

**SACE TWO**

# **ACCOUNTING**

**WORKBOOK**  
**EIGHTH EDITION**

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\* indicates general knowledge that supports the understanding of accounting but is not essential for assessment

# Chapter 1 - The Balance Sheet

## The Purpose of the Balance Sheet

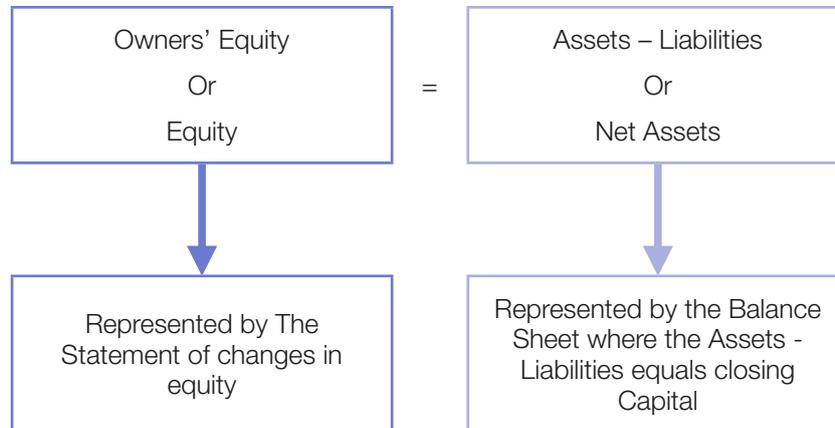
The Balance Sheet, or Statement of Financial Position, is a general-purpose report, which provides an outline of a business' asset and liabilities. It provides a snapshot of the business position at a point in time. The Balance Sheet reveals information about a firm's short term and long term financial risk in terms of liquidity and gearing.

**Liquidity:** The availability of liquid assets available to cover firms' short-term financial obligations.

**Gearing:** The relative proportions of debt and equity that a firm uses to fund its operations.

The Statement of Changes in Equity accompanies the Balance Sheet, which summaries movements in the equity accounts. The statement explains the changes in a business's capital, retained profits and drawings that occurred during the reporting period. The statement essentially breaks down the changes in the owners' investment in the business over the accounting period.

The Balance Sheet and Statement of Changes in Equity is essentially an expression of the accounting equation.



## Reading the Balance Sheet

Figure 1.1 presents an example Statement of Changes in Equity and Balance sheet. It is important that the information can be interpreted by general -purpose users, therefore it must be presented in a readable form, which follows accounting conventions.

<b>Statement of Changes in Equity</b> <b>CTS Plastics</b> <b>For the year ending 30 June</b>	
Opening Capital	1,206,444
Profit/ loss	-407,600
Less drawings	<u>60,000</u>
Closing Capital	<b>738,844</b>
<b>Balance Sheet</b> <b>CTS Plastics</b> <b>As at 30 June</b>	
<i>Current Assets</i>	
Debtors	110,000
	110,000
<i>Non-current Assets</i>	
Office Equipment	3,000
Less Accumulated depreciation	<u>2,400</u>
	600
Plant and Equipment	500,000
Less Accumulated depreciation	<u>400,000</u>
	100,000
Land	1,000,000
	<u>1,100,600</u>
<b>Total Assets</b>	<b>1,210,600</b>
<i>Current Liabilities</i>	
Overdraft	48,756
Creditors	<u>70,000</u>
	118,756
<i>Non-current liabilities</i>	
Secured loan	<u>353,000</u>
<b>Total Liabilities</b>	<b>471,756</b>
<b>Net Assets</b>	<b>738,844</b>

*Owners' equity represents the owner's stake in the business after all liabilities have been deducted from assets.*

*It also represents internal sources of finance and the owner's contributions used to finance asset purchases and cover costs of operations.*

**Current assets** represent assets which are liquid and will become monetary assets in next year or consumed in the next year.

**Non-current assets** represents assets that have been bought to assist the business in generating income.

**Current liabilities** represent the firms financial obligations due in the coming 12 months.

**Non-current liabilities** represent the firms long term financial obligations, not expected to be paid within 12 month.

**Net assets** are equal to closing capital. It represents the residual amount after liabilities has been deducted from assets. It represents the owners claim on the business assets and therefore should equal closing capital.

Figure 1.1: Example Balance Sheet and Statement of Changes in Equity

**Activity**

**Reading the Balance Sheet Activities**

1. Review the Balance Sheet and Statement of Changes in Equity in Figure 1.1 and answer the following;

(a) Entity name:

.....

(b) The accounting period ends on:

.....

(c) Net assets equals:

.....

(d) What financial information is represented on the Balance Sheet:

.....

(e) Can this business pay its immediate bills?

.....

(f) What are the immediate bills?

.....

(g) What can be used to pay the immediate bills?

.....

(h) Is this a profitable business?

.....

(i) What other information would be useful to assess the financial position of the business?

.....

.....

## Stakeholders interested in the General Purpose Statements

The general purpose financial statements provide a wide range of information for both internal and external stakeholders. These stakeholders are interested in the business's activities and utilise accounting data to make informed economic decisions. It is generally assumed that users have a reasonable understanding of the business and can interpret how the information will impact their decisions. However, it is important to recognise that accounting information reflects past performance, which stakeholders use to guide future decisions. For example, details about expenses can help predict future cash flows, though past profitability is not always a reliable indicator of future profitability.

**Internal stakeholders** rely on reports such as the Balance Sheet and Income Statement, in addition to other internal documents. In contrast, **external stakeholders** have access only to general-purpose reports (such as the Balance Sheet, Income Statement, and Statement of Cash Flows), which limits their insight into the business's accounting information.

Stakeholder	Use of the General Purpose Statement	Economic decision of the user
Owner(s) and managers	Calculations for determining efficiency and profitability, Liquidity and Solvency. Identify which costs contribute the most to earning income.  Monitor performance and stability by comparison against past years figures, competitors, key performance indicators, and industry benchmarks.	Make strategic decisions on improving profitability, business growth, and risk management.
Shareholders and potential investors	Compare profit and dividend payments against other investment opportunities. Evaluate corporate governance	Buy, sell or hold onto shares.  Evaluate whether the board of directors are performing their role with good corporate governance.
Lenders / Creditors	Analysis of business's expenses, profitability, liquidity and gearing.	Determine risk of providing credit, set appropriate interest rates for loans provided to the business and assess its ability to repay existing loans.
Employees	Evaluate overall profitability and liquidity for job security and compensation prospects.	Assess whether the business is able to offer job security and appropriate rewards, pay increases and bonuses.
Government	Use reported profit to determine and verify the amount of income tax and Goods and Services Tax (GST) the business should be paying.	Determine if a business has correctly followed tax law or if additional investigation and legal action is required.
Customers	Monitor sales trends, profitability, and business stability.	Evaluate the capability of the business to continue supplying products, provide after sales service and support warranty claims.
General Public and community groups	Analyse profitability trends and assess environmental and social impacts.	Assess whether the business is operating in a sustainable and socially responsible manner. Additional information from published sustainability reports will be needed.

Figure 1.2 Use of the General Purpose Statements by stakeholders and their economic decisions.

2. Review the Balance Sheet presented in Figure 1.1. Identify three stakeholders who may be interested in this report. Discuss the specific information that they may be interested in, and any decisions which these stakeholders can make using the accounting information presented.

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### Classifications

The Balance Sheet and Statement of Changes to Equity outlines three main accounting classifications;

Classification	Definition
<b>Assets</b>	Future <b>economic benefits</b> controlled by an entity as a result of past transactions or other events.
<b>Liabilities</b>	The future <b>sacrifice</b> of <b>economic benefits</b> that the entity is presently obliged to make to other entities as a result of past transactions or events.
<b>Owner’s Equity</b>	The <b>residual interest</b> in the <b>assets</b> of the entity after <b>deduction</b> of its <b>liabilities</b> .

#### Activity

### Classification activities

3. Refer to the accounts listed on Figure 1.1 (Page 2) within the Balance Sheet of **CTS Plastic**.

(a) Identify the accounts classed as assets.

.. .. .

(b) Identify the accounts classed as liabilities.

.. .. .

(c) Identify the accounts classed as owner’s equity.

.. .. .

.. .. .

# The Accounting Equation

The accounting equation sets the foundation for all double-entry accounting and the fundamental elements of the Balance Sheet.

## The Accounting Equation

$$\text{Total Assets} = \text{Total Liabilities} + \text{Owner's Equity}$$

This equation expresses the relationship between total assets and total equities (i.e. total assets, liabilities and owner's equity). The equation must always be in balance, i.e. Assets (A) = Liabilities (L) + Owner's Equity (OE).

The equation is usually expressed as:

- $A = L + OE$

However, it may be expressed as:

- $L = A - OE$

OR as

- $OE = A - L$

The Balance Sheet essentially expresses this equation in detail. Hence the use of the word 'Balance' in the title, referring to the balancing of the accounting equation.

Another way to view the accounting equation:

$$\text{Total Assets} = \text{Total Liabilities} + \text{Owner's Equity}$$

*This side of the equation represents items which have been purchased.*

*This side of the equation represent sources of finance which funded the purchases. Finance can be sourced through loans (Liabilities), Owners Contributions and profits (Owner's Equity)*

The Accounting Equation relates to the concept of Duality.

Every transaction has at least two effects on the accounting equation.

Duality: Accountants see total assets as equal to total equities (liabilities + owner's equity).

## Activities

### Accounting Equation Activities

4. Using one of the versions of the Accounting Equation, calculate the missing figure;

(a) Assets \$80 000, Liabilities \$15 000, Owner's Equity?

.....

(b) Liabilities \$40 000, Owners Equity \$75 000, Assets?

.....

(c) Owner's Equity \$50 000, Assets \$95 000, Liabilities?

.....

### Classification Activities

5. Classify the following as either Assets (A), Liability (L) or Owners Equity (OE).

Account Name	Description	Classification
Overdraft	A deficit in a bank account caused by drawing more money than the account holds.	
Cash on hand	Cash kept on the premise.	
Accounts payable	Amounts owed to suppliers for unpaid inventory. Also known as Creditors.	
Plant and Equipment	The fixed assets used to produce goods for the firm.	
Premise	The property used by the business in their operations.	
Debtors	Amounts owed to the firm from customers as a result of a past credit sale. Also known as Accounts receivable.	
Creditors	Amounts that the firm owes its suppliers as a result of past credit purchase.	

6. Classify the following items as Assets (A), Liabilities (L) or Owners Equity (OE):

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

7. Account names will vary, and often-different names can refer to items of the same nature.

Merchandise	Creditors	Bank	Inventory
Trade Creditors	Accounts Receivable	Cash	Trade Debtors
Accounts payable	Debtors	Cash at Bank	Stock
Payables	Receivables		

Identify the names of the accounts which describe the following;

- (a) Amounts owed from customers as a result of credit sales  
 .. .....  
 (b) Asset held by the business with the intention of being resold  
 .. .....  
 (c) Money held in the businesses bank account.  
 .. .....  
 (d) Amounts the business owes to suppliers as a result of past credit purchases  
 .. .....

8. **Justify** why the following accounts are classified as either an Asset, Liability or Owner's Equity

(a) Cash at bank is classified as an Asset because:

.. .....  
 .. .....

