer feedback.
- **Trademarks and patents** – these are legally registered concepts that add value to a business. Every major brand has a trademark; think of Nike, Google, Facebook and one of the most famous of all, McDonald's. Trademarks are fiercely protected by businesses because it is an easily recognisable image of what this business stands for and reflects their values to the community.
- **Goodwill** – this refers to the reputation and performance of a business and is used at the time of sale to determine additional 'business value'. For example, a business that has a reputation for excellent customer service, will be able to 'sell' that as part of the goodwill of the business that the new owners will benefit from.

Helpful online resources

Watch this video "What are Assets?" to check your understanding of this concept:

https://tinyurl.com/j47bskk2

Liabilities refers to the debts of the business. A more formal definition is:

Liabilities are the future sacrifices of economic benefits that the entity is presently obliged to make to other entities as a result of past transactions or other past events.

These are debts the business has incurred to operate the business. An example of a liability is a bank loan that a business owner may need to start their business. This loan becomes a liability for the business. It must be repaid to the bank over a period of time.

Liabilities are further divided as follows:

Current: exist in the short-term. These are debts the business has an obligation to pay within a short period of time. For example, accounts payable (creditors). Accounts Payable is a result of an arrangement with the suppliers the business uses to purchase stock to sell. The business agrees to purchase stock from the supplier with payment to be made at a later date – usually 7-14 days.

In other words, the future sacrifice will be made **within** the next accounting period (within 12 months).

Non-current: these are debts the business has agreed to pay over a longer period of time, generally over 12 months. For example, a bank loan.

In other words, the future sacrifice is of **a long-term** nature.

Helpful online resources

Watch this video "What are Liabilities?" to check your understanding of this concept:

https://tinyurl.com/56a5unrw

Owner's Equity refers to the **owner's financial contribution** to the business. It is treated as a debt of the business – i.e. that the **business now owes** the owner this amount of money because the owner 'loaned' the business the capital (money) needed to start/invest in the business.

Items that appear in Owner's Equity include **Capital** (the amount of money invested by the owner), **Drawings** (the amount of money the owner has withdrawn from the business for personal use) and **Profit/Loss** (the amount of money the business has repaid to the owner – in the case of profit OR the amount of money the business owes the owner as it made a loss). If the business makes a **profit**, then this is **added** to Owner's Equity. If the business makes a **loss**, then it is **deducted** from Owner's Equity.

What does this all mean? It comes back to the accounting equation. Assets = Liabilities + Owner's Equity. Total Assets (**Net Assets**) must always equal Liabilities + Owner's Equity (**Total Equities**) so that the accounting equation balances. In other words, **assets** refer to what the business **owns** and **equities** refers to what the business **owes**.

What is equity?

Equity is the **residual value** of an entity's assets after deducting its liabilities. Residual value refers to what is **left over** when total liabilities have been deducted from total assets. Therefore, equity represents the **Net Assets** of a business. This means that the owners of a business own, or have a claim on, all of the net assets of the business.

Helpful online resources

Watch this video "What does equity actually mean?" to check your understanding of this concept:

https://tinyurl.com/45ksave8

Case Study

Helpful online resources

Read the case study on "Whole Kids" attached and then answer the questions below:

https://www.smartcompany.com.au/finance/funding/whole-kids-equity-crowdfunding-birchal/

(e) Who are the owners of this business?

(f) How are the business owners raising funds for their business?

(g) Explain what is meant by 'crowdfunding'?

(h) In a Balance Sheet, where would a contribution of capital be listed?

(i) Provide two reasons why the business owners might be looking to raise funds for their business?

(j) What is another way of raising funds that the owners could consider?

(k) What are the advantages and disadvantages of public funding?

(l) How would the ownership structure of this business change if they accept public funding?

(m) Imagine you are the accountant for Whole Kids. James and Monica Meldrum have asked your opinion about how to raise finance for their business. They would like to know about the pros and cons of:

- Using crowdfunding

or

- Obtaining a bank loan.

Write a brief letter to James and Monica about the option you think suits them best. Ensure you include a description of the type of funding you are discussing as well as the pros and cons for them.

Classification in the Balance Sheet

In order to prepare the Balance Sheet, the three sections must be **classified**. This requires assets and liabilities being divided into **Current Assets/Current Liabilities** and **Non-current Assets/Non-current Liabilities**.

The financial position of the business is represented by the relationship between Assets, Liabilities and Owner's Equity as shown in the **accounting equation**:

ASSETS = LIABILITIES + OWNER'S EQUITY

A = L + OE

Common Classification of Accounts for Balance Sheet				
Current Assets	**Non-current Assets**	**Current Liabilities**	**Non-current Liabilities**	**Owner's Equity**
Cash at Bank Debtors/Accounts Receivable Stock (Closing stock)/Inventory Cash on Hand/Petty Cash	Building Equipment Motor Vehicles Investments Shares Goodwill Land and Buildings Machinery Furniture Fixture & Fittings Premises Patents	Bank overdraft Creditors/ Accounts Payable Bank Loan (Short term loan – less than 12 months)	Mortgage Bank Loan (usually over $10,000)	Capital Net Profit/ Net loss Drawings

Classifying Assets and Liabilities as Current and Non-Current Items	
Item	**What is it?**
ASSET	The business could also have assets such as debtors, bank balance, and stock, which are liquid in nature, meaning that can be converted to cash easily in the next 12 months. These are known as **Current Assets.** Assets refer to motor vehicles, furniture, land that are purchased by a business with a view to continuously earn revenue. They are essential to the operations of the business and are not intended to be resold in the foreseeable future. These are known as **Non-current Assets.**
LIABILITY	Liabilities such as creditors and bank overdrafts are debts that are due to be repaid within 12 months. These are known as **Current Liabilities.** Liabilities include mortgages and loans of more than 1 year that are debts that must be repaid in a period exceeding 12 months. These are known as **Non-current Liabilities.**
OWNER'S EQUITY	Owner's Equity refers to the investment made by the owner of the business. This is referred to as **Capital**. Profit made by the business is returned to the owner (retained earnings) and this is known as **Net Profit**. This is **added** to Owner's Equity. Withdrawals made by the owner from the business for personal use are known as **Drawings**. These are **deducted** from Owner's Equity.

Activity

Classification

1. Classify the following Assets and Liabilities as either **Current Asset, Non-current Asset, Current Liability or Non-current Liability.**

Windows		Land	
Chairs		Creditors	
Loan (long term)		Furniture	
Petty Cash		Accounts Payable	
Stock		Debtors	
Delivery Vehicle		Supplier	
Premises		Plant and equipment	
Loan (short term)		Rent owing	
Inventory		Mortgage	
Investments		Accounts Receivable	
Merchandise		Bank Overdraft	
Cash at Bank		Building	

PRESENTATION OF A SIMPLE BALANCE SHEET

There are two commonly used styles for preparing a Balance Sheet. They are:

(a) ***T-shaped*–(A = L + OE)**

Business Name
Balance Sheet
as at 30 June 2021

Assets			***Liabilities***		
Current Assets			*Current Liabilities*	3,800	
Cash	1,700		Creditors	3,300	7,100
Debtors	2,100		Loan		
Stock	1,200	5,000	*Non-current Liabilities*		
Non-current Assets			Mortgage		22,000
Delivery Vehicle	29,700		***Owner's Equity***		
Building	38,000		Capital (Owner's name)	41,400	
Equipment	1,800		*less* Drawings	(500)	
		69,500	*add* Profit	4,500	45,400
		$74,500			$74,500

(b) ***Narrative form* – (OE = A–L)**

Business Name
Balance Sheet
as at 30 June 2021

OWNER'S EQUITY			
Capital (Owner's name)		41,400	
less Drawings		(500)	
add Profit		40,900	
represented by: ***ASSETS***		4,500	**$45,400**
Current Assets			
Cash	1,700		
Debtors	2,100		
Stock	1,200	5,000	
Non-current Assets			
Delivery Vehicle	22,000		
Building	38,000		
Equipment	1,800	69,500	74,500
Less: ***LIABILITIES***			
Current Liabilities			
Creditors	3,800		
Loan	3,300	7,100	
Non-current Liabilities			
Mortgage		22,000	(29,100)
Net Assets			**$45,400**

Activity

Preparing a Simple Balance Sheet

Classify the following items and prepare a fully classified Balance Sheet.

1. (a) Connie Cakes, the owner of "Cookie and Batter", presents you with the following information. Prepare a T-shaped Balance Sheet as at the 30 June 2021.

Debtors $22,040	Loan (due in 7 months) $2,300	Profit $39,400
Cash at Bank $360	Buildings $210,000	Creditors $23,000
Capital $95,000	Kitchen Equipment $17,000	Vehicle $21,000
Land $65,000	Drawings $1,600	Stock $2,700
Mortgage $180,000		

COOKIE AND BATTER

BALANCE SHEET AS AT ____________________

Assets			**Liabilities**		
Current Assets			Current Liabilities		
			Non-current Liabilities		
Non-current Assets					
			Owner's Equity		
TOTAL ASSETS			TOTAL EQUITIES		

4

(b) Prepare a narrative form Balance Sheet for Cookie and Batter.