(b) Motor vehicles are classified as an Asset because:

.. .....  
 .. .....

(c) Creditors are classified as Liabilities because:

.. .....  
 .. .....

(d) Bank Loan is classified as an Liability because:

.. .....  
 .. .....

(e) Profit is classified as Equity because:

.. .....  
 .. .....

### Preparing the Balance Sheet

9. Follow the steps below to prepare the Balance Sheet and Statement of Changes in Owner's Equity for JJ House of Homewares as at 30 June.

- (a) Label the Balance Sheet and Statement of Changes in Owner's Equity with the date and business name. Use most recent financial year for the date.
- (b) Transfer the account names and amounts into the appropriate sections of the Balance Sheet according to their classification.
- (c) Calculate and record totals next to the appropriate headings;
  - (i) Total Owners Equity (Opening Capital – Drawings+ Profit)
  - (ii) Total Assets
  - (iii) Total Liabilities
  - (iv) Net Assets (Total Assets – Total Liabilities)

<b>Assets</b>		<b>Liabilities</b>	
Bank	9,000	Creditors	4,000
Debtors	6,000	Loan	8,000
Inventory	10,000	Mortgage	65,000
Plant and equipment	56,000		
Furniture	16,000	<b>Owners' Equity</b>	
Premises	95,000	Capital	80,000
		Drawings	-30,000
		Profit	65,000



10. Follow the steps below to prepare Balance Sheet and Statement of Changes in Owner's Equity for Ice Cold Tea House as at 30 June.
- Label the Balance Sheet and Statement of Changes in Owner's Equity with the date and business name.
  - Classify the accounts as either Assets, Liabilities or Owners Equity.
  - Transfer the account names and amounts into the appropriate sections of the Balance Sheet according to classification.
  - Calculate and record the totals next to the appropriate headings:
    - Total Owners Equity
    - Total Assets
    - Total Liabilities
    - Net Assets

Bank	5,000		Creditors	5,000
Mortgage	45,000		Kitchen Equipment	30,000
Capital	161,000		Drawings	-40,000
Debtors	4,000		Loan	20,000
Inventory	2,000		Premise	200,000
Furniture	20,000		Profit	70,000

**Statement of Changes in Equity**

**Tea House**

As at.....

Total Owner's Equity
----------------------

**Balance Sheet**

**Tea House**

As at.....

Assets
<b>Total Assets</b>
Liabilities
<b>Total Liabilities</b>
<b>Net Assets</b>



## Full Classification

A fully classified Balance Sheet further classifies Assets and Liabilities into current and non-current. Organising the Balance Sheet into these categories makes it easier to read and simpler for the user to extract the information. Furthermore, a fully classified Balance sheet assists in calculating ratios. A fully classified Balance Sheet provides more information about liquidity and gearing. It also assists the reader to determine factors such as:

- Does the business have sufficient working capital
- Can the business pay their debts as they fall due
- What proportion of assets are income-producing

The full classifications are as follows:

Classification	Definition
Current Assets	The benefits of these assets will be gained within 12 months. This category includes cash-based assets. Examples include Cash at Bank, Debtors and Inventory.
Non-current Assets	The benefits associated with these assets will be gained over a period greater than 12 months. Examples include motor vehicles, buildings and land.
Current Liabilities	These are future sacrifices that will be made within the next accounting period, i.e. within 12 months. Examples include creditors and overdrafts.
Non-current Liabilities	These are future sacrifices of a long term nature, i.e. longer than 12 months. Examples include mortgage and loans, which are due after 12 months.  Note: a loan can be split in to current and non-current liabilities, to recognise the payments due in the next 12 months, and the outstanding amounts due post 12 months.

## Intangible Assets

Accountants also consider some intangible assets when valuing businesses. Intangible assets are not physical in nature and are often hard to measure. Intangible assets are often associated with intellectual property and include Goodwill, Trademarks, Patents and Copyright. These items are classified as Non-current Assets.

Goodwill	Goodwill is valued as an Asset on the Balance Sheet when a buyer acquires an existing business. The buyer of the business will pay a premium for the business over and above the valuation of its tangible assets, this premium is referred to as Goodwill. The elements that determine goodwill include a business' good reputation, customer loyalty or client base, brand identity and recognition, talented workforce, and proprietary technology.
Registered Trade marks	A recognisable symbol, design or phrase associated with a brand, which the business has exclusive use of.
Patents	Government patents are given to inventors to protect their intellectual property. Patents can protect any device, substance, method or process that is new, inventive and useful. A patent will restrict other businesses from using this intellectual property.
Copyright	A copyright grants the creator of an original creative work the exclusive legal right to ownership of their work. Copyrights enables creators to manage how their content is used and receive compensation for the distribution of their work.

The following balance sheet depicts a fully classified Balance Sheet.

**Balance Sheet**  
**CTS Plastics**  
**As at 30 June**

<i>Current Assets</i>	
Debtors	<u>110,000</u>
	110,000
<i>Non-current Assets</i>	
Office Equipment	3,000
Less Accumulated depreciation	<u>2,400</u>
	600
Plant and Equipment	500,000
Less Accumulated depreciation	<u>400,000</u>
	100,000
Land	1,000,000
	<u>1,100,600</u>
<b>Total Assets</b>	<b>1,210,600</b>
<i>Current Liabilities</i>	
Overdraft	48,756
Creditors	<u>70,000</u>
	118,756
<i>Non-current liabilities</i>	
Secured loan	<u>353,000</u>
<b>Total Liabilities</b>	<b>471,756</b>
<b>Net Assets</b>	<b>738,844</b>

Debtors are defined as a current asset because the business will receive cash for these debtors, probably within 30 days.

Overdraft is classified as a Current Liability, as the Bank can call in the liability for full repayment at any time.

Creditors are classified as Current Liabilities as they are generally due within 30 days.

Figure 1.2: Example of a Fully Classified Balance Sheet

## Activities

### Full Classification Activities

12. Classify the following items as: Current Assets (CA), Non-current Asset (NCA), Current Liabilities (CL), Non-current Liability (NCL) or Owners Equity (OE):

Description	Classification	Description	Classification
Creditors		Loan <b>to</b> J Jones (due 3 years)	
Loan <b>from</b> bank (due 1 year)		Loan secured by mortgage	
Register Trademark		Motor vehicle	
Owner's interest in the business (Capital)		Debtors	
Bank overdraft		Inventory	
Furniture		Premises	
Loan from J Green (due 2 years)		Land	
Cash at Bank		Goodwill	

13. In each of the following lists of business items, name the account and identify the assets (current and non-current), liabilities (current and non-current) and owner's equity.

**(a) Wilson Grocery**

Item	Name	CA, NCA, CL, NCL&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		

**(b) Bencher's Cabinet Making**

Transaction	Name	CA, NCA, CL, NCL&OE
(a) Tools and machines used in the manufacture of benches		
(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 materials		
(f) Amounts owing by customers who have purchased benches from the business.		
(g) Money that the owner has taken out of the business for personal use		
(h) Unsold benches		

14. (a) Classify Halbert Traders accounts as Current Assets (CA), Non-current Assets (NCA), Current Liabilities (CL), Non-current Liabilities and Owner's Equity. The Profit, or loss, will need to be calculated (hint, Net Assets, Total Assets less Total Liabilities, should equal the total Owners' Equity, once profit, or /loss, has been added).

Overdraft	10,000		Vehicles	68 000	
Inventory	34,200		Office furniture	20,000	
Creditors	14,000		Goodwill	27,000	
Debtors	10,000		Petty cash	180	
Capital: J Halbert	377,000		Premises	290,000	
Machinery	210,000		Mortgage	280,000	
Investments (Maturity 3 years)	35,000		Drawings	26,000	
Loan from ANP (Due 2 years)	50,000		Profit/ Loss		

- (b) Use the account list provided in (a) to complete the Balance Sheet and Statement of Changes in Equity for Halbert Traders for the year ended 30 June. Don't forget to label the Financial Reports and calculate all necessary totals. There is a balance sheet template provided on the following page.



15. Use the following information to complete the Balance Sheet and Statement of Changes in Equity for Greens Nursery for the year ended 31 December. Remember to calculate profit or loss. **Profit is a divided split equally amongst the partners.** Hint: the equity of each partners needs to be clearly indicated on the Statement of Changes in Equity. There is a Balance Sheet template provided on the following page.

Bank	11,000
Inventory	74,020
Accounts Payable	13,550
Accounts Receivable	10,000
Capital: G Thumb	143,700
Machinery	210,000
Shares	5,035
Drawings: G Thumb	32,300

Delivery Vehicle	52,250
Office furniture	500
Premises	375,000
Mortgage	282,000
Drawings: T Green	27,000
Capital: T Green	143,700
Nursery Fixtures and Fittings	40,350
Loan From NNB (Due 10 months)	15,000



16. Use the following information to complete the Balance Sheet and Statement of Changes in Equity for Custom Prints for the year ended 30 June. Remember to calculate profit or loss.

Recommend approach: Prepare the Balance Sheet first. This will require you to calculate Net Assets, which will be equal to the closing Capital figure that would use in your Statement of Changes in Equity.

Note: Don't forget to label Reports and Calculate all required totals.

Creditors	20,000
Accounts Receivable	3,000
Bank	50,000
Capital: J Dance	143,700
Petty Cash	40
Stock	20,000
Office Equipment	1,200

Office furniture	1,500
Loan From NNB (Due 3 years)	40,000
Drawings; J Dance	27,000
Term deposit (Maturity 6 months)	7,000
Stock of Stationery	300
Delivery Vehicle	52,250
Machinery	62,000



## Analysing a Fully Classified Balance Sheet

Preparing a Fully Classified Balance Sheet involves classifying Current and Non-current Assets and Liabilities on the Balance Sheet. This provides the reader with information which will allow assessment of the firm's liquidity, gearing and long term stability.

Users of accounting information often use financial ratios to assist in the evaluation of a firm's financial performance and position. Financial ratios express relationships between financial statement items. Financial ratios can provide awareness into what is happening within a business, insights that are not always apparent upon review of the financial statements alone. Ratios express financial information in a way that makes it easy to compare the financial results across periods and to like organisations.

Analysis, which compares items vertically down financial statements, is referred to as **vertical analysis**. The following section will outline ratios, which are used to perform vertical analysis in the Balance Sheet and Statement of changes in Equity.

### Balance Sheet

#### CTS Plastics

As at 30 June

<i>Current Assets</i>	
Debtors	<u>110,000</u>
	110,000
<i>Non-current Assets</i>	
Office Equipment	3,000
Less Accumulated depreciation	<u>2,400</u>
	600
Plant and Equipment	500,000
Less Accumulated depreciation	<u>400,000</u>
	100,000
Land	1,000,000
	<u>1,100,600</u>
<b>Total Assets</b>	1,210,600
<i>Current Liability</i>	
Overdraft	48,756
Creditors	<u>70,000</u>
	118,756
<i>Non-current liabilities</i>	
Secured loan	<u>353,000</u>
<b>Total Liabilities</b>	471,756
<b>Net Assets</b>	<b>738,844</b>

Vertical Analysis compare items down the statement.  
e.g. compares current assets to current liability.

Vertical Analysis - A method of analysing financial statements which compares figures within an accounting period.

## Liquidity

Liquidity refers to a firm's ability to pay its debts, which are due, in the short-term. When assessing a firm's liquidity, Accountants compare the current assets to current liabilities. The following ratio equations are often used to help analyse an entity's liquidity;

Liquidity - Refers to how quickly an asset can be turned into cash. Also refers to a firm's ability to meet short term financial commitments.

- **Working Capital = Current Assets – Current Liabilities**
  - The Working Capital measures, in monetary form, the amount of excess current assets the firm has after covering its current liabilities.
- **Working Capital Ratio =  $\frac{\text{Current Assets}}{\text{Current Liabilities}}$  expressed as a ratio e.g. 2:1**
  - The Working Capital Ratio (current ratio) measures the proportion of current assets to current liabilities. It is used to assess the firm's liquidity within the next 12 months.
  - For most industries, the ratio is recommended to be between 1.5:1 and 2:1
- **Quick Asset Ratio =  $\frac{\text{Cash Assets} + \text{Receivables}}{\text{Current Liabilities}}$  expressed as a ratio**
  - The Quick Asset Ratio (acid test) measures the firm's immediate liquidity, which is its ability to cover debts in the next 90 days.
  - For most industries, the ratio is recommended to be between 1.1:1 and 1.5:1

Please note that some textbooks instruct students to deduct bank overdrafts from current liabilities when calculating this ratio. Please **DO NOT USE THIS METHOD**.

### Summary

The Working Capital and Quick Asset ratio can be used to analyse a firm's liquidity.

- A result of < 1:1 indicates insufficient current assets to cover the firm's short-term financial obligations.

### Strategies improving liquidity

- Sell stock/inventory
- Sell unnecessary non-current assets
- Owners/capital contributions
- Control expenses
- Longterm financing

## Activity

### Liquidity Activity

17. Refer to the Balance Sheet on page 21 to perform the following calculations to aid you in analysing the firm's liquidity. Make sure you show all your workings.

(a) Calculate the Working Capital. (The answer must be presented in monetary form)

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(b) Calculate the Working Capital Ratio. (The answer must be presented as a ratio)

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(c) Calculate the Quick Asset Ratio. (The answer must be presented as a ratio)

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(d) Comment on what your answers to a-c indicate about the firm's liquidity.

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(e) Use the Balance Sheet on page 21 to investigate the factors contributing to the firm's liquidity.

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(f) Suggest actions that the owners' of CTS Plastics could take to improve the firm's liquidity.

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(g) Thinking about the broader external environment, discuss other possible factors, which could have directly or indirectly influence the liquidity of CTS Plastics.

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## Gearing

Gearing compares the level of funding from owners capital as opposed to external debt funding. The debt to equity ratio indicates the level of gearing. It indicates if the business has relied on external debt finance or internal equity finance to fund its activities.

$$\text{Debt to Equity Ratio} = \left( \frac{\text{Total Liabilities}}{\text{Total Equities}} \right) \times 100$$

This ratio is always presented as a percentage.

A business which has proportionally high levels of equity funding, in relation to Liabilities, is described as lowly geared and will have a debt to equity ratio of lower than 100%. Lowly geared businesses source the majority of their finance from the owners and thus is deemed to be a lower risk of bankruptcy. This is because equity finance does not require principle or interest payments, and therefore, the business has fewer payment obligations. It also has less exposure to the risk of interest rate increases.

A business with proportionally higher levels of liabilities in relation to equity is described as highly geared or leveraged. Highly geared businesses will have a debt to equity ratio of higher than 100%. This result indicates that the business has sourced a large amount of its finance from external debt sources. The sources require repayment with interest and thus are at high risk of bankruptcy.

### Summary

The Debt to Equity ratio can be used to assist in analyse a firm's gearing.

- A result of < 100% indicates low gearing levels
- A result of > 100% indicates higher gearing levels.

$$\text{Debt ratio} = \left( \frac{\text{Total Liabilities}}{\text{Total Assets}} \right) \times 100$$

This ratio is always presented as a percentage.

Debt ratio: Similar to debt to equity ratio, the debt ratio measures extent of a firms leveraging. It expresses the proportion of the firms assets financed by debt. A ratio greater than 50% reflects a high portion of leveraging.

### Strategies improving gearing

- Control expenses (allows more money to be allocated to debt reduction)
- Improve profits (allows more money to be allocated to debt reduction)
- Owners/capital contributions

## Evaluating asset efficiency

$$\text{Return on assets} = \frac{\text{profit} + \text{interest expense}}{\text{total assets}^*} \text{ expressed as a percentage}$$

\* Average is used for this value where opening and closing values for assets are available. (asset value at beginning of the period + asset value at end of the period) / 2

The return on assets measures how profitable a business is in relation to its assets. It indicates how effectively assets have been used to generate earnings. Management should, therefore, aim for high returns. This ratio is best compared to industry benchmarks.

To improve this ratio, management can:

- Sell off underperforming or underutilised assets
- Increase earning. Management should seek ways assets can be used more productively to generate higher returns.
- Invest excess liquidity into assets that generate higher returns

### Activities

18. The following information was presented in the Annual Reports for Dimitri's Sports Supplies:

- Total Assets 200,000
- Profit 50,000
- Interest 5,000
- Industry benchmark 20%

(a) Calculate the Return on Asset Ratio for Dimitri's Sports Supplies:

(b) Comment on the results.

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19. ABC Learning supplies has supplied you with the following information:

- Total Current Assets 300,000
- Total Current Liabilities 100,000
- Total Non-current Assets 100,000
- Profit 35,000
- Interest 2,000
- Industry benchmark 10%

(a) Calculate the Return on Asset Ratio for Dimitri's Sports Supplies:

(b) Comment on the results.

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(c) Recommend a strategy to improve the return on asset ratio.

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20. (a) Review at the Balance Sheet and Statement of Changes in Equity on page 21. What information would you use to assess the firms gearing?

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(b) Refer to CTS plastics Balance Sheet and Statement of Changes in Equity

(i) Calculate the Debt to Equity Ratio

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(ii) Comment on the firm's gearing.

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(c) What actions can the owner of CTS plastics take to change the firm's gearing level? What actions would you recommend?

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# Comparative Analysis

Comparative analysis can be useful in assessing a business's position. Comparative analysis involves comparing the financial records and ratios against data from past periods, budgeted figures, competitors, and industry benchmarks.

## Past periods

Past period comparison involves comparing the most recent figures in the Financial Reports against previous years' results. This type of analysis is best performed over at least three consecutive periods to allow the detection of trends. A trend is formed when consecutive periods show a continuing relationship, e.g. declining liquidity or solvency. Past period analysis can be done by comparing results in their monetary or ratio form. This type of analysis is referred to as **horizontal analysis** as it compares items across consecutive years.

**Safeway Stores**  
**Comparative Balance Sheets**

Assets	Year 1	Year 2	Increase or Decrease	
			Amount	Percentage
Current Assets:	\$	\$	\$	%
Cash and short-term investments	74,442	75,574	(1,132)	(1.50)
Receivables	105,166	91,642	13,524	14.76
Merchandise inventories	1,563,244	1,433,254	129,990	9.07
Prepaid expenses and other current assets	118,537	128,676	(10,139)	(7.88)
<b>Total Current Assets</b>	<b>1,861,389</b>	<b>1,729,146</b>	<b>132,243</b>	<b>7.65</b>
Property				
Land	236,876	210,427	26,449	12.57
Buildings	345,001	305,006	39,995	13.11
Leasehold improvements	557,5.	.9,711	97,793	21.27
Fixtures and equipment	2,023,914	1,789,136	234,778	13.12
Transport equipment	186,485	173,576	12,909	7.44
Property under capital lease	1,144,409	1,155,493	(11,084)	(0.96)
	4,494,189	4,093,349	400,840	9.79
Less: Accumulated depreciation and ammortization	1,894,333	1,731,138	163,195	9.43
<b>Total property, net</b>	<b>2,599,856</b>	<b>2,362,211</b>	<b>237,645</b>	<b>10.06</b>
Excess of cost over net assets acquired	16,588	16,557	31	0.19
Other Assets	59,396	66,449	(7,053)	(10.61)
<b>Total Assets</b>	<b>4,537,229</b>	<b>4,174,363</b>	<b>362,866</b>	<b>8.69</b>



Horizontal analysis: Comparing figures across consecutive periods.

Activity

Activity: Analysis of Past Periods

The following represents a summary of LMM Designs Balance Sheet.

	Year 3		Year 2		Year 1
	Monetary Figure	% change	Monetary Figure	% change	Monetary Figure
Assets	\$ 54,000		\$ 42,000		\$ 35,000
Liabilities	\$ 27,000		\$ 25,000		\$ 19,000
Owner's Equity	\$ 27,000		\$ 17,000		\$ 16,000

21. (a) Use the data presented in the information above to calculate the percentage change in Asset, Liabilities and Owners equity for Years 2-3.

The following formula is used to find the percentage change:

$$\text{Percentage change} = \left( \frac{\text{Increase}^*}{\text{Original figure}} \right) \times 100$$

\*Increase refers to the new year less the previous year

- (b) Comment on any changes appearing using the results calculated in (a) .

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- (c) Calculate the Working Capital, Working Capital Ratios and Debt to Equity Ratios for Years 1-3. Write your answers in the table above.

	Current Assets	Non-current Assets	Current Liabilities	Non-current Liabilities	Owners Equity	Working Capital	Working Capital Ratio	Debt to Equity Ratio
Year 3	\$ 20,000	\$ 34,000	\$ 7,000	\$ 20,000	\$ 27,000			
Year 2	\$ 8,000	\$ 34,000	\$ 5,000	\$ 20,000	\$ 17,000			
Year 1	\$ 5,000	\$ 30,000	\$ 3,500	\$ 15,500	\$ 16,000			



## Analysing Financial Position

22. Sienna is the owner of Café Blue, a small coffee shop that has been operating for three years. Sienna has some concerns in regards to the financial position of the café. She has provided to you with a comparative Balance Sheet and Statement of Changes in Equity, below, and asked you to analyse the position of the business.

### Statement of Changes in Equity Café Blue

	Current		Prior	
Opening Capital Luna Barks	\$ 70,000		\$ 67,500	
Less Drawings	<u>-\$ 44,000</u>	\$ 26,000	<u>-40,000</u>	\$ 27,500
Add Profit		\$ 61,950		<u>42,500</u>
Closing Capital		\$ 87,950		\$ 70,000

### Balance Sheet Café Blue Comparative Balance Sheet

	Current		Prior	
	\$	\$	\$	\$
<i>Current Assets</i>				
Cash at Bank	\$ 22,000		\$ 17,000	
Debtors	\$ 10,000		\$ 12,000	
Inventory	<u>\$ 30,000</u>		<u>\$ 15,000</u>	
<i>Total Current Assets</i>		\$ 62,000		\$ 44,000
<i>Non-current Assets</i>				
Motor Vehicle	\$ 20,000		\$ 20,000	
Office Furniture	\$ 500		\$ 500	
Furniture and Fittings	\$ 11,000		\$ 11,000	
Premise	<u>\$ 285,000</u>		<u>\$ 285,000</u>	
<i>Total Non-current Assets</i>		\$ 316,500		\$ 316,500
<b>Total Assets</b>		\$ 378,500		\$ 360,500
<i>Current Liability</i>				
Creditors	\$ 10,000		\$ 11,000	
Loan from D Red	\$ 30,550			
Credit Card			<u>\$ 9,500</u>	
<i>Total Current Liabilities</i>		\$ 40,550		\$ 20,500
<i>Non-current liabilities</i>				
Loan From NNB (Due 2 years)		<u>\$ 250,000</u>		<u>\$ 270,000</u>
<i>Total Non-current Liabilities</i>		\$ 250,000		\$ 270,000
<b>Total Liabilities</b>		<u>\$ 290,550</u>		<u>\$ 290,500</u>
<b>Net Assets</b>		\$ 87,950		\$ 70,000

(a) Calculate the following ratios and compare the results to the industry benchmarks provided.