COOKIE AND BATTER

BALANCE SHEET AS AT ______________________________

OWNER'S EQUITY			
represented by:			
ASSETS			
Current Assets			
Non-current Assets			
Less: ***LIABILITIES***			
Current Liabilities			
Non-current Liabilities			
Net Assets			

Activity

Interpreting Information

2. Refer to the Balance Sheet prepared for Envy Beauty Supplies below. Use the information from this Balance Sheet to answer the questions that follow.

Envy Beauty Supplies

Balance Sheet as at 30 June 2021

ASSETS			***LIABILITIES***		
Current Assets			*Current Liabilities*	71,200	
Cash at Bank	55,900		Accounts Payable	1,100	72,300
Accounts Receivable	112,000		Overdraft		
Stock	65,500	223,400	*Non-current Liabilities*		
Non-current Assets			Mortgage		205,000
Furniture & Fittings	105,000		***OWNER'S EQUITY***		
Equipment	96,000		Capital (Krystle Kain)	116,600	
Investments	16,500	217,500	*less* Drawings	(2,700)	
			add Profit	49,700	163,600
TOTAL ASSETS		$440,900	TOTAL EQUITIES		$440,900

(a) Summarise the information presented on the Balance Sheet.

(b) Which internal stakeholders would be using this Balance Sheet?

(c) What are the Total Assets of this business?

(d) What are the Total Liabilities of this business?

(e) What is the Owner's Equity of this business?

(f) What is included in the Owner's Equity calculation?

(g) Why is profit included in Owner's Equity?

(h) Comment on what this Balance Sheet tells the owner about the business.

(i) What is the difference between Capital and Owner's Equity?

4

(j) What is the difference between the items listed on the left and right side of the Balance Sheet for Envy Beauty Supplies?

....

....

Practical Tasks

3. Sarah Sheers owns "Cutting with Care Hairdressers". She wants you to prepare a simple Balance Sheet (in T-shaped and Narrative form) as at the end of November 2021. You have been provided with the following information:

Overdraft $1,600	Buildings $82,000	Debtors $19,000
Profit $7,000	Capital $70,900	Mortgage $12,000
Stock $15,000	Office Equipment $9,000	Loan (due 2025) $12,000
Cash on Hand $3,200	Loan (due Dec 2021) $1,000	Creditors $29,000
Drawings $1,300	Fixtures and Fittings $4,000	

CUTTING WITH CARE HAIRDRESSERS

BALANCE SHEET AS AT 30 NOVEMBER 2021

Assets			**Liabilities**		
Current Assets			*Current Liabilities*		
Non-Current Assets			*Non-Current Liabilities*		
			Owner's Equity		
TOTAL ASSETS			TOTAL EQUITIES		

With reference to the Balance Sheet above, **explain,** what is meant by:

(a) Stock

....

....

(b) Loan (due 2021)

....

....

CUTTING WITH CARE HAIRDRESSERS

BALANCE SHEET AS AT 30 NOVEMBER 2021

Owner's Equity			
Represented by:			
Assets			
Current Assets			
Non-Current Assets			
Less: Liabilities			
Current Liabilities			
Non- Current Liabilities			
NET ASSETS			

4. Giles Bridges owns "Across the Bay Constructions". Prepare his Balance Sheet using the following information as at 30 June 2021. Prepare the Balance Sheet using both T-shaped and Narrative styles.

Accounts Receivable $43,500	Accounts Payable $87,900	Bank $100
Net Loss $3,200	Buildings $230,000	Motor Vehicle $43,000
Moving Equipment $120,000	Tools $54,000	Loan (8 months) $11,000
Inventory $42,800	Mortgage $190,000	Capital $247,950
Drawings $250		

ACROSS THE BAY CONSTRUCTIONS

BALANCE SHEET AS AT 30 JUNE 2021

Assets			**Liabilities**		
Current Assets			*Current Liabilities*		
Non-Current Assets			*Non-Current Liabilities*		
			Owner's Equity		
TOTAL ASSETS			TOTAL EQUITIES		

(a) State **one reason** why a Balance Sheet is titled 'as at'.

(b) **State** two external users who may be interested in the Balance Sheet of Across the Water Construction.

(c) Advise the owner about the **financial health** of this business. Comment on whether the business is currently in a stable financial position based on the information in the Balance Sheet.

ACROSS THE BAY CONSTRUCTIONS

BALANCE SHEET AS AT 30 JUNE 2021

Owner's Equity			
Represented by:			
Assets			
Current Assets			
Non-Current Assets			
Less: Liabilities			
Current Liabilities			
Non- Current Liabilities			
NET ASSETS			

4.2 Statement of Changes in Equity

Changes to the Balance Sheet

In recent years, the **presentation of the Balance Sheet has changed** to extract the owner's equity component from this report and include a new report titled "Statement of Changes in Equity". This now means that ow ner's equity no longer appears in the Balance Sheet. It will instead be dealt with separately as another financial report.

Australian Accounting Standards Board (AASB)

The role of the AASB is to provide a framework for accounting standards in Australia. This is to develop and maintain high standards for financial reporting of information for all sectors in the Australian economy. The accounting standards set by the AASB are then enforced by regulators such as the Australian Security and Investments Commission (ASIC).

This is a result of changes made by the Australian Accounting Standards Board (AASB). The following is an extract from the AASB showing the inclusion of Statement of Changes in Equity from July 2015:

Statement of changes in equity

Information to be presented in the statement of changes in equity

106 **An entity shall present a statement of changes in equity as required by paragraph 10. The statement of changes in equity includes the following information:**

(a) **total comprehensive income for the period, showing separately the total amounts attributable to owners of the parent and to non-controlling interests;**

(b) **for each component of equity, the effects of retrospective application or retrospective restatement recognised in accordance with AASB 108; and**

(c) [deleted]

(d) **for each component of equity, a reconciliation between the carrying amount at the beginning and the end of the period, separately (as a minimum) disclosing changes resulting from:**

(i) **profit or loss;**

(ii) **other comprehensive income; and**

(iii) **transactions with owners in their capacity as owners, showing separately contributions by and distributions to owners and changes in ownership interests in subsidiaries that do not result in a loss of control.**

Statement of Changes in Equity

The Statement of Changes in Equity **connects** the Balance Sheet and the Income Statement and explains the **changes** that took place in **equity** during the accounting period. This statement will record the changes that have occurred such as any profit allocated to the owner and any drawings the owner made. This essentially removes this detail in the Balance Sheet. It will reflect all the changes that have occurred in owner's equity between the beginning of the accounting period and the end of the accounting period.

For example, it will show Capital at the start of the accounting period, Drawings that occurred during the accounting period and the Profit/Loss calculated at the end of the accounting period.

What is included?

The Statement of Changes in Equity is calculated using the following information:

(*Opening Capital + Profit – Drawings = Closing Capital*)

An example of how it is presented is below:

Business Name		
Statement of Changes in Equity		
as at		
	$	**$**
Owner, Capital – *starting date*	XXXXX	
Add: Profit for the year	XXXX	XXXXX
Less: Drawings		XXX
Owner, Capital – closing date		XXXXX

In the following example, the Statement of Changes in Equity is shown for J Jones Surfboard Supplies. You will see the Opening Capital (at the start of the accounting period), the profit which has been added, and the drawings which have been deducted. At the bottom of this statement, you will notice there is now a closing balance (the amount left over once profit has been added and drawings deducted).

J Jones Surfboard Supplies

Statement of Changes in Equity

as at 30 June 2020

J Jones, Capital – 1 July 2019	$100,000
Add: Profit for the year	$20,000
	$120,000
Less: Drawings	$1,500
J Jones, Capital – 30 June 2020	$118,500

This information would usually be included in the Balance Sheet, however, this is no longer the case. You will need to remember to prepare a Statement of Changes in Equity in future as well as a Balance Sheet that does not include Owner's Equity.

4

What does the Balance Sheet look like now?

The example below shows you how the Balance Sheet is prepared **without** Owner's Equity included

Balance Sheet

as at ....

ASSETS		
Current Assets		
	XXXXX	
	XXXXX	*Total CA*
Non-current Assets		
	XXXXX	
	XXXXX	*Total NCA*
Total Assets		**A = CA + NCA**
LIABILITIES		
Current Liabilities		
	XXXX	
	XXXXX	*Total CL*
Non-current Liabilities		
	XXXX	
	XXXXX	*Total NCL*
Total Liabilities		**L=CL + NCL**
NET ASSETS		**Total Assets–Total Liabilities**

Practise using the Statement of Changes in Equity and the Balance Sheet

Mario Zingarella, runs an Italian Restaurant in town called "Pasta From Roma". He gives you all his financial information but warns you that he didn't get to the bank before it closed to get the bank statement. You tell him "No worries, I'll use the bank figure to balance the statement by using the accounting equation".

1. Prepare the Statement of Changes in Equity and the Balance Sheet with the estimated bank figure for 30 June 2021.

Dining room furniture $42,300	Loan (due Dec 2025) $23,900	Mortgage $265,000
Capital $72,880	Land/Buildings $340,000	Debtors $3,470
Creditors $43,600	Goodwill $18,000	Inventory $6,500
Fixtures and Fittings $7,420	Loan (due Oct 2021) $2,460	Profit $99,300
Kitchen Equipment $73,000	Bank $________	

Pasta from Roma

Statement of Changes in Equity

as at ……………………………………………..