	Working Capital Ratio	Quick Asset Ratio	Debt to Equity Ratio
Current			
Prior			
Industry Benchmark	1.8:1	1.3:1	100%

(b) Comment on the liquidity of Café Blue.

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(c) Comment on the gearing of Café Blue.

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(d) Advise Sienna on what she can do to solidify the financial position of Café Blue.

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## Summary of Accounting concepts and conventions

The following concepts and conventions form the foundation of accounting principles and practices, guiding all areas of accounting studied at Stage 2:

Concept/ Convention	Definition	Example
<b>Accrual Accounting</b>	Requires entities to record transactions in the period to which they relate, meaning revenue is recorded when earned and expenses when incurred.	If a business delivers a service in December but receives payment in January, the revenue is recorded in December.
<b>Accounting Entity</b>	Views the business as separate from its owners, meaning business transactions are kept distinct from the owner's personal accounts regardless of the legal entity. This separation allows for an accurate assessment of the business's performance and financial position.	If the owner of a small business buys a personal car, this transaction should not be recorded in the business's accounts.
<b>Accounting Period</b>	Divides the life of a business into arbitrary periods for the purpose of recording and reporting.	A business might produce monthly, quarterly, or annual financial statements to assess performance. It depends on how frequently the owner desires this information for decision making.
<b>Consistency</b>	Ensures that accountants apply the same principles and methods consistently from one period to the next.	If a business uses the straight-line method to depreciate assets, it should continue to use this method in subsequent periods unless a change is justified.
<b>Duality</b>	Requires every transaction to have a dual impact on the accounting equation, ensuring it remains balanced after each transaction.	When a business borrows money, it increases both its assets (cash) and its liabilities (loan payable).
<b>Going Concern</b>	Assumes that reports are prepared with the expectation that the business will continue to operate in the foreseeable future.	If a business is expected to continue in the future, assets are valued at historical cost rather than market or liquidation value.
<b>Monetary Unit</b>	States that accountants should record only those business aspects that can be quantified in monetary terms.	The property of a business is recorded in the accounts because it has a dollar value, while employee satisfaction is not, as it cannot be measured in dollars.
<b>Legal Entity</b>	Considers who is legally responsible for the business. For sole traders and partnerships, the owner(s) are responsible, whereas for incorporated businesses, the entity itself is legally responsible.	If a customer sues a sole trader, the lawsuit is against the owner. However, if a customer sues an incorporated business, the business entity is responsible for the lawsuit.
<b>Historical Cost</b>	Requires assets to be valued at their acquisition cost, including any costs associated with preparing the asset for use.	A business that purchased a building 10 years ago for \$500,000 will continue to report it at that price, even if the market value has since increased to \$700,000.
<b>Materiality</b>	Requires the inclusion of all items that could influence decision-making. Accountants only include information that is material and relevant for decision-making.	A business may have used \$50 worth of stationery stock, but this may not be reflected in the financial statements because it does not have a material impact on decision-making.
<b>Prudence</b>	Calls for care and caution in valuing assets, liabilities, and profits.	The business should apply the lower of cost or market rule when valuing inventory to ensure inventory is not overstated in financial statements.
<b>Realisation</b>	States that revenue can only be recognised once it has been earned.	If a business manufactures custom furniture and receives payment for a furniture order, the revenue should not be recognised until the furniture is completed and delivered to the customer.

Concept/Convention	Definition	Example
<b>Relevance</b>	Requires that all significant, timely, and meaningful information be included in financial reports to meet the decision-making needs of users.	Financial statements should include information about a major customer that is about to go bankrupt, as it will impact future cash flows.
<b>Faithful Representation</b>	Ensures that financial information accurately reflects the true financial position of the business. Financial statements must be complete, error-free, and unbiased.	If a business sells goods on credit to a customer who is known to be having financial difficulties, it should record a provision for doubtful debts based on the likelihood of non-payment. Failing to do so would overstate accounts receivable and income, thus not faithfully representing the business's financial position.

## Legal Entities

From a legal perspective, businesses are either structured as:

- Incorporated

Or

- Unincorporated

## Unincorporated legal Entities

An **unincorporated legal** entity has **not** gone through the process of **incorporation** and thus has not established itself as a separate legal entity. From a legal perspective, there is no distinction between the owner and the business; they are regarded as the same. Thus, these entities are subject to **unlimited liability**.

**Unlimited liability** means that there no limit on the extent of the owner's responsibility for the debts of the business. The owners' personal debts and their business debts are regarded as the same, and thus, the owner is responsible for all the business debts.

**Sole Traders/ Proprietors** and **Partnerships** are **unincorporated legal entities**. Sole Traders are businesses owned by one person, whereas Partnerships are owned by multiple people (up to twenty). Unlimited liability under partnerships means that each partner, both individually and together with other partners, can be held responsible for the actions of every other partner. Note that there are types of Partnerships where some partners' liability can be limited. These are referred to as limited partnerships.

The legal structure of an entity will be reflected in the Statement of Changes to in Equity. If the business is a sole trader, then only one owner will be represented in the statement, this is shown in table 1.1.

Table 1.1: Statement of Changes in Equity Sole Trader

Statement of Changes in Equity	
Custom Prints	
30-Jun	
Opening Capital	143,700
Less Drawings	27,000
Add Profit	<u>164,290</u>
Closing Capital	137,290

**Only one capital account indicates only one owner.**

### Reading the statement of changes in Owners Equity

The Statement of Changes in Equity is represented in a different way to the Balance Sheet. All items on the Balance sheet are cumulative. On the Statement of Changes in Equity, the Opening Capital is the Closing Capital from the previous year and thus is cumulative, however, the Drawings account and Profit/ Loss account represents transaction only from the current accounting period. The Closing Capital, therefore, represents the total cumulative balance.

If a business is structured as a Partnership, the statement will have separate sections for each owner, communicating each partner's total stake in the business (table 1.2).

Table 1.2- Statement of Changes in Equity Partnership

Statement of Changes in Equity		
Opening Capital G Thumb	\$ 143,700	
Less Drawings	<u>\$ 32,300</u>	\$ 111,400
Add Profit		<u>\$ 14,753</u>
Closing Capital		\$ 126,153
Opening Capital T Green	\$ 143,700	
Less Drawings	<u>\$ 27,000</u>	\$ 116,700
Add Profit		<u>\$ 14,753</u>
Closing Capital		\$ 131,453
Total Closing Capital		<u>\$ 257,605</u>

**Each owner has a separate section, clearly showing the amount of drawings they have taken over the period and their share in the profit made.**

**Grand total of all partners' investment in the firm.**

## Incorporated Entities

An incorporated entity is one which has undergone the process of establishing the business as a separate legal entity. Incorporated entities are referred to as companies and are considered to be **separate legal entities** from the **owners**. This means that shareholders (i.e. owners) are subject to **Limited Liability**.

**Limited liability** restricts the shareholders risk in the investment. The most a shareholder can lose is the amount that they invested in the business. Shareholders are not personally held responsible for the debts of the company.

There are two types of Companies, Private and Public. A Private Company must have Pty Ltd (Proprietary Limited) in its name. This signifies that proprietorship (shareholders) is restricted to 50 members. Share in Private Companies cannot be sold publicly on the stock exchange.

Public Companies must have Ltd (Limited) in its name. Public Companies have no restriction in terms of the number of shares and are sold publicly on the Share Market. For Australian Public Companies, this means that shares are traded on the Australian Stock Exchange. Any member of the public can buy shares in Public Companies, hence the name Public Company.

A Statement of Changes in Equity for a company will appear differently to that of an unincorporated entity. As Table 1.3 shows, owners capital is referred to as Share Capital, as proprietors of companies are called shareholders. The profit distributed to shareholders is referred to as dividends instead of drawings. Retained earnings represent profits, which are not distributed to the shareholder, which are to be retained by the company to be used in future operations. General reserves are profits retained to meet a company's future (known or unknown) obligations.

Table 1.3: Statement of Changes in Equity for a Corporation

### Statement of Changes in Equity For the period ending 30 June

	Share Capital (\$)	Retained Earnings (\$)	General Reserve (\$)	Total Equity (\$)
Balance at 1 July 2020	2,527,000	5,277,650	1,000,000	<b>8,804,650</b>
Dividend declared & paid		(357,000)		<b>(357,000)</b>
Total Comprehensive Income		5,426,820		<b>5,426,820</b>
Bonus Share Issue	122,400		(122,400)	
Transfer from retained earnings		(2,000,000)	2,000,000	
<b>Balance at 30 June 2021</b>	<b><u>2,649,400</u></b>	<b><u>8,347,470</u></b>	<b><u>2,877,600</u></b>	<b><u>13,874,470</u></b>

# The Accounting Entity vs Legal Entity

Although the unincorporated legal entities are not viewed as separate legal entities from their owners, in the eyes of the law, from an Accounting perspective, the owner and the business are **always treated as separate entities**.

### The Accounting Entity Concept

Accountants view the business to be separate from its owners. Thus all business records are separated from the owner's personal records.

What this means in practice is that no assets that are used for personal use are listed on the Balance Sheet. Furthermore, any business assets used for personal use such as inventory or cash, are recorded as Drawings, reducing the owner's residual stake in the business. Any purchases financed through the owners personal savings is recognised as a capital contribution, increasing the owners' investment in the business. The financial reports only reflect the business' activity, allowing the performance of the business to be measured and evaluated.

### Activity

## Review Questions – Legal Entities

23. (a) Identify the legal structure of RM Consultancy using the Statement of Changes in Equity presented in Figure 1.5 below. Discuss what this means in terms of owners liability.

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(b) Refer to the Statement of Changes in Equity shown in Figure 1.5, identify the entities;

(i) Legal structure

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(ii) Whether it is incorporated or unincorporated

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(iii) The accounting entity

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(iv) The legal liability

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Figure 1.5

### Statement of Changes in Equity R and M Consultancy for the year ended 31 December

Opening Capital K Richards	\$ 200,000	
Less Drawings	\$ 40,000	\$ 160,000
Add Profit		\$ 100,000
Closing Capital		\$ 260,000
Opening Capital T Matthews	\$ 100,000	
Less Drawings	\$ 20,000	\$ 80,000
Add Profit		\$ 50,000
Closing Capital		\$ 130,000
Total Closing Capital		\$ 390,000

## Extended Activity 1

Luna Barks is the owner of Dog World; a discount pet supplies retail store. She has come to you to help her prepare her financial reports and provide advice in regards to her financial position.

Capital Luna Barks	\$ 230,400	Drawings	-\$ 57,000
Inventory	\$ 74,020	Debtors	\$ 10,000
Accrued Wages owed	\$ 5,000	Premises	\$ 375,000
Creditors	\$ 70,000	Overdraft	\$ 12,000
Office Furniture	\$ 500	Motor Vehicle	\$ 52,250
Mortgage	\$ 300,000	Loan from M Cat-Due 4 years	\$ 30,550
Furniture and Fittings	\$ 10,000	Personal Savings Account- Luna Barks	\$ 40,000

### Industry Benchmark Information

Working Capital Ratio	1.5:1
Debt to Equity Ratio	79%



(b) Justify your treatment of the personal savings account.

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(c) Calculate the working capital ratio and quick asset ratio for Dog World as at 30 June.

Working capital ratio

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 Quick asset ratio

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(d) Comment on the liquidity of Dog world.

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(e) Identify the legal structure of Dog World and discuss the impact this has on Luna Barks personal liability.

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(f) Can Dog world currently pay its bills as they fall due? What impact may this have on Luna's personal assets?

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(g) Luna is considering changing the legal structure of her business. Advise her of her options and the major factors she must consider before changing the structure.

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# Chapter 2 - Income Statement

## Abstract

Introduction to Fully Classified Income Statements and stakeholder interests.

## Introducing the Income Statement

**The Income Statement**, like the Balance Sheet, is a **General Purpose report**. It is a summary of financial performance over a period of time, usually one year. The Income Statement provides a measure of profit or loss for a business and the results of the management's stewardship of business's assets and resources. Profit (or loss) is the total income of the business, less expenses. Figure 2.1. Shows the simplified income statement for a retailer showing classification of the components. Retailers purchase final goods to be sold to customers. Therefore there is inventory moving in and out of the business. Expenses have been classified according to their function.

2

BEACH DESIGNS  
Income statement  
For the year ended 30 June

INCOME		
Sales revenue		\$572,500
Less: Cost of sales		\$343,200
		,300
GROSS PROFIT		
EXPENSES		
Selling and distribution expenses	\$110,500	
Administrative expenses	\$11,930	
Finance and other expenses	\$16,200	138,630
		\$90,670
PROFIT		

Figure 2.1.

Figure 2.2 shows a simplified income statement for a **service entity**. Service based businesses such as medical clinics, real estate agents and airlines offer a product that can only be used once and charge fees. The classification of the components for service entities will be different to a trading entity because a service-based business does not sell inventory. The Income Statement will therefore not have a cost of sales (cost of goods sold). Expenses in this example have been classified according to their nature.

THEO'S ELECTRICAL SERVICES  
Income statement  
For the year ended 30 June

INCOME		
Fees for electrical services		\$195,455
EXPENSES		
Advertising	\$6,000	
Mobile phone	\$3,445	
Supplies expense	\$90,300	
Vehicle expenses	\$15,280	\$115,025
		\$80,430
PROFIT		

Figure 2.2.

## Activity 2.1

## Income Statement for Service Entity

Construct an Income statement for Fresh Cuts hair dressing salon for the period ending June 30. Service fees 110,000, rent 20,000, hairdresser salaries 25,000, supplies 10,000, electricity 1,000, phone and internet charges 300.

.....  
Income statement  
For the period ended .....

INCOME
EXPENSES
PROFIT/ LOSS

## Classifications in the Income statement

An entity will record the income it makes from its main activity. Income can be earned from sales of stock or fees for services. Income from other sources such as gains (or losses) from the sale of assets or other one-off events, will be listed separately as **Other Income**.

Expenses are an amount of money spent or incurred to generate income. Expenses can be classified according to their nature or by their function. The method chosen must suit the users of financial information and help them understand the entity's financial performance. Regardless of the format a business chooses, it must continue to use the same format to satisfy consistency of presentation.

However, businesses normally choose to organise the expenses by to the business function they relate to. Therefore individual expenses are classified as; selling and distribution, administration and finance as shown in figure 2.4. For example, the wages of sales staff will be listed separately under selling and distribution, and office salaries will be listed under administrative. Depreciation expense is not listed as one figure. Depreciation on the vehicle used for deliveries is listed under selling and distribution expenses whereas depreciation on office computers will be listed under administrative expenses.

<b>INCOME</b>
Sales revenue
Less: Discount allowed
Less: Sales returns
Total income
Less: Cost of sales
<b>GROSS PROFIT</b>
<b>Other income</b>
<b>EXPENSES</b>
Selling and distribution expenses
Administration expenses
Finance and other expenses
<b>Net Profit</b>

Figure 2.4 Classification of expenses by function

The advantage of classifying by function is that it can provide more relevant information to users than the classification of expenses by nature. A weakness of this method is that it requires a judgement by the accountant about which function an expense belongs to. For example, it is a subjective decision about which employee costs are Selling and which are Administrative when they may perform both functions. Wages and salaries must be split between into those for selling and those for administration.

Classification	Definition
<b>Income</b>	Sales represents income received during the accounting period from the business's ordinary activities such as sales for a retailer and fees, commissions, fares and charges for a service provider. Sales returns are also recorded in this section. Discounts given to customers, although an expense, should be reported here.
<b>Cost of Goods Sold / Cost of Sales</b>	All expenses for acquiring inventory, transportation (inwards) to the business and preparing for resale. Discounts received, although income, should be reported here as they reduce the cost of sales.
<b>Other income</b>	Listed separately will be income from sources <b>other than</b> the primary activity of the business, such as interest, rent and dividend income.
<b>Selling expenses</b>	Costs incurred in promoting goods for sale and placing them in the hands of customers. Advertising, sales salaries, delivery (outwards) and inventory storage costs. <i>*This also includes depreciation costs for assets used in the retail store or in delivering goods to customers.</i>
<b>Administrative expenses</b>	General expenses of running the business, the office, employees and the accounting system. If the expense cannot be categorised as either Selling or Financial, it is included here. <i>*This also includes depreciation items related to assets used in the office.</i>
<b>Financial expenses</b>	Costs of obtaining finance for the business such as interest expense on loans. The cost of managing the collection of debts is also recorded here such as Bad and Doubtful Debts expense.

Figure 2.5 Summary of classifications used in the Income statement.

\* Depreciation is the amount of an asset's cost that has been allocated and reported as an expense in the reporting period. It accounts for the consumption of the economic benefits over an assets life. This concept will be covered in greater depth in subsequent chapters.

**Refer to Figure 2.7 for an exemplar of the Income Statement**

## Activity 2.2

Classify the following accounts as either Income (I), Other income (OI), Cost of Sales (COGS), Selling expense (SE), Administrative expenses (AE) or Financial expenses (FE).

Account	Classification	Account	Classification
Electricity		Interest on mortgage	
Advertising		Delivery inwards	
General expenses		Sales staff vehicle	
Insurance		Postage	
Sales staff wages		Delivery of sales	
Rent of shop		Office salaries	
Inventory at beginning		Repairs to building	
Discount expense		Bad debts	
Purchases		Repairs to sales staff cars	
Stationery expense		Purchase returns	
Sales staff commission		Buying expenses	

## Classification for service and trading entities

**Service based business** have no inventory and therefore will not have any cost of goods sold. A service can only be used once and no physical product is provided to the customer. Service based entities include;

- Accommodation – hotels, motels, resorts
- Building and construction trade –carpentry, carpet laying, painting, tiling
- Repairs and maintenance – car repairs, electricity repairs
- Professional – tax, investment advice, legal services, architectural
- Medical, health care and personal services – doctors, physiotherapists, dentists, beauty, hairdressing
- Education and training – coaching, tutoring
- Support services – cleaning, lawn moving and gardening
- Transport – freight, courier, ride-share

**A trading business** typically is like a retailer purchasing finished goods as inventory and reselling them. Therefore, trading businesses must record a cost of sales to calculate gross profit using the **Trading Account**. Gross profit is the profit on buying and selling goods. At the end of every accounting period the entity must determine the stock left in the business because these goods are yet to be sold. There are two approaches:

- Periodic inventory method
- Perpetual (continuous) inventory method.

The differences in recording the two methods will be explained later. However, for this chapter the **Periodic inventory method** will be used. In this instance a stocktake is used to physically count left over stock and the value recorded as ending inventory.

Inventory at beginning of the accounting period	+	Net purchases of stock during the accounting period	-	Inventory at the end of the accounting period	=	Cost of goods sold
---	---	---	---	---	---	--------------------

The following illustrates the breakdown of **Cost of Goods Sold** (figure 2.6).

Cost of <b>beginning inventory</b>	6,200
Add: Purchases of stock	17,500
Add: Freight (cartage inwards)	840
Less: Purchase returns	360
Less: Discount received	875
Less: Cost of <b>ending inventory</b> from stocktake	5,100
<b>Cost of Goods Sold</b>	<b>18,205</b>

Figure 2.6

### Activity 2.3

## Calculating Gross Profit Activities

1.

Sales–cash	\$16,000
Sales–credit	42,000
Opening inventory	12,000
Closing inventory	14,000
Purchases	51,000

<b>Sales</b>		
<b>Less: Cost of Goods Sold</b>		
<b>Gross Profit</b>		

2.

Sales	184,000
Sales returns	12,000
Inventory: Opening	17,000
Inventory: Closing	23,000
Purchases: cash	62,000
credit	74,000
Cartage inwards	5,400

<b>Sales</b>		
<b>Less: Cost of Goods Sold</b>		
<b>Gross Profit</b>		

3.

Sales	390,000	Inventory–opening	46,000
Sales returns	14,200	Inventory–closing	25,000
Purchases	221,000	Customs duty	600
Purchases returns	16,100	Buying expenses	2,300

<b>Sales</b>		
<b>Less: Cost of Goods Sold</b>		
<b>Gross Profit</b>		

4.

Sales–cash	194,700	Inventory closing	94,300
Sales–credit	262,400	Purchases	274,000
Sales returns	19,900	Purchases returns	16,500
Inventory opening	93,000	Cartage inwards	14,400
Duty & wharfage	7,700	Discount allowed	5,000
		Discount received	2,000

	\$	\$
<b>Sales</b>		
<b>Less: Cost of Goods Sold</b>		
<b>Gross Profit</b>		

2

Figure 2.7 shows a fully classified Income Statement for a sole trader.