	$	$

PASTA FROM ROMA

BALANCE SHEET AS AT 30 JUNE 2021

Assets			
Current Assets			
Non-Current Assets			
TOTAL ASSETS			
Less: Liabilities			
Current Liabilities			
Non- Current Liabilities			
TOTAL LIABILITIES			
NET ASSETS			

2. List the items that could appear on a Balance Sheet for **Austin's Veterinary Care** (*write as many as you can think of*).

ASSET	LIABILITY	OWNER'S EQUITY

Review Questions

1. Make a list of the **assets** and **liabilities** you think a **cafe** business might have.

Assets	Liabilities

2. Define Owner's Equity.

....

....

3. What are Drawings and why are they deducted from Capital?

....

....

4. Why is Profit added to Capital?

....

....

5. Classify the following items as assets, liabilities (current/non-current) or owner's equity:

Description	Classification	Description	Classification
Creditors		Loan to James Jones	
Loan from bank (due 1 year)		Loan secured by mortgage	
Owner's interest in the business		Motor vehicle	
Bank overdraft		Debtors	
Furniture		Inventory	
Loan from Chris Green		Premises	
Cash at Bank		Land	
Drawings		Petty Cash	

6. (a) Refer to the list below and circle the **assets**:

i) Cash at bank　　iv) Debtors
ii) Land and buildings　　v) Motor Vehicle
iii) Creditors　　vi) Inventory on shelves

(b) Refer to the list below and circle the **liabilities**:

i) Capital (J Smith)　　iv) Mortgage
ii) Loan to G Green　　v) Debtors
iii) Loan from A Allen　　vi) Furniture and fittings

(c) Refer to the list below and circle the **owner's equity**:

i) Shares in X Co. Ltd　　iv) Buildings
ii) Capital　　v) Drawings
iii) Mortgage on buildings　　vi) Cash at Bank

7. R Roger's business has the following assets and liabilities:

Cash at bank $6,000; Motor vehicles $21,000; Debtors $4,000; Inventory $15,000 and Creditors $3,000.

Using the above information, Roger's equity in the business is:

i) $49,000　　ii) $43,000　　iii) $41,000　　iv) $31,000.

8. Refer to the two businesses below. Identify the account name from the transactions provided and classify these into assets (current and non-current), liabilities (current and non-current) or owner's equity. The first one has been completed for you.

Fresh Grocery Store

Transaction	Account Name	Classification (A, L, OE)
(a) Amount the owner invested to begin the business	*Capital*	*OE*
(b) Money in the business' bank account		
(c) Building from which the store operates		
(d) Grocery items which will be sold to make a profit		
(e) Amount of money the owner taken out of the business for his own use		
(f) Van used to deliver goods to customers		
(g) Shelves in the shop		
(h) Computer and other office machinery		

Benches by Ben – Cabinet Maker

Transaction	Account Name	Classification (A, L, OE)
(a) Tools and machines used in the manufacture of benches		
(b) Money Ben has invested into the business		
(c) The building purchased with the borrowed funds		
(d) Amounts owing by the business to suppliers		
(e) Amounts owing by customers who have purchased benches from the business		
(f) Unsold benches		

9. You have been asked to prepare the *Statement of Owner's Equity* and *Balance Sheet* for Pet Love, a small pet accessory store, owned by Tracy Cavoodle. Tracy has provided you with the following list of accounts as at 30 June 202X.

Opening Capital – T Cavoodle	30,000
Profit	2,500
Cash at Bank	6,000
Loan from Pug Finance – due in 3 months	1,000
Petty Cash	500
Accounts Receivable	12,000
Accounts Payable	25,500
Premises	23,000
Furniture	7,000
Inventory	10,000
Equipment	2,500
Loan from Pets4Eva Bank (5 years)	9,000
Drawings	2,000

Pet Love

Statement of Changes in Equity

as at ……………………………………………..

	$	$

PET LOVE

BALANCE SHEET AS AT ______________________________

Assets			
Current Assets			
Non-Current Assets			
TOTAL ASSETS			
Less: Liabilities			
Current Liabilities			
Non- Current Liabilities			
TOTAL LIABILITIES			
NET ASSETS			

4.3 The Income Statement

The Income Statement is another important general-purpose report which **shows the financial performance of the business over the accounting period**. The financial performance for the period is measured by profit. Profit is the difference between the revenue earned and the expenses incurred by the firm during the period.

Profit = Revenue – Expenses

The **Accounting Period Concept** is referred to as **the period of time when the performance of the business is being measured**. The period specified by the Australian Taxation Office (this is a legal requirement) is **1 July to 30 June each year** (one year period). This is known as the **financial year**. A business may choose to prepare an Income Statement more regularly of course, but at a minimum, it must be prepared once per financial year.

Below you will see an example we have referred to before – Annie's Trading Store. This is what an Income Statement looks like. Note the key features highlighted below:

Name of report and accounting period

Business's trading name (known as the accounting entity)

Annie's Trading Store
Income Statement
for the period ending 31 December 2020

Revenue	$	$	$	$
Sales				
- Homewares			47,000	
- Gifts			31,000	
- Bathroom Accessories			15,000	93,000
***Less* Cost of Goods Sold**				
Opening Stock		35,000		
Purchases	18,500			
Less Purchase Returns	(600)	17,900	52,900	
Less Closing Stock			(18,000)	(34,900)
GROSS PROFIT				**58,100**
***Less* Expenses**				
Selling Expenses				
Delivery Expenses		3,700		
Petrol for Delivery Vehicle		1,700	5,400	
Administrative Expenses				
Wages		43,000		
Electricity		1,400	44,400	
Financial Expenses				
Bad Debts			100	(49,900)
NET PROFIT				**8,200**

Revenue (i.e. income the business has earnt through sales)

Cost of Goods Sold (determines Gross Profit)

Gross Profits the business's earnings before general expenses are deducted

Expenses of the business are listed here by category

Net Profit/Loss is calculated by deducting expenses from revenue

There are many items that may be included in the Income Statement. These items relate to the revenue earnt by the business (Sales) or the expenses incurred by the business (Cost of Goods Sold, Selling Expenses, Administrative Expenses, Financial Expenses). Figure 4.3.1 on the next page lists some of the items you may see in an Income Statement and where they will likely appear. These classifications are discussed in more detail in Figure 4.3.1.

Common Classification Items for Income Statement					
Revenue	Cost of Goods Sold	Other Revenue	Selling Expenses	Administrative Expenses	Financial Expenses
Sales Sales Returns Discount Allowed	Opening Stock Purchases Purchases Returns Discount Received Cartage Inwards Freight Inwards Delivery Inwards Buying Expenses Import Duties Custom Duties Closing Stock Loss of stock through theft	Commission Received Rent Received Dividend received	Advertising Promotions Delivery Vehicle Expenses Delivery Vehicle Repairs Salespersons' Wages Delivery Outwards Cartage Outwards Freight Outwards	Office Salaries/ Wages Petrol and Oil Expenses Postage Rates and Taxes Insurance Cleaning Expenses Stationery Electricity Telephone Expenses Equipment Repairs Rent Service of equipment General Office Expenses	Bad Debts Doubtful Debts Interest on Loan/Mortgage Expense Bank Charges

Figure 4.3.1: Common Classification of Items in Income Statement.

Revenue

Revenue is income that is generated by a business during their **usual business operations** usually from **selling goods/products or by providing services**. Revenue appears at the top of the Income Statement. Some examples of income are Sales and Service Fees.

Other Revenue is income the business receives that **does not** relate to the main revenue earning activities of the business. Some examples are Rent Received, Bank Interest Received, Commission Received, Sale of a Non-Current Asset.

Expenses

Expenses are costs incurred by the business as part of operating a business. Some costs are associated with preparing stock ready for sale. These items will be recorded in a section of the Income Statement called **Cost of Goods Sold (COGS).** This is explained in more detail below.

Other expenses incurred by a business include:

Selling Expenses – these are the costs incurred in selling the business' products. Some examples are advertising, promotions, sales staff salaries and delivery expenses.

Administrative Expenses – these are those costs largely associated with the administrative (office) side of the business. These expenses relate to the general running of the business. Some examples are office salaries, stationery, postage, telephone expenses, vehicle registration and insurance expenses.

Finance Expenses – these are the costs associated with the borrowing of money and costs associated with debtors not paying amounts owed. Some examples are interest, bad and doubtful debts.

Cost of Goods Sold (COGS)

Cost of Goods Sold refers to the section in the Income Statement that deals with the movement of stock. It is an expense for the business which occurs when stock is bought, returned to the supplier such as when it is faulty, and the cost of getting the stock ready for sale. This can include such costs as shipping or freight costs and customs duty. Cost of Goods sold are recorded in the period that these expenses occur.

Some further examples of the items that are included in Cost of Goods Sold are shown in the previous table (see Figure 4.3.1).