**Steve's Surf and Swim**  
**Income Statement**  
For the year ended 30 June

<b>INCOME</b>		
<b>Sales revenue</b>		
Sales Revenue	918,245	
Sales returns	(13,420)	
Discount allowed	(4,590)	
<b>Net sales revenue</b>		900,235
<b>Cost of Goods Sold</b>		
Opening inventory 1 July 2024	112,600	
Purchases	570,000	
Purchase returns	(26,765)	
Discount received	(14,314)	
Freight/Cartage inwards	7,000	
Customs Duty	2,560	
Buying expenses	1,220	
Closing inventory 30 June 2025	(84,264)	
<b>Cost of Sales</b>		568,037
<b>GROSS PROFIT</b>		<b>332,198</b>
<b>Other income</b>		
Rent received	6,000	
Interest received	4,000	
Dividends received	2,000	
		12,000
<b>TOTAL INCOME</b>		<b>344,198</b>
<b>EXPENSES</b>		
<b>Selling and distribution expenses</b>		
Advertising expense	34,412	
Delivery (outwards) expense	3,205	
Depreciation—shop fittings	7,198	
Promotion expenses	4,000	
Delivery van expenses	5,000	
Depreciation Delivery van	2,500	
Rent expense on Retail Shop	7,800	
Sales salaries	41,200	
		105,315
<b>Administration expenses</b>		
Depreciation—office Equipment	1,075	
Insurance	5,000	
Electricity	3,000	
Rent	12,000	
Rates and Taxes	5,000	
Office salaries	56,000	
Phone and internet	3,600	
		85,675
<b>Financial expenses</b>		
Interest expense	12,568	
Bad and Doubtful debts expense	9,010	
		21,578
<b>Total Expenses</b>		<b>212,568</b>
<b>PROFIT</b>		<b>131,630</b>

**Review Questions 2.4**

1. What is the purpose of the income statement?  
 .. .....  
 .. .....
2. Review the **Income statement for Steve's Surf and Swim** on page 47 and answer the following;
  - (a) What is the entity's name?  
 .. .....
  - (b) What is the accounting entity and what is the legal entity?  
 .. .....
  - (c) What other names can be used for the Income statement?  
 .. .....
  - (d) Identify the accounting period.  
 .. .....
  - (e) State the net income of the business.  
 .. .....
  - (f) Explain what the Cost of Sales represents for this business.  
 .. .....  
 .. .....  
 .. .....
  - (g) Explain the relationship between income, expenses and profit.  
 .. .....  
 .. .....  
 .. .....
  - (h) Outline two other sources of other information needed to assess the financial performance of the business, information that could be used to assess the financial performance of the business.  
 .. .....  
 .. .....  
 .. .....  
 .. .....



3. Classify the following as income, other income or expense.

Account Name	Classification
Purchases of inventory	
Depreciation on delivery vehicle	
Loss on sale of delivery vehicle	
Received fees for services	
Office rent	
Council rates	
Sales	
Staff wages	
Manager's salary	
Gave a customer a refund	
Bought office stationery	

4. Read the following statements and explain the appropriate classification and name the relevant account.

(a) A business paid a performance bonus of \$3,000 to its top performing sales person.

.. .....  
 .. .....  
 .. .....

(b) The business earned \$450 in interest on its savings account.

.. .....  
 .. .....  
 .. .....

(c) Insurance premiums on the building a manufacturer uses increased from \$12,000 a year to \$15,000 a year.

.. .....  
 .. .....  
 .. .....

(d) \$350 worth of stock was returned to the supplier when it was found to have been damaged during delivery.

.. .....  
 .. .....  
 .. .....



5. Classify the following expenses as selling, administration or finance.

Expense	Selling	Administration	Financial
Sales staff wages			
Interest on loan			
Petrol for manager's car			
Advertising			
Electricity			
Sales staff mobile plan			
Internet and data use			
Software upgrades and anti-virus software for office computers			
Commission paid to sales staff			
Bank fees and charges			

6. (a) Explain why discount received is classified with **Cost of Goods Sold**.

.. .....  
 .. .....  
 .. .....

(b) Explain why discount allowed is reported with **Income**.

.. .....  
 .. .....  
 .. .....

7. Prepare a classified Income Statement for Business Enterprises for the period ended 31 March this year from the information provided:

Type	\$	Type	\$
Salespersons Salaries	9,500	Promotions	300
Sales	65,000	Sales returns	500
Rates and Taxes	670	Telephone expenses	340
Purchase returns	900	Customs Duty	350
Opening stock	8,000	Purchases	22,000
Office salaries	12,000	Insurance	280
Freight Inwards	120	Buying expenses	230
Doubtful debts expense	100	Bad debts expense	40
Discounts received	125	Advertising	1,300
Discounts allowed	50	Interest on mortgage	900
Delivery outwards expenses	800	Stationary	40
Closing Stock	3,000	Interest received	550

**Revenue**

**Cost of Goods Sold**

**Gross Profit**

**Other Revenue**

**Selling Expenses**

**Administrative Expenses**

**Financial Expenses**

**Profit**



**Review Questions 2.5**

1. Which stakeholders are most likely to be interested in;
  - (a) Short term profitability? .....
  - (b) Long term profitability? .....
  - (c) Cost of sales? .....
  - (d) Selling and distribution expenses? .....
  
2. Cronulla Snow Riders is a ski club with a lodge on Mt Buffalo, located inside the National Park. The lodge is privately owned by the club and leases the land from Parks Victoria. Consequently there are strict regulations to ensure sustainable use of the national park by private organisations.

As a not-for-profit organisation the club provides accommodation for up to 19 members and their friends at rates well below commercial resorts. A lodge manager lives on-site during the peak season. The constitution of the club allows new members to buy shares in the lodge, although the total number of members is restricted to 80. Financial statements are prepared each year by one of the directors using Xero accounting software.

Consider the following users of accounting information. Describe the needs of the user and the accounting information that may assist them in making decisions. Identify the relevant information the income statement provides these users.

Stakeholder	Stakeholder information needs	Relevant information from the Income statement
Members		
Friends and other non-members guests		
Directors of the lodge		
Lodge manager		
Traditional owners of the park		
Parks Victoria		
Building committee		
Accountant		

3. Since the Uluru-Kata Tjuta National Park was returned to its traditional owners in 1985, it has been managed by the Anangu board of management who work with Parks Australia (a part of the Department of the Environment and Energy) to manage and care for the national park. Explore the website for the Uluru-Kata Tjuta National Park <https://parksaustralia.gov.au/uluru/> and explain the use of financial information by two stakeholders.

.. .....  
 .. .....  
 .. .....  
 .. .....  
 .. .....  
 .. .....

4. How would each of the following managers use accounting information?

(i) Marketing manager

.. .....  
 .. .....

(ii) Operations manager

.. .....  
 .. .....

(iii) Human Resources manager

.. .....  
 .. .....

5. 'Even though accounting information reports on what has already happened it is still useful for making decisions about the future.'

Discuss this statement.

.. .....  
 .. .....  
 .. .....  
 .. .....  
 .. .....  
 .. .....  
 .. .....  
 .. .....



3. Damien Lee started his business with assets of \$84,300 and liabilities of \$26,370  
 During the accounting period he recorded sales of \$69,200 and total expenses of \$33,420. Damien also withdrew \$5,000 from the business for his own use.
- (a) What was the value of his equity at the **end** of the accounting period?  
 .. .. .  
 .. .. .
- (b) What was the change in his equity during the accounting period?  
 .. .. .  
 .. .. .
4. At the beginning of the accounting period an entity had assets worth \$178,000 and its only liability was a \$90,000 bank loan. During the year the business recorded a profit and finished with equity of \$165,000. The owner did not purchase any additional assets or pay off the loan.  
 Calculate the profit the business made.
5. Kay Jaggi owns and operates a convenience store. The business had the following assets and liabilities at the beginning of the accounting period: Cash at bank \$8,770, Debtors \$1,025, Stock of goods \$22,150, Store furniture \$6,450, Creditors \$12,320.  
 During the year, the owner invested an additional \$10,000 into business. The business earned \$51,130 in income and paid \$25,250 in expenses.  
 What was the change in her equity during the accounting period?  
 .. .. .  
 .. .. .

## Links between financial reports

It is usual practice to create the income statement first because the profit of the business will change the value of equity that is represented in the balance sheet and the statement of changes in equity.

Figure 2.10 Links between the income statement and other reports.

Income statement	Profit from the income statement increases equity	<b>Statement of changes in equity</b> <b>Equity at the start</b> of the period + Profit – Drawings = <b>Equity at the end</b> of the period
Income statement	Profit is transferred to the equity component	Balance sheet

**Activity 2.7**

1. Using the following information for Tian's Toys, complete the income statement for the business for the year ended 30 June. *Hint, you need to total each group the expenses, total the categories and use the totals for each category in the Income Statement.*

	\$
Advertising	3,150
Electricity	5,210
Cost of goods sold	72,600
Accountants fees	1,200
Insurance expense	6,400
Interest expense	940
Council rates and fees	2,690
Sales revenue	242,000
Sales returns	1,560
Wages of sales staff	48,350
Delivery vehicle expenses	2,600
Shop rent	15,000

	\$
<b>INCOME</b>	
Sales revenue	
<i>Less: sales returns</i>	
Total Income	
<i>Less: Cost of Goods Sold</i>	
<b>GROSS PROFIT</b>	
<b>EXPENSES</b>	
Selling and distribution expenses	
Administration expenses	
Finance expense	
Total expenses	
<b>PROFIT</b>	

2. Explain how sales can increase yet profit decrease.

.. .....  
 .. .....  
 .. .....

3. Explain why when a business makes a profit, the accounting equation still holds true.

.. .....  
 .. .....  
 .. .....

4. Prepare an Income statement from the following trial balance.

**E. Span, Cleaning**

as at 30 June

<b>Account</b>	<b>Amount</b>
Bank	\$6,000
Debtors	200
Mobile and internet expense	320
Insurance expense	120
Equipment	2,800
Vehicle	7,000
Fuel and vehicle maintenance expense	400
Advertising expense	80
Fees for services	4,800
Creditors	1,100
Capital – E. Span	11,120
Drawings	100
	\$17,020

**E Span, Cleaning**

Income statement

For the year ended 30 June

INCOME	
EXPENSES	
PROFIT	_____

5. Prepare an **Income statement** and **Balance sheet** from the following list of accounts. Classify expenses by their nature.

**A. Win's Tax and Investment Service**

**Account balances as at 30 June**

<b>Account</b>	<b>Amount</b>
Bank	\$3,600
Debtors	2,350
Mobile and internet expense	1,890
Insurance expense	1,700
Stationery and printing	2,830
Office equipment	4,000
Rent expense	15,000
Advertising expense	3,240
Fees for services	17,410
Creditors	1,200
Capital – A. Win	20,000
Drawings	4,000

**A. Win's Tax and Investment Service**

Income statement

For the year ended 30 June

INCOME	
EXPENSES	
PROFIT	_____

**Statement of Changes in Equity**

Name: \_\_\_\_\_

Period: \_\_\_\_\_

**Balance Sheet****As at** \_\_\_\_\_*Current Assets**Non-current Assets***Total Assets***Current Liabilities**Non-current liabilities***Total Liabilities****Net Assets**

6. Use the following information to complete the income statement for Halbert Traders as at 30 June. Classify expenses by their nature.

Advertising expense	6,240	Opening inventory	7,900
Discount allowed	8,550	Office salaries	89,500
Discount received	7,950	Purchases	397,600
Depreciation equipment	4,200	Purchase returns	8,430
Freight outwards	3,300	Rent expense	15,000
Gain on sale of equipment	2,500	Sales revenue	618,430
Insurance expense	12,000	Sales returns	17,270
Interest expense	2,000	Sales salaries	51,600

\* Stocktake revealed \$19,300 of inventory on hand at the end of the period.