The formula used to calculate COGS is as follows:

(Opening Stock + Cost of Goods) – Closing Stock = COST OF GOODS SOLD

The Cost of Goods Sold section in the Income Statement appears after Revenue. It is usually presented as follows:

LESS: COST OF GOODS SOLD			
Opening Stock			XXXX
Add: Purchases	XXXX		
Less: Purchases Returns	(XXX)		
	XXXX		
Add: Customs Duty	XXX	XXXX	
Less: Closing Stock		(XXX)	(XXX)
GROSS PROFIT			XXXX

Discount Allowed and Discount Received

When a customer buys goods or services from a business on **credit**, they may be offered an incentive to pay the amount outstanding before the end of the credit period. For example, if the payment terms are 14 days for credit sales, the business may offer the customer a **discount** for paying this invoice before the due date. A **cash discount** is referred to as **Discount Allowed** by the seller (the business) and **Discount Received** by the buyer (the customer).

A **Discount Allowed account** is used by the seller (the business) to record the amount of discount offered to customers. As this discount represents a **reduction** in the selling price to the customer, it is **deducted** from **Sales Revenue** in the **Income Statement**. This then shows a more accurate picture of the **net sales** of the business for that period.

A **Discount Received account** is also used by the business to record the **discount they receive** when they make **purchases** from their **supplier** (as a customer). **Discount Received** is **deducted** from **Purchases** as part of the **Cost of Goods Sold** in the **Income Statement** to accurately reflect the **cost** of buying stock.

Let's see how this looks in the Income Statement we used for Annie's Trading Store earlier:

Annie's Trading Store
Income Statement
for the period ending 31 December 2020

Revenue	$	$	$	$
Sales				
- Homewares			47,000	
- Gifts			31,000	
- Bathroom Accessories			15,000	93,000
Less Discount Allowed				(150)
				92,850
***Less* Cost of Goods Sold**				
Opening Stock		35,000		
Purchases	18,500			
Less Purchase Returns	(600)			
Discount Received	(125)	17,775	52,775	
Less Closing Stock			(18,000)	(34,775)
GROSS PROFIT				**58,075**
***Less*Expenses**				
Selling Expenses				
Delivery Expenses		3,700		
Petrol for Delivery Vehicle		1,700	5,400	
Administrative Expenses				
Wages		43,000		
Electricity		1,400	44,400	
Financial Expenses				
Bad Debts			100	(49,900)
NET PROFIT				**8,175**

Discount Allowed is deducted from Sales

Discount Received is deducted from Purchases

Helpful online resources

Watch "Revenue Principles" to check your understanding of Income Statements so far.

https://youtu.be/37PPccwsYJI

Activity

1. Complete the following:

   Classify these items into their Income Statement categories e.g. Revenue (R), Other Revenue (OR), Cost of Goods Sold (COGS), Selling Expenses (SE), Administrative Expenses (AE) or Finance Expenses (FE).

Opening Stock		Sales	
Discount Received		Delivery Van Expenses	
Gain on Sale of Equipment		Purchases	
Promotion expenses		Sales Staff Wages	
Commission Received		Purchases Returns	
Loss through Theft		Electricity	
Discount Allowed		Doubtful Debts	
Postage		Advertising	
Fees for Service		Delivery Van Repairs	
Sales Returns		Bad Debts	
Insurance		Buying Expenses	
Petrol and Oil		Cartage Inwards	
Closing Stock		Cartage Outwards	
Rent Paid		Rates and Taxes	
Office Salaries		Interest on Mortgage	
Cash Sales		Credit Sales	
Repairs to Computers		Interest Earnt	
Salesperson Commission		Stationery Expenses	
Service Revenue		Freight Outwards	
Interest on Overdraft		Refreshments for Customers	

   ***Hint**: If an expense does not match up with the definitions of COGS, Selling or Finance expenses, then place the item under Administrative Expenses.*

2. **Fill in the table below**. You are required to identify the *differences* between the Balance Sheet and the Income Statement.

	Balance Sheet	Income Statement
What is it?		
When is it prepared?		
What does it show?		
Why is it prepared?		
Headings used		
Formula Used		

4

Activity

Practical: Complete the following activities.

1. You are the owner of a newsagency. Identify the following transactions for the month of April in the table below. *The first one has been completed for you.*

Date	Transaction	Revenue/Expense	Account
April 1	*Sold magazines*	*Revenue*	*Sales*
2	Paid telephone bill		
	Paid delivery vehicle repairs		
3	Purchased cards and stationery (stock)		
4	Paid wages to sales staff		
11	Paid rent		
12	Returned faulty cards to supplier		
15	Sold giftware and stationery		
17	Paid interest on loan		
20	Paid bank fees		
25	Sold newspapers		
27	Customer returned faulty giftware		
28	Paid rates and taxes		

2. Calculate the **Gross Profit** from the following information provided to you by Sweet-n-Sour Bakery.

Cash Sales	43,900	Opening Stock	14,000	Purchases	32,070
Freight In	310	Credit Sales	9,800	Purchases Returns	100
Closing Stock	11,500	Sales Returns	2,450		

Sweet-n-Sour Bakery

Income Statement

for the period ending 30 June 2021

	$	$	$	$
Revenue				
Less Cost of Goods Sold				
Gross Profit				

3. Prepare the Income Statement for "Broad's Gym and Gym Equipment" using the following information, for the period ended 30 June 2021.

Account	$	Classify	Account	$	Classify
Sales	93,000		Electricity	7,000	
Purchases	24,000		Customs Duty	2,700	
Rent Received	3,100		Telephone	900	
Insurance	12,000		Closing Stock	6,000	
Office Wages	31,000		Interest on Loan	3,000	
Opening Stock	8,000		Advertising	3,500	
Delivery Van Repairs	2,400		Sales Returns	1,200	

BROAD'S GYM AND GYM EQUIPMENT

INCOME STATEMENT

for the period ending 30 June 2021

REVENUE				
Less: COST OF GOODS SOLD				
Gross Profit				
Add: Other Revenue				
Less: Expenses				
SELLING EXPENSES				
ADMINISTRATIVE EXPENSES				
FINANCIAL EXPENSES				
Profit/Loss				

4

4. (a) Prepare an Income Statement for "All-Over Cleaning" using the information provided below, for the period ended 30 June 2021.

Closing Stock	20,000		Commission received	1,700		Sales Staff Wages	28,000	
Loss through Theft	1,700		Office Expenses	17,900		Sales Returns	3,000	
Delivery Expenses	2,800		Credit Sales	136,000		Insurance	4,850	
Electricity	1,600		Freight In	4,300		Bank Interest	85	
Discount Allowed	4,000		Admin Wages	38,000		Bad Debts	3,900	
Cash Sales	17,000		Purchases Returns	2,350		Advertising	7,300	
Purchases	65,500		Rates and Taxes	7,340		Opening Stock	21,000	

(b) Using the information provided in the Income Statement you completed in part (a), advise the owner, Chad Detergent, about the future viability of his business. In your response, suggest what he can do to improve his profits in the future. Use specific references to information from the Income Statement. For example, how could the owner reduce some of his expenses?

ALL-OVER CLEANING
INCOME STATEMENT
for the period ending 30 June 2021

REVENUE				
Less: COST OF GOODS SOLD				
Gross Profit				
Add: Other Revenue				
Less: Expenses				
SELLING EXPENSES				
ADMINISTRATIVE EXPENSES				
FINANCIAL EXPENSES				
Profit/Loss				

5. Find the Cost of Goods Sold value using the following information.

   A business had $8,000 stock at the start of the period and during the year they purchased $32,700 more stock. The cost of freight to bring the stock in from interstate was $1,500 for the year. $3,000 of the purchased stock was returned during the year as it was damaged. At the end of the year, a physical stocktake was performed and there was $4,450 stock still on hand.

   What was the **Cost of Goods Sold** for the year? ....

	$	$	$	$
Revenue				
Less Cost of Goods Sold				
Gross Profit				

6. Prepare a fully classified Income Statement for 'Shut the Drapes' for the period ending 30 June 2021 from the account balances provided below:

Sales	65,000
Interest on Loan	1,600
Office Stationery	2,400
Purchases	33,500
Advertising	1,200
Sales Returns	500
Customs Duty	900
Salespersons' Wages	8,100
Insurance	4,050
Opening Stock	25,500
Cartage Inwards	1,300
Delivery Expenses	2,800
Purchases Returns	600
Closing Stock	14,800

SHUT THE DRAPES

INCOME STATEMENT

for the period ending 30 June 2021

REVENUE				
Less: COST OF GOODS SOLD				
Gross Profit				
Add: Other Revenue				
Less: Expenses				
SELLING EXPENSES				
ADMINISTRATIVE EXPENSES				
FINANCIAL EXPENSES				
Profit/Loss				

Activity

Practical Exercise – Completing Financial Reports

You are required to prepare the Income Statement, Statement of Changes in Equity and the Balance Sheet for **Big Bikes**, a small retail business owned by Ryder Hightop, for the period ending 30 September 2021. Ryder has provided you with the following accounts.

Hint: you will need to prepare the Income Statement first to find out the Profit/Loss figure.

Accounts	$	Classify
Capital, R Hightop	11,000	
Machinery	5,000	
Debtors	4,200	
Rates & Taxes	400	
Cash at Bank	4,000	
Opening Stock	2,700	
Purchases	15,000	
Sales	25,000	
Sales Returns	500	
Purchase Returns	360	
Freight Inwards	400	
Discount Allowed	380	
Insurance	650	
Discount Received	340	
Sales staff Salaries	6,800	
Drawings	1,300	
Motor Vehicle	3,700	
Custom Duty	370	
Loan – AZN Bank	5,300	
Bad Debts	280	
Advertising	300	
Creditors	2,600	
Freight Outwards	600	
Rent Paid	520	
Interest Paid	200	
Closing Stock	3,700	

Statement of Changes in Equity
as at 30 September 2021

	$	$
Add:		
Less:		

Balance Sheet
as at 30 September 2021

Assets	$	$	$
Current Assets			
Non-Current Assets			
TOTAL ASSETS			
Less: Liabilities			
Current Liabilities			
Non- Current Liabilities			
TOTAL LIABILITIES			
EQUITY			

4

____

INCOME STATEMENT

for the period ending 30 September 2021

REVENUE				
Less: COST OF GOODS SOLD				
Gross Profit				
Add: Other Revenue				
Less: Expenses				
SELLING EXPENSES				
ADMINISTRATIVE EXPENSES				
FINANCIAL EXPENSES				
Profit/Loss				

Activity

Accounting Advice

Using the information from the above reports, prepare an **email** to Ryder with some accounting advice. Remember that the role of an accountant is to work beside business owners to help them improve their business and make decisions moving forward. Usually, business owners will look for some guidance with regards to profitability (ability to increase profits), liquidity (ability to increase cash flow) and solvency (financial sustainability) of the business.

In your email, you may want to discuss:

- Overall profit/loss position of his business during this accounting period
- Whether there are any areas of the business that Ryder could improve upon so as to increase his profits for the next financial year – e.g. reducing expenses, increasing sales
- Anything else you deem is relevant for the forecasting for the next accounting period.

4.4 Statement of Cash Flows

A Statement of Cash Flows is a general purpose financial statement that measures the movement of cash in and out of a business. It shows how much money is coming in and out of a business during a given period. An Income Statement does not report on a business' cash flows, but on its income and expenses. Income and expenses do not necessarily represent **cash flowing in and out** of the business. Therefore, a Statement of Cash Flows is needed to report on this to help users (such as the owner of the business) assess whether the business is able to pay its debts, and to internally generate net cash inflows. This information will enable users to make informed decisions about the future of the business.

Cash flow is measured in terms of *inflows* and *outflows*. Positive cash flow occurs when a business has more money coming into the business than going out. For example, Cash Sales. A ***positive*** cash flow enables a business to pay their bills and cover expenses. When a business has ***negative*** cash flow, it means they are spending more than they are earning. This will make it difficult to make payments that are due in that period, such as general expenses.

A Statement of Cash Flows looks like this:

Helpful online resources

Watch "Small Business Accounting: Cash Flow Statements" which explains the importance of cash flow for businesses.

https://youtu.be/wROrC2sHd8k

Bob's Bobcats and Big Movers
Statement of Cash Flows

	$	$	$
Cash Flows from Operating Activities			
Inflows			
Cash Sales	8,000		
Receipts from debtors	5,000		
Dividends received	1,100		
Interest received	400	14500	
Outflows			
Payments to creditors	3,500		
Cash Purchases	1,200		
Payment to employees	780		
Interest paid	220	(5,700)	
Net cash from operating activities			8,800
Cash Flows from Investing Activities			
Inflows			
Sale of non-current assets/investments		950	
Outflows			
Acquisition of non-current assets/investments		(275)	675
Net cash used in investing activities			
Cash Flows from Financing Activities			
Inflows			
Proceeds from loans	150		
Capital contributions	10,000	10,150	
Outflows			
Drawings	750		
Loan repayments	1,200	(1,750)	8,400
Net cash from financing activities			
Net increase in cash			17,875
Cash at beginning of year			5,000
Cash at end of year			12,875

A Statement of Cash Flows:

- is of equal importance to the Income Statement and the Balance Sheet
- shows the cash *inflows* of a business entity during a period and the cash *outflows* from the business during that period
- it is a general-purpose financial report that will provide information useful to users in making and evaluating decisions about the allocation of scarce resources
- it can be prepared from the Cash at Bank account
- its main purpose is to highlight the operating, investing and financing activities of the entity during a period.
- it is also useful in predicting future cash flow to determine how liquid a business will be in the future.

The **Income Statement** concentrates on revenues and expenses of the business and is used to **determine profit**, and the **Balance Sheet** shows the **financial position** of the business in terms of all assets, liabilities and owner's equity account balances. These reports help the business to determine how well it has achieved its objectives in terms of profitability, and to some extent in terms of financial stability and solvency. However, these statements do not clearly indicate the ability of the business to:

- generate positive cash flows (so inflows are greater than outflows)
- pay debts as they fall due
- fund future expansion projects
- obtain funds from owners, lenders and so on, as required
- pay drawings (sole trader, partnership) and dividends (company).

You will already realise that there is a clear difference between profit and cash – i.e., between profitability and remaining solvent and financially stable. Profit is usually determined using the **accrual basis of accounting**. This can often mean that although profit has been recognised in a particular period, no cash has been received yet. As a result, the business may not be able to meet its financial commitments for that particular period. Indeed, there have been many businesses that have failed due to their inability to correctly balance the timing of cash inflows and outflows.

A Statement of Cash Flows should:

- clarify information shown in the financial statements by **disclosing cash flows** in and out of the entity, which may not already be indicated in the other statements
- assist management in understanding **changes in financial position**
- assist external users in making decisions concerning **capital contributions or loans**
- assist the development and evaluation of **investment expenditure programs**, which could involve changes in the scope and/or nature of a business' activities
- assist in **obtaining external finance** where necessary.

Such information is vital to the operation, survival, and growth of an entity. Management must carefully consider all available sources and uses of funds.

Understanding cash flow is essential to business success. Business owners will rely on the Statement of Cash Flows to show them whether their business has positive cash flow or negative cash flow. The Statement of Cash Flows will help identify where funds have been sourced from and the business' reliance on external sources of finance.

External sources of funds, such as banks and finance companies, charge different interest rates and require repayment over varying lengths of time. Internal sources, such as owners' contributions and retained earnings, have fewer such restrictions but may be more limited in amount. The business must use its funds to obtain the greatest possible return for the least risk. Large projects may cause the business to be short of funds for many years to come. For example, if a large project were to fail, it could mean the business would be financially ruined.

The nature of cash and cash flows

Cash means cash on hand and cash at bank. Cash equivalents are short-term, highly liquid investments that are readily converted to cash.

Cash does not include such items as accounts receivable, equity securities (such as shares), accounts payable, or any borrowings subject to a term facility.

Cash flows are inflows and outflows of cash and cash equivalents.

Cash can flow into and out of a business for many reasons. All these would be regarded as cash flows and would be reported in the Statement of Cash flows. Most would be reflected in the business' Cash at Bank account.

For transactions or items to be regarded as a **cash flow** and be reported in the Statement of Cash Flows, the following conditions must be satisfied:

- the transaction much involve a cash flow. Therefore, transactions such as selling services on credit to accounts receivable, purchasing on credit from accounts payable, purchase or selling non-current assets on credit, would not be reported in the Statement. (However, the cash flows that result when credit transactions are paid for or received would be included.)
- the transaction must involve an external party. Therefore, transactions such as transfers of cash from one account to another, depreciation and amortisation are simply entries in our own books and would not be reported in the Statement.

Such transactions are still important in the overall funding decisions of the organisation, **but they do not result directly in cash flows**. They are often reported as notes below the statement to give more complete information to users of the Statement of Cash Flows.

Review Questions

1. Explain **ONE** reason for preparing a Statement of Cash Flows.

2. Explain the difference between ***cash inflow*** and ***cash outflow***.

3. List the main **inflows** and **outflows** of cash for a **service entity** (such as a hairdresser).

4. How does the Statement of Cash flows provide a link between the Income Statement and the Balance Sheet?

5. Classify the following transactions as either **cash flows** or **non-cash flows**:
   (a) Bought furniture on credit from Furniture Traders Ltd for $5000
   (b) The owner, A Allen, paid $10,000 cash as additional capital.
   (c) Sold a motor vehicle for cash at its book value of $8,000.
   (d) Paid drawings of $500 cash to the owner, A Allen.
   (e) Received cash $1,000 from A Customer, an accounts receivable.
   (f) Received allowance of $50 from A Supplier, a creditor.
   (g) Provided for depreciation of $5,000 on motor vehicle.

Preparation of a Statement of Cash Flows

In preparing the statement, the basic aim is to **convert the figures prepared on the basis of accrual accounting to what they would be if prepared on a cash basis**. Therefore, the effects of accrual accounting must be eliminated.

All the items that affect cash flows must be shown. The results of all these flows are reflected in the changes to the cash position and the final cash balances.

The key headings in the Statement of Cash Flows are:

- Operating Activities
- Investing Activities
- Financing Activities.