## Section

The following section explores the Accounting concepts which influence the presentation and preparation of the Income Statement. It introduces the techniques and the strategies used to analyse and interpret the Income Statement

## Concepts and conventions relevant to the Income statement

Concepts are the underlying ideas, assumptions and language of accounting so that accounting information can be easily understood by users.

Conventions are the basic rules and common practices followed for recording and presenting accounting information.

### Accounting period

The Accounting period is a convention that allows a business to divide up its financial activities into artificial time periods. The period of time covered by the Income Statement may be 1 month, quarterly (3 months) or a year. Interim reports are more relevant for timely decision making. However, there is a trade-off. A single month financial statement shows a less reliable picture of the business compared to the annual financial statement.

A limitation of the accounting period concept is that it is just an arbitrary time period generally accepted to be a year. It is used to make comparisons easy. In Australia, an accounting period ending 30 June, may not suit the seasonal nature of a business. Significant transactions that may impact the business may postponed to the next period and change how users use the reports and make different decisions.

### Realisation

The realisation convention states that revenue can only be recognised after it has been earned and expenses after they have happened. This is usually the point when an invoice has been sent or received. A business can not realise income when it has been paid in advance. Thus it must be recorded as a liability because the goods or service have not been provided yet.

For example, a business which earns revenue through leasing retail spaces, may collect rent one week in advance. However, the business cannot realise it as income when they receive the money. They can only realise this as income when they have provided the service, which in this case is the provision of rental space. Thus, the accountant only record this as revenue when the week has lapsed.

### Going concern

Under the going concern assumption, financial statements are prepared anticipating that the business will continue to trade into the future. That is, at least twelve months from the end of the reporting period. If the business has a record of profitable operations and has access to finance, it is safe to assume the business will continue as a going concern.

If the owners or managers intend to liquidate the business or to cease trading, then this must be declared and the financial statements will not prepared on a going concern basis. Additional information must be provided for stakeholders about the reasons why the business is not regarded as a going concern.

### Faithful representation

Faithful representation means that the financial statements accurately reflect the conditions of the business. They present a 'true and fair' view. The financial statements need to be complete, unbiased, and free from error. Fundamentally, a stakeholder must be given all the useful and relevant information in a reliable, comparable and understandable manner so that they can make good decisions. Figure 2.12, outlines aspects of faithful representation:

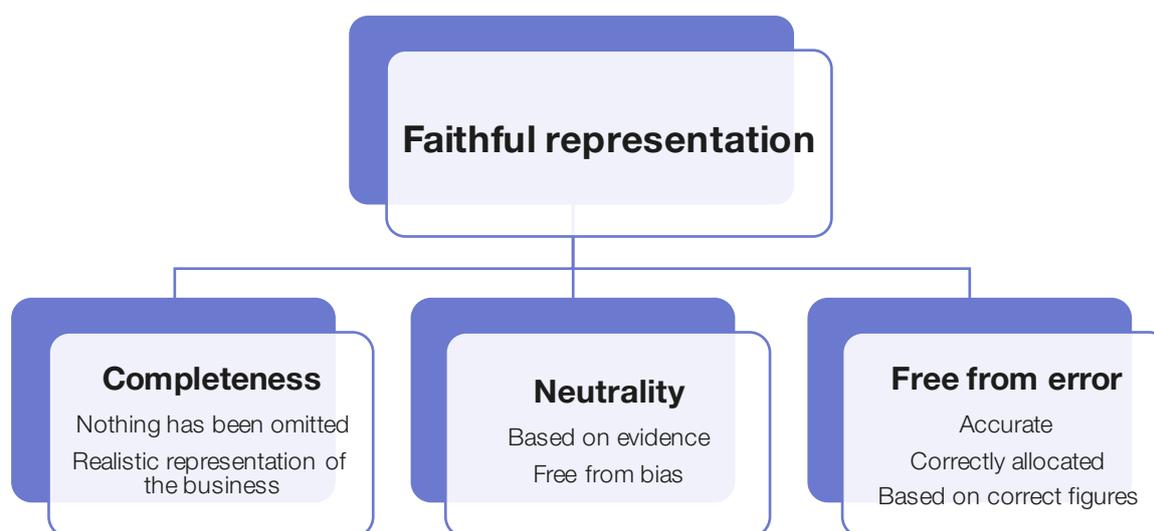


Figure 2.12: Faithful representation.

A business can achieve a fair presentation by complying with Australian Accounting Standards. These standards clearly set out the principals, rules and conventions of accounting which must be followed when preparing financial reports. A business cannot justify using their own version of accounting processes by using notes or other explanation. By following the Australian Accounting Standards, and providing additional information when necessary, it is presumed to result in a financial report that achieves a faithful representation.

Accountants preparing the financial statement will need to:

- Provide complete information by including necessary descriptions and explanations. For example, leaving out one small, minor expenses may not seem significant however, a number of small, minor expenses added together are material and must be included.
- Provide neutral, unbiased information so that users are not influenced to interpret it favourably or unfavourably. For example intentional manipulation of expenses to reduce profit and therefore tax liability.
- Provide information that is free from error in the process used to record a transaction and produce accounting information. For example, correct application of appropriate depreciation formulae.

However, sometimes following accounting standards will not provide enough information for users to understand the impact of a particular transaction or event on the business's financial position and performance. Additional information must be provided so that users can make fully informed decisions.

## Materiality

The materiality concept requires those who prepare the financial statements to include items which could influence the decisions that users make. However, financial statements result from processing and summarising large numbers of transactions. A figure, such as a minor expense, may be immaterial and therefore not recorded as a separate item, instead included within a more significant expense category. For example, \$500 of pens will not be their own expense line but the \$500 will be included in the stationery expense. Although individual items may be immaterial, when added together they are significant. Collectively the amount could influence economic decisions of users. Therefore the total amount is recorded as it is not worth the cost or effort to present each item separately. This can be also explained in the notes to the reports. In addition, an small amount may be considered immaterial and therefore omitted. However, the nature of the item is relevant to stakeholders. For example, \$1,000 may be considered immaterial for a large company but if the \$1,000 was an unexplained payment to a senior manager the amount is relevant because it indicates lack of control over expenses and possible fraud.

Additional information can be included in the Notes accompanying the financial statements that describe the nature of what was left out and why not included in the financial statements. For Example; a business may round the figure in their General Purpose Reports to the nearest dollar, thousand or million, as this information may not be material and impact the decisions made by stakeholders.

## Analysing the Income Statement

Managers and owners will analyse the income Statement to make decisions. As well as interim income statements which are not published they will also create profitability reports for individual departments, divisions or business segments for more detailed analysis and informed. For example, should the business expand, close down a part of the business or cut costs in a specific area.

External users and stakeholders such as investors will also analyse the published financial performance of the business to more informed decision making. For example, whether to invest or divest. Competitors may analyse the business's financial statements to assess its strengths and weaknesses and guide their own strategy.

For all users profitability ratios are very useful tools of analysis because they clearly express the relationships between revenue, profit and the costs of running the business.

The following ratio equations are often used to analyse an entity's profitability:

### Return on equity

$$\text{Return on Equity} = \frac{\text{profit}}{\text{owner's equity}^*}$$

*Note: this ratio should be expressed as a percentage. The owner's equity figure will need to be averaged (i.e. the average of the opening and closing).*

This ratio measures how profitable a business is for the owner. Put simply, for every \$1 of investment this ratio provides a percentage return which can be compared against other investments. As a guide, the ratio should be between 10% and 12% for a business providing a good return on equity.

It can be useful to compare return on equity results to passive investment such as average returns from shares, real estate or interest bearing securities. However, the owner should also consider whether the returns are high enough to reward them for their labour investment in the business and their personal risk.

### Return on total assets

$$\text{Return of Assets} = \frac{\text{profit} + \text{interest expense}}{\text{total assets}^*}$$

*Note: this ratio should be expressed as a percentage. The Asset figure will need to be averaged.*

This ratio measures the amount of profit for every dollar of assets. The result will vary considerably between industries. Some industries such as airlines, power generation and mining use a lot of assets in their operations and therefore will have very low returns on total assets. Other industries that require few assets, such as professional services and insurance will have higher results.

Both the Return on equity and the Return on total assets compare profit to information on the balance sheet. These ratios measure the efficiency with which the business can produce profit using equity or the business's assets. Overall, the higher the ratio result the better.

### Profit margin

$$\text{Profit Margin} = \frac{\text{profit}}{\text{revenue}^\dagger}$$

*Note: this ratio should be expressed as a percentage. Net sales (sales less sales returns) should be used for revenue, except in the case where a business only provides service.*

The Profit margin is also known as the Net Profit Ratio. It measures the percentage of income that remains after all expenses have been paid. This income can be distributed to the owners or reinvested back into the business. Profit is very different to cash flow because net profit includes all non-cash expenses such as accrued expenses and depreciation.

The higher the result the more profitable the business is. However, the result will again vary considerably between industries. A result of 10% or more is considered very good, when compared to safer alternatives such as savings accounts. Small businesses in Australia can average around 15%, which is better than the average return for investing in Australian shares over the last 30 years which is 9.4%. The Profit margin is very good for comparing different sized businesses in the same industry.

It is useful to compare Profit margin results against prior year, industry benchmarks, budgeted figures and other comparable like businesses results.

A limitation of the profit margin is that is only a short-term measure of performance. There will be other factors used by managers and senior leadership to maintain the profitability over the long term.

## Expense ratio

$$\text{Expense ratio} = \frac{\text{individual expenses}}{\text{revenue}^\dagger}$$

*Note; this ratio should be expressed as a percentage. Net sales (sales less sales returns) should be used for revenue, except in the case where a business only provides service.*

The Expense ratio measures the efficiency of the business in generating profit. That is, the size of the expenses compared to the revenue of the business or the proportion of revenue spent on the costs of running a business. However, it is more useful for managers to calculate individual expense ratios. For example, the ratio for selling expenses will determine the marketing costs to achieve every dollar of sales. This ratio is best analysed against budgeted figures, past results and industry averages.

A limitation of the Expense ratio is that because it summarises events over an accounting period, typically a year, it does not reflect changes in efficiency during the year.

## Gross profit margin

$$\text{Gross Profit Margin} = \frac{\text{gross profit}}{\text{revenue}^\dagger}$$

*Note; this ratio should be expressed as a percentage. Net sales (sales less sales returns) should be used for revenue, except in the case where a business only provides service.*

The Gross profit margin shows the proportion of profit generated from every dollar of sales before distribution, administration and financial expenses are paid. It is the profit made from selling its goods and providing its services.

There is no general benchmark as the costs of sales will vary widely between industries and between firms. The Gross profit margin is not relevant to service based businesses because there is no change in inventory for these firms. These results are best analysed against past results, industry averages, budgeted figures and like businesses results.