Classification of **common cash receipts** and **cash payments** for the Statement of Cash Flows are below include:

Cash Receipts	Cash Payments
Operating Activities	**Operating Activities**
Services performed for customers for cash	Payments for purchases to suppliers
Rent received	Payment for expenses such as electricity, telephone, etc
Dividend received	Payments to employees for wages
Interest received	Payment for interest expense
Commission received	
Investing Activities	**Investing Activities**
Sale of non-current assets	Payment for purchase of non-current assets
Sale of investments	Payment for investments such as shares
Loan repayment receipt	Loans to other parties
Financing Activities	**Financing Activities**
Owner's investment in business	Owner's drawings
Loan by business	Repayment of loans

Practice Questions

1. The following list of items relate to the business of Eliza's Beach Wear. You are required to **list** the **cash flow classification** (Operating, Investing, Financing) and the **direction** (inflow or outflow) for **each transaction**.
   - (a) Cash paid into the business by Eliza to start her business.
   - (b) Shelving purchased to display merchandise to customers.
   - (c) Building leased for 3 years, with rent payable each month.
   - (d) Beach wear products purchased from the manufacturer.
   - (e) Amount owing to the manufacturer for products purchased.
   - (f) Insurance due for the business.
   - (g) Cash withdrawn for the owner's personal use.
   - (h) Wages paid to a casual employee.
   - (i) Cash sales of beach wear to customers.
2. Refer to the Cash at Bank account for **Tony's Accounting Services** which is a **new** business. Prepare a Statement of Cash Flows for the business owner.

Cash at Bank

Date	Particulars	Amount $	Date	Particulars	Amount $
July 1	Capital	20,000	July 3	Wages	1,600
6	Share Dividend	1,900	17	Wages	1,600
7	Service Fees	2,100	23	Shares – Shell Oil	2,000
12	Cash services	11,000	30	Drawings	500
				Bal c/d	29,300
		35,000			35,000
August 1	Bal b/f	29,300			

3. Using the Cash at Bank account for **Janey's Interior Designs**, prepare a Statement of Cash Flows.

Cash at Bank

Date	Particulars	Amount	Date	Particulars	Amount
May 1	Capital	100,000	May 3	Rent	10,000
16	Investment Interest Received	500	16	Wages	1,500
17	Service Fees	20,000	23	Shares in BHP	5,000
29	Services Fees	8,000	30	Drawings	500
				Wages	1,500
				Bal c/d	110,000
		128,500			128,500
June 1	Bal b/f	110,000			

Activity

Accounting Advice

1. Using the information from Question 2, **prepare a letter** to Tony explaining the movements shown in the Statement of Cash Flows. Make recommendations as to how Tony can overcome any cash flow issues. In your letter, use the following headings to ensure you address each part of the Statement of Cash Flows:
   - Operating Activities
   - Investing Activities
   - Financing Activities.
2. Using the information from Question 3, **prepare either a report or a video of you giving the advice,** for Janey explaining the movements shown in the Statement of Cash Flows. Make recommendations as to how Janey can overcome any cash flow issues. In your response, use the following headings to ensure you address each part of the Statement of Cash Flows:
   - Operating Activities
   - Investing Activities
   - Financing Activities.

Chapter 5 – Ratios and Decision-making

5.1 Introduction to Ratios

Glossary of Terms

ratio	profitability	liquidity
solvency	interpreting data	sustainability
investment	gearing	leverage

An important stage in the accounting process is **analysing and interpreting data**. Accounting reports provide data for business owners to review and to make decisions for the future profitability of their business. In order to make better use of this data, **accounting ratios** are used.

Ratios measure the profitability, liquidity, and sustainability of a business. Accountants use this information to investigate problems and find solutions so that they can provide advice to business owners to help them overcome any financial difficulties.

The step in the accounting process that relates to the use of ratios is **ANALYSING** (as shown below). This is when the business analyses and interprets information gathered from data to make decisions about the financial future of their business.

Accounting Process

Collecting → Recording → Reporting → Analysing → Budgeting

Analysing data is an important part of the effective management of any business since it will:

- aid decision making
- direct 'control' action
- identify weaknesses in accounting processes that can be corrected
- allow more detailed comparisons with other businesses and over accounting periods
- highlight weaknesses in management.

Owners/managers when evaluating the performance of a business need to ask themselves:

- What should have happened?
- What has happened?
- What does it mean?
- What can be done about it?

One of the ways a business owner assesses the performance of their business is through calculation of ratios and interpretation of that data. This information will show broad trends that can help a business owner with their decision-making.

A ratio can be defined as:

a tool used to discover trends, relationships, strengths and weaknesses from the final reports, thus creating a clearer picture of the performance and financial position of the business.

In reviewing the performance and financial position of a business using ratios, we will concentrate on two main areas:

Measures Earning Capacity	Measures Financial Stability
Profitability Ratio: • Return on Equity • Net Profit Margin • Gross Profit Margin	**Liquidity Ratio**: • Working Capital Ratio • Quick Asset Ratio **Solvency Ratio**: • Debt/Equity Ratio

Helpful online resources

Watch: Clickview – "Evaluating Business Performance: Small Business Case Studies" and complete the worksheet provided. This program will help you understand the link between businesses and the tools used to evaluate business performance:

https://clickv.ie/w/buxr

Measuring Earning Capacity

Profitability

The ratios used to measure earning capacity are Return on Equity, Profit Margin and Gross Profit Margin ratios. These ratios are expressed as a **percentage**.

RETURN ON EQUITY = $\dfrac{\textbf{Profit}}{\textbf{Owner's Equity*}}$ **× 100% (expressed as %)**

* Average Owner's Equity

- **The Return on Equity ratio shows the return on the owner's investment in the business.**
- This is used by business owners to compare the return offered by alternative uses of funds.
- If a manager is in charge of the business, this ratio shows how well the manager is using the owner's funds to generate profits.
- The higher the return on owner's equity, the better.

PROFIT MARGIN = $\dfrac{\textbf{Profit}}{\textbf{Revenue*}}$ **× 100% (expressed as %)**

* Revenue = Sales – Sales Return

- **The Profit ratio shows the amount of profit generated from each dollar of sales. It indicates the effectiveness of management to minimize operation expenses per dollar of sales.**
- A business will always attempt to increase its profit margin
- A low ratio indicates less opportunity for profits and the need for investigation of expense control methods, pricing practices and selling techniques.
- To improve this ratio, a business could increase revenue through increased prices or advertising, or decrease costs in any way possible, eg reducing staff.

GROSS PROFIT MARGIN = $\dfrac{\textbf{Gross Profit}}{\textbf{Revenue*}}$ **× 100% (expressed as %)**

* Revenue = Sales – Sales Return

- **The Gross Profit Margin indicates the margin of profit available to cover other operating expenses and shows whether the markup of stock is sufficient to generate enough overall profit for the business**.
- This is important if the business is to achieve a net profit.
- This ratio should be as high as possible to allow the business to cover all expenses, earn a reasonable profit and provide a satisfactory return to investors.
- To improve this ratio, a business might consider reducing their Cost of Goods Sold expense and increasing customer demand by lowering their selling price.

Liquidity

The liquidity of a business measures how easily it can meet its obligations in the short term. It is an indication of potential cash flow problems. Liquidity ratios are expressed as a ratio.

WORKING CAPITAL RATIO = $\dfrac{\textbf{Current Assets}}{\textbf{Current Liabilities}}$ **(expressed as ratio)**

- **The Working Capital ratio shows the business' ability to meet its short-term commitments within the next 12 months.**
- Generally, a ratio of 2:1 is considered reasonable but this does depend on the nature of the business. For a more informed decision to be made, additional information such as industry averages would be useful.
- This ratio shows how many dollars of current assets are available to 'cover' the current liabilities and whether the business will be able to meet any unexpected emergencies. It will show the business's ability to pay its debts and will often be considered by creditors before they extend credit to the business.
- The higher the Working Capital Ratio, the more beneficial for the business.
- To improve this ratio, a business would have to decrease current liabilities or increase current assets. Increasing revenues and decreasing costs will flow through to current assets and liabilities.
- Short term loans or other liabilities could be converted to long term ones, if appropriate.
- If the ratio is too high, the business could invest in long term assets or pay off long term liabilities to avoid having idle cash and incurring unnecessary costs.

QUICK ASSET RATIO = $\dfrac{\textbf{Cash Assets + Receivables}}{\textbf{Current Liabilities}}$ **(expressed as ratio)**

- **The Quick Asset ratio show the business' ability to pay its immediate short-term debts within the next 30 to 90 days.**
- Receivables refer to debtors that the business can follow up with for payment.
- The higher the Quick Asset Ratio, the greater the liquidity of the business but a ratio of 1:1 is considered to be liquid. Again, this would depend upon the nature of the business.
- To improve this ratio, the business would try to pay their short-term debts quickly as well as increase sales and turnover of inventory. The business might also try to collect their debtors more efficiently to ensure they have cash available to pay their short-term debts.

5

Solvency

Solvency is the ability of the business to meet all its debts, both short term and long term. The solvency ratio is expressed as a percentage.

DEBT/EQUITY = $\dfrac{\textbf{Total Liabilities}}{\textbf{Owner's Equity}} \times 100\%$ **(expressed as %)**

- **The Debt/Equity ratio shows the percentage of external finance compared to internal finance. It indicates how much the business relies on outside finance, eg banks rather than the owner's funds and therefore it indicates who has major control over the assets of the business.**
- It measures the GEARING or LEVERAGE of the business. It shows how the assets are financed by comparing owner's equity to borrowings (funds to buy assets can come from the owner's investment or borrowed funds).
- To a creditor, this ratio should be as low as possible since it would indicate greater protection for them.
- To the owner, this ratio should be as high as possible since that may increase the return on owner's equity.
- A ratio greater than 100% means the business is becoming more highly geared.
- To improve this ratio, the business might try to restructure their external finance to look for a lower (or more competitive) interest rate and also try to increase their sales, so they have more cash available to repay loans.

Helpful online resources

Watch: Clickview–"Financial Stability". This program explains the importance of ratios in decision making for businesses. Complete the worksheet provided to check your understanding:

https://clickv.ie/w/PgUp

5.2 Liquidity Ratios

Working Capital Ratio

The **Working Capital Ratio** is a financial tool used to determine the short-term liquidity position of an accounting entity. Working capital provides the business with a measure of the **liquid assets available** to the business after it has settled all its current debts i.e., liabilities to be paid over the next 12 months.

This ratio measures the business' ability to pay its short-term debts within 12 months and to cover any emergencies which may arise. The minimum level of Working Capital is 1:1 which means for every $1.00 of Current Liabilities, the business has $1.00 worth of Current Assets. This would indicate that there is no money available for unexpected emergencies.

An ideal ratio for a business is 2:1. A Working Capital Ratio of less than 1:1 means that the business might need to seek external finance to meet its financial commitments over the next 12 months.

The Working Capital Ratio is calculated as follows:

$$\textbf{WORKING CAPITAL RATIO} = \frac{\textbf{Current Assets}}{\textbf{Current Liabilities}}$$

If a business has a **positive** working capital, then it may use the excess working capital to invest, buy stock or leave it in the bank for any unanticipated expenditures or new opportunities.

If a business has a **negative** working capital, then the business will have to either liquidate some of its non-current assets or seek external finance.

<table>
<tr><td>Working Capital Ratio = $\frac{\textbf{Current Assets}}{\textbf{Current Liabilities}}$
Ideal ratio CA : CL
2 : 1</td><td>Important to see that the business has sufficient cash flow (liquidity) to be able to pay its debts, to pay off its current liabilities in time.</td></tr>
<tr><td colspan="2">2:1 working capital ratio means that for every $1 of current liability that the business needs to pay within 12 months, it has $2 worth of current assets that can be used to convert to cash.</td></tr>
<tr><td colspan="2">This ratio measures the ability of the business to pay its short-term debts within 12 months and to cover any emergencies which may arise.
• An <u>ideal ratio would be 2:1</u>, which means for every $1 of current liability they have $2 of current assets.
• A <u>minimum requirement would be 1:1</u>
• A working capital <u>ratio of less than 1</u> means that external finance or the sale of non-current assets will be needed in order for the business to meet its financial commitments over the next 12 months.</td></tr>
</table>

Quick Asset Ratio

<table>
<tr><td>QUICK ASSET RATIO = $\frac{\textbf{Cash Assets + Receivables}}{\textbf{Current Liabilities}}$
between <u>1:1 and 2:1</u></td><td>Only takes those assets and liabilities into consideration which can be converted to cash quickly and that need to be paid in the next 90 days.</td></tr>
<tr><td colspan="2">e.g. 1:1–this means that for every $1 of current liability that the business needs to pay in the next 3 months, it has $1 worth of current assets that can be used to convert to cash.</td></tr>
<tr><td colspan="2">• This ratio indicates the ability to pay its immediate short-term debts (30 to 90 days or 3 months)
• Also known as the Acid Test Ratio
• A general <u>safe</u> quick asset ratio should be between <u>1:1 and 2:1</u>
• <u>Below 1:1</u> indicates the firm is unable to meet its debts within the next 90 days
• A ratio <u>above 2:1</u> indicates idle funds which could be put to better use by the business.</td></tr>
</table>

Lou's Electrical
Income Statement
for period ended 30 June 2020

Revenue	
Net Sales	190,000
Cost of Goods Sold	101,000
Gross Profit	**89,000**
Expenses	
Wages	22,000
Admin Expenses	11,700
Advertising	8,000
Insurance	9,000
Repairs	3,500
Interest	2,000
Profit	**32,800**

Lou's Electrical
Balance Sheet
as at 30 June 2020

Owner's Equity		
Capital	195,000	
Drawings	(11,200)	
Profit	32,800	**216,600**
Current Assets		
Stock	36,000	
Bank	71,600	
Debtors	45,000	152,600
Non-current Assets		
Equipment	16,000	
Vehicle	35,000	
Land & Buildings	230,000	281,000
Total Assets		**433,600**
less		
Current Liabilities		
Creditors	22,000	
Loan (due Nov 2020)	3,000	25,000
Non-current Liabilities		
Mortgage	192,000	192,000
Net Assets		**216,600**

5

Activity

Using the information provided in the above financial statements for Lou's Electrical, **calculate the liquidity ratios.** Make sure you show your calculations, to check your understanding.

Working Capital Ratio:
Comment on the result:
Provide a solution:

Quick Asset Ratio:
Comment on the result:
Provide a solution:

Comparative Balance Sheets
of Best & Bold Carpentry

	2021	2020	2019
	$	$	$
ASSETS			
Current			
Bank	0	120	3,200
Debtors	8,000	8,800	8,800
Inventory	4,900	4,800	4,600
	12,900	13,720	16,600
Non-current			
Fitting and furniture	5,000	4,200	3,000
Land and buildings	24,000	21,000	16,000
	29,000	25,200	19,000
TOTAL ASSETS	41,900	38,920	35,600
LIABILITIES			
Current			
Creditors	3,000	4,500	0
Bank overdraft	7,900	6,120	5,000
	10,900	10,620	5,000
Non-current			
Mortgage on buildings	6,000		
TOTAL LIABILITIES	16,900	10,500	5,000
OWNER'S EQUITY			
Capital	28,300	30,600	28,000
Add Net Profit	100	1,900	4,460
	28,400	32,500	32,460
Less Drawings	3,400	4,200	1,860
	25,000	28,300	30,600
TOTAL EQUITIES	41,900	38,920	35,600

5

Activity

1. Use the space provided below to calculate the **liquidity ratios** for **Best & Bold Carpentry** for the past 3 years.

Liquidity Ratios		**2021**	**2020**	**2019**
Working capital ratio	$\frac{\textbf{Current Assets}}{\textbf{Current Liabilities}}$			
Quick asset (acid test)	$\frac{\textbf{Cash Assets + Receivables}}{\textbf{Current Liabilities}}$			

(a) Analyse the results of the Working Capital Ratio in 2020. What does this mean for the business?

(b) Briefly comment on the change to the Working Capital Ratio over the last 3 years. What does this show?

(c) Analyse the results of the Quick Asset Ratio in 2020. What does this mean for the business?

(d) Briefly comment on the change to the Quick Asset Ratio over the last 3 years. What does this show?

Analysing the Liquidity Ratios

The Balance Sheet is designed to highlight the financial position and stability of an accounting entity. One of the ways it does this is by ***determining liquidity***.

2. Complete the following table to check your understanding of liquidity:

Define liquidity	
Define liquid asset	
Provide an example of each	

3. Calculate the working capital ratio using the following information:

			Working Capital Ratio
(a)	Current assets – $50,000	Current liabilities – $3,000	
(b)	Current assets – $300,000 Non-current assets – $750,000	Current liabilities – $270,000 Non-current liabilities – $460,000	

The inability of a business to service its debts is one of the **major causes of business failure**. It is therefore important that every business has sufficient cash flow (liquidity) to be able to pay its debts both in the short and long term.

4. Use the space below to calculate the ratio and indicate whether the business has a liquidity problem.

Business 1		**Business 2**		**Business 3**	
Current assets	$10,000	Current assets	$20,000	Cash	$1,000
Current liabilities	$20,000	Non-current asset	$300,000	Debtors	$10,000
		Current liabilities	$60,000	Stock	$50,000
				Creditors	$2,000

5

5. Calculate the Working Capital Ratio for the following accounting entities.

Sandrine Enterprises		**Zhen Chow Industries**	
Current assets	$75,000	Cash	$5,000
Current liabilities	$60,000	Stock	$50,000
		Debtors	$20,000
		Creditors	$90,000
Working capital ratio =		Working capital ratio =	
Comment on the results.		Comment on the results.	

5.3 Solvency Ratio

Debt/Equity Ratio

The Debt/Equity ratio is used to test the **solvency** of a business; in other words, to what extent is the business able to meet all its debts, both short term and long term? This ***solvency ratio*** is expressed as a percentage.

The table below shows how to calculate the debt/equity ratio and provides an overview of what the ratio indicates to a business owner.

DEBT/EQUITY = $\dfrac{\textbf{Total Liabilities}}{\textbf{Owner's Equity}}$ **× 100% (expressed as %)**

- **The Debt/Equity ratio shows the percentage of external finance compared to internal finance. It indicates how much the business relies on outside finance, eg banks rather than owner's investment and therefore it indicates who has the majority of control over the assets of the business.**
- It measures the GEARING or LEVERAGE of the business. It shows how the assets are financed by comparing owner's equity to borrowings (money to buy assets can come from the owner's investment or borrowed funds).
- To a creditor, this ratio should be as low as possible since it would indicate greater protection.
- A ratio greater than 100% means the business is becoming more highly geared.

Activity

1. Using the previous example, of Lou's Electrical business, calculate the **debt/equity ratio** and analyse the impact on this business.

Lou's Electrical
Income Statement
for period ended 30 June 2020

Revenue	
Net Sales	190,000
Cost of Goods Sold	101,000
Gross Profit	**89,000**
Expenses	
Wages	22,000
Admin Expenses	11,700
Advertising	8,000
Insurance	9,000
Repairs	3,500
Interest	2,000
Profit	**32,800**

Lou's Electrical
Balance Sheet
as at 30 June 2020

Owner's Equity		
Capital	195,000	
Drawings	(11,200)	
Profit	32,800	**216,600**
Current Assets		
Stock	36,000	
Bank	71,600	
Debtors	45,000	152,600
Non-current Assets		
Equipment	16,000	
Vehicle	35,000	
Land & Buildings	230,000	281,000
Total Assets		**433,600**
less		
Current Liabilities		
Creditors	22,000	
Loan (due Nov 2020)	3,000	25,000
Non-current Liabilities		
Mortgage	192,000	192,000
Net Assets		**216,600**

5

(a) Calculate the debt/equity ratio for Lou's Electrical:

Show calculations in this space	**2020**

(b) Define debt/equity ratio.

(c) Why should an owner analyse their debt/equity ratio?

(d) Comment on the debt/equity ratio for Lou's Electrical. Is this positive or negative for the business? What decisions could the owner make with this information?

5.4 Profitability Ratios

Every business is concerned with its profitability. One of the most frequently used tools to measure profitability are **profitability ratios**. They are used to determine the business' return on equity to its investors. In other words, is the business able to **return a profit** for the owner. Three common profitability ratios are **Gross Profit Margin, Profit Margin** and **Return on Equity**.

Profitability measures are important to business owners/managers. Information gained from profitability ratios are used by management to make informed decisions for the future direction of the business.

The 3 profitability ratios used by most businesses include:

RETURN ON EQUITY = $\dfrac{\text{Profit}}{\text{Owner's Equity*}} \times 100\%$ **(expressed as %)**

* Average Owner's Equity

- **The Return on Equity ratio shows the return on the owner's investment in the business.**
- This will be useful for the owners to compare the return offered by alternative uses of the funds, such as whether to invest in shares or in long-term savings accounts, for example.
- If a manager runs the business, this ratio can indicate how well the manager is using the owner's funds to generate profits.
- The higher the return on owner's equity, the better.

PROFIT MARGIN = $\dfrac{\text{Profit}}{\text{Revenue}} \times 100\%$ **(expressed as %)**

Where, Revenue = Sales – Sales Return

- **The Profit ratio shows the amount of profit generated from each dollar of sales. It indicates the effectiveness of management to minimize operation expenses per dollar of sales.**
- A business will always attempt to increase its Profit Margin
- A low ratio indicates less opportunity for profits and the need for investigation of expense control methods, pricing practices and selling techniques.
- To improve this ratio, a business could increase revenue through increased prices or advertising or decrease costs in any way possible, e.g. reducing staff.

GROSS PROFIT MARGIN = $\dfrac{\text{Gross Profit}}{\text{Revenue}} \times 100\%$ **(expressed as %)**

Where, Revenue = Sales – Sales Return

- **The Gross Profit Margin indicates the margin of profit available to cover other operating expenses and shows whether the mark up of stock is sufficient to generate enough overall profit for the business**.
- This is important if the business is to achieve a profit.
- This ratio should be as high as possible to allow the business to cover all expenses, earn a reasonable profit and provide a satisfactory return to investors.

5

Activity

1. Refer to the following financial statements provided by Trinkets and Treasures to calculate the appropriate profitability ratios for this business. Answer the questions that follow.

Trinkets and Treasures

Income Statement

for the period ending 30 June 2021

REVENUE	**$**	**$**	**$**
Cash Sales		110,000	
Credit Sales		185,000	295,000
Less COST OF GOODS SOLD			
Opening Stock	22,000		
Purchases: Cash	38,000		
Credit	146,000		
Freight Inwards	3,000	209,000	
Less Closing Stock		(12,000)	(197,000)
GROSS PROFIT			98,000
OTHER REVENUE			
Interest Received			1,250
			99,250
OTHER EXPENSES			
SELLING			
Advertising	3,265		
Salespersons' Wages	21,060		
Freight Outwards	5,800	30,125	
ADMINISTRATIVE			
Insurance	3,225		
Rates and Taxes	2,100		
Office Salaries	35,600	40,925	
FINANCIAL			
Interest on Mortgage		2,200	(73,250)
PROFIT			26,000

		Trinkets and Treasures		
		Balance Sheet		
		as at 30 June 2021		
ASSETS		**LIABILITIES**		
Current Assets		**Current Liabilities**		
Cash at Bank	20,000	Creditors	14,000	
Debtors	16,000	Loan (due 31 Dec 2021)	9,000	23,000
Inventory	12,000			
	48,000	**Non-current Liabilities**		
		Mortgage		80,000
Non-current Assets				
Motor Vehicles	30,000	**OWNER'S EQUITY**		
Office Equipment	44,000	Capital	205,000	
Premises	120,000	Add Profit	26,000	
Machinery	96,000	Less Drawings	(4,000)	235,000
	290,000			
TOTAL ASSETS	**338,000**	**TOTAL EQUITIES**		**338,000**

(a) Calculate Gross Profit Margin ratio.

(b) Comment on the result. What does this indicate to the owner?

5

(c) Calculate Profit Margin ratio.

(d) Comment on the result. What does this indicate to the owner?

(e) Calculate Return on Equity ratio.

(f) Comment on the result. What does this indicate to the owner?

2. Complete the return on equity for ABC Travels using the information provided.

Statement of Changes in Equity:

The Owner's Equity section of the Balance Sheet could also be presented as follows:

ABC Travels Statement of Changes in Equity for the period ending 31st December 2021	
	$
Opening Capital	180 000
plus Additional Capital Contributions	50 000
plus Net Profit	80 000
less Drawings	(6 000)
Closing Capital	304 000

(a) Calculate the Return on Equity.

(b) Comment on the result. What does this indicate to the owner?

5.5 Ratio Revision and Accounting Advice

Scenario:

Cherry Cake is the owner of 'Specialist Cakes Bakery'. They specialise in making cakes for restaurants and 5-star hotels. The bakery's equipment is now old and inefficient. Cherry wishes to upgrade her equipment this financial year and replace it with new equipment. This will cost her $50,000. You will need to identify a source of finance for her.

Task:

Using the information provided:

- complete the ratio calculations;
- answer the questions that follow; and finally,
- prepare advice to Cherry regarding upgrading her equipment. You may also include some advice regarding other financing options that might suit her should a loan not be feasible.

Financial Reports:

Cherry Cake has presented you with the following financial reports:

Income Statement for period ending 30 June 2021	
Revenue	$
Sales	725,000
Less: Sales Returns	(15,000)
Cost of Goods Sold	266,500
GROSS PROFIT	**443,500**
Expenses	
Selling	148,000
Administration	187,400
Financial	75,700
PROFIT	**32,400**

Balance Sheet as at 30 June 2021		
Owner's Equity		
Capital	288,000	
Drawings	(13,800)	
PROFIT	32,400	**306,600**
Current Assets		
Inventory	76,200	
Debtors	89,200	165,400
Non-current Assets		
Fixtures and Fittings	32,080	
Delivery Vehicle	80,000	
Land and Buildings	380,000	482,000
TOTAL ASSETS		**647,400**
Current Liabilities		
Overdraft	1,400	
Creditors	85,500	
Loan	13,900	100,800
Non-current Liabilities		
Mortgage	240,000	240,000
Total Liabilities		340,800
NET ASSETS		**306,600**

- Sales include credit sales of $500,000
- Financial expenses include $18,000 of interest fees

Calculations	2021	2020	2019
Profitability			
Return on Equity		15.6%	17.1%
Profit Ratio		11%	15%
Gross Profit Ratio		58%	57%
Financial Stability			
Working Capital Ratio		2.1:1	2.3:1
Debt/Equity Ratio		93%	69%

(a) Explain Debt Equity Ratio to Cherry.

(b) What does a high debt equity ratio mean?

(c) Explain to Cherry how the debt equity ratio of Specialist Cakes Bakery will impact her ability to seek external finance for her business in the future.

(d) Discuss the impact borrowing $50,000 will have on the Income Statement and the Balance Sheet.

5

(e) As the accountant of the business, would you advise Cherry to borrow $50,000 from an external lender? Provide reasons for your answer.

Accounting Advice:

Using the information you have gathered so far, provide accounting advice to Cherry. In your response, you may want to:

- Refer to the ratios and comment on what these mean for the business in terms of financial stability and profitability;
- Provide recommendations for improvement to Cherry about what you have calculated from the ratios. For example, if the business is highly geared, what is a solution for her?
- Recommend two sources of finance which will best suit the business.
- Make some recommendations to Cherry about the future of her business.

Aim for 200-300 word response. Use business and accounting terms where possible. Be concise.