Figure 2.13 summarises the reasons for change in a ratio over time when interpreting the results and how a user would apply this knowledge

Profitability (return) ratio	Reason for increase	Reason for decrease
Return on equity	Rising profit Reduced equity because of drawings	Falling profit Increasing use of capital to finance the business
Return on total assets	Rising profit Reduction in value of assets Sale or disposal of assets	Falling profit Purchase or acquisition of assets
Profit margin	Rising revenue Increase in gross profit Falling expenses Larger scale of operations spreads fixed costs over more sales.	Falling revenue Decrease in gross profit Rising expenses
Expense	Falling revenue New fixed cost or rise in a fixed cost such as rent Increasing costs	Rising revenue Elimination or reduction in a fixed cost such as negotiating a lower rent and insurance. Larger scale of operations Fall in costs
Gross profit margin	Increase in selling price without an rise in cost of sales Bulk buying and gaining discounts on purchasing inventory Higher percentage of high-profit product lines selling of the product mix Stock revalued at lower of cost or net realisable value	Decrease in selling price Heavy discounting More low margin stock selling and less high margin stock selling

Figure 2:13

The evaluation of business performance requires analysis of a range of ratios and other key performance indicators used in the business's industry. External factors and qualitative information such as the state of the economy, trends, and competitors will also need to be considered.

### Activity 2.8

1. (a) Using the financial information for Simon's Boat Sales calculate
  - (i) Gross Profit margin  
.....
  - (ii) Profit ratio  
.....
  - (iii) Expense ratio for each category of expense  
.....

- (b) Comment on the profitability of the business. (Hint, when commenting on profitability it is useful to define the terminology used, describe the ratio, comment on the results/ trends, analyse the impact on the business and if needed, recommend strategies to improve this ratio.

**Simon's Boat Sales  
Income Statement  
For the year ended 30 June  
(\$000)**

	\$
Revenue	210,000
Less: Cost of sales	97,000
<b>Gross profit</b>	<b>113,000</b>
Less: Expenses	
Selling and distribution expenses	46,000
Administration expenses	16,500
Financial expenses	8,000
<b>Profit</b>	<b>\$42,500</b>

- (c) Explain how the Accounting concept of accounting entity has been applied when preparing the income statement.

- .. .. .
2. (a) Using the financial information for Bloomingdales Flowers calculate
- (i) Gross Profit margin .. .. .
- .. .. .
- (ii) Profit ratio .. .. .
- .. .. .
- (iii) Expense ratio for one of the expenses categories. .. .. .
- .. .. .
- (b) Comment on the profitability of the business.

**Bloomingdales Flower Shop  
Income Statement  
For the year ended 30 June**

	\$
Revenue	240,000
Less: Cost of sales	160,000
<b>Gross profit</b>	<b>80,000</b>
Less: Expenses	
Selling and distribution expenses	
Advertising	4,000
Casual sales wages	18,000
Delivery	6,000
Administration expenses	
Cool room rent	8,500
Insurance	2,500
Stationery	400
Financial expenses	
Interest	600
<b>Profit</b>	<b>\$40,000</b>

- (c) Explain how the Accounting concept of accounting entity has been applied when preparing the income statement.

.. .. .

3. State whether the ratio has increased or decreased as a result of the following transactions.

Transaction	Ratio	Increase/Decrease
(a) Sales doubled compared to the previous accounting period	Profit margin	
(b) Supplier increased costs	Gross profit margin	
(c) Owner invested an additional \$50,000 into their business	Return on equity	
(d) Disposed of obsolete equipment	Return on total assets	
(e) Insurance expenses increased	Expense ratio	

4. (a) Complete the calculations for profitability and efficiency for each component of the income statement for J. Lewis Wholesalers.

.....

(b) Advise the owner where two efficiency improvements can be made.

.....

.....

<b>J. Lewis Wholesalers</b>				<b>Ratio</b>	<b>Ratio calculations</b>
<b>Income Statement</b>					<b>Answer</b>
for the year ended 30 June 2021					
<b>INCOME</b>					
Sales revenue			\$ 801,200		100%
Cost of Sales					
	Inventory 1 July 2020	\$ 242,600			
	<i>Add:</i> Purchases	\$ 352,560			
Cost of goods available for sale		\$ 595,160			
	<i>Less:</i> Inventory 30 June 2021	\$ 336,760			
Cost of sales			\$ 258,400		
GROSS PROFIT			\$ 542,800	Gross Profit ratio	
<b>EXPENSES</b>					
Selling and distribution expenses					
	Advertising expense	\$ 100,000			
	Delivery expense	\$ 13,600			
	Sales wages	\$ 91,000	\$ 204,600	Selling expense ratio	
Administration expenses					
	Rent	\$ 31,200			
	Insurance	\$ 18,000			
	Phone and internet	\$ 12,200	\$ 61,400	Administration expense ratio	
Financial expenses					
	Interest expense	13 600	\$ 13,600	Financial expense	
Total Expenses			\$ 279,600	Expense ratio	
PROFIT			\$ 263,200	Profit ratio	

- 5. (a) A business has sales of \$450,000 and a Profit ratio of 12%. What is the value of its Profit?  
 ..  
 ..
- (b) A business has a Gross Profit ratio of 61% and Profit ratio of 9%. What is the value of its operating expense ratio?  
 ..  
 ..
- (c) A business records sales of \$240,000 and operating expenses of \$96,000. If its Profit ratio is 8% what is the dollar value of the cost of sales?  
 ..  
 ..
- 6. Outline two non-financial factors which stakeholder may consider in addition to profitability ratios, when evaluating profitability performance of an entity. Identify at least two factors, which would be considered.  
 ..  
 ..
- 7. On the 14<sup>th</sup> of March a fire at Its A Party! Party Supplies damaged all stock. The owner is hoping to make an insurance claim on the stock that has been lost but does not have a good estimate of what was stored at the business, nor had he done a stocktake since the previous year. The accountant has the following records.

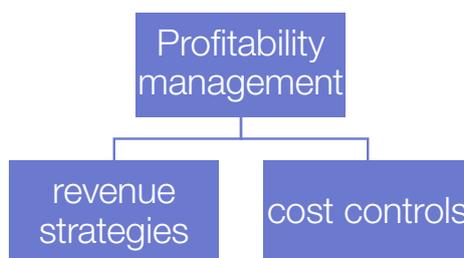
Sales	\$227,330
Sales returns	3,540
Discount allowed	12,490
Purchases	218,000
Purchase returns	14,500
Inventory on hand 1 July	68,290
Freight inwards	3,500

- (a) If the Gross Profit margin is typically 34% each year, estimate the value of the stock on hand.  
 ..  
 ..
- (b) Explain two accounting concepts that will influence the production of the financial accounts for Its A Party!  
 ..  
 ..

## Strategies for improving profitability

Profit is how much revenue remains after all expenses have been paid. Maximising profit is a key financial objective for owners as they can use this residual income for any purpose. Sole traders and partners can withdraw profit as their reward, or choose to reinvest back into the business for growth and future profits. Companies distribute profit as dividends to shareholders which will support share price, they can also choose to retain profits in the forms of retained profits and reserves.

A number of strategies can be implemented to increase revenue and cost controls, thus improving profitability



## Revenue strategies

Managers may set sales objectives and targets based on accounting information and their own evaluation of the business environment and employee capabilities. Sales data from internal sales reports would be a good starting point. It is the role of the marketing manager to develop strategies to increase income. This may require changing the sales mix based on data from past sales of individual products; eliminating the poor performers and increasing promotion of revenue generating products. Pricing policies may be changed as well to stimulate sales. The accountant may work with the marketing manager to develop a promotions budget and use efficiency ratios to determine which promotional spending generates the most revenue.

## Cost controls

Cost controls include using:

- Cost centres
- Variance reports
- Expense minimisation
- Budgets

Cost centres are different parts, subsidiaries or departments within a business that perform a specific function. Cost centres do not directly produce profit but support the business. Expenses are allocated to the centre and monitored using budgets. Examples of different cost centres within departments is summarised in figure 2.13. A budget encourages managers to minimise waste and make maximum use of the resources they have available. However, a manager may not want his division to be too efficient as this will lead to having the budget cut for the following year. Budgeting is discussed extensively in the next section.

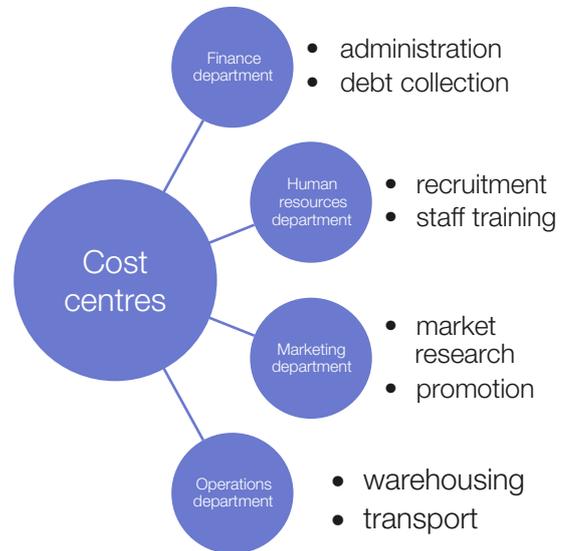


Figure 2.14 Cost centres

Variance reports such as the one in figure 2.15 are used to compare actual spending against what was budget as a method of cost control. Managers can easily detect which costs exceeded the budget and more investigation will reveal the reasons, and take corrective actions in future periods.

	Budget	Actual	Variance %
Advertising	5,000	5,900	+18
Delivery	300	310	+3
Sales wages	55,600	61,200	+10
Insurance	5,000	5,000	0
Office wages	62,000	81,000	+31
Phone and internet	3,600	3,600	0
Interest on loans	1,500	1,540	+2.6
<b>Total expenses</b>	<b>133,000</b>	<b>158,550</b>	<b>+19.2</b>

Figure 2.15

Expense minimisation usually involves analysis of variable costs to see where savings can be made. By comparing different providers and suppliers managers can seek out the least expensive deal. Examples of variable costs include:

- Advertising
- Electricity, gas and water
- Phone and internet
- Cost of sales and other inputs
- Casual wages
- Delivery and freight

Some tasks within each business department can be outsourced to a specialist company who can perform the task at lower cost than the business itself. For example, security and printing. Managers may also choose to postpone non-essential spending to minimise expenses in the short term. Although, spending on advertising, maintenance or equipment upgrades, staff training, and Research and Development (R&D) may impact the future financial sustainability of the business

## Forecasting and budgeting

Accountants will use tools such as forecasting and budgeting to improve profitability. Creating a budgeted income statement enables managers to evaluate performance by comparing actual income and costs against targets, gain more control over revenue and expenses, and provide insight into what changes need to be in the business to reach these targets. Therefore strategies will focus on increasing income and reducing expenses to improving gross profit and net profit.

It is important to develop an accurate sales forecast as this will influence expenses. That is, the expense budget will depend on the predicted income of the business. When making forecasts, predictions are based on patterns for sales and expenses from previous years and likely impacts from the business environment. Accountants will rely on market research and data when making predictions. The dynamic nature of the business environment makes accurate forecasting difficult. Factors which can influence business revenue and expenses include:

- Health of the economy, interest rates, consumer and business confidence
- Social trends and demographic changes
- Government policy, laws and regulations (for example that increase labour costs)
- Stage in the life cycle of the business and the stage in the product's life cycle
- Strength of competitors and their strategies

The life cycle of a business illustrates the change in income and profitability over time as show in Figure 2.16. It can also guide forecasting and budgeting. For example, the accountant will expect increasing revenue and profitability for a business in the growth phase.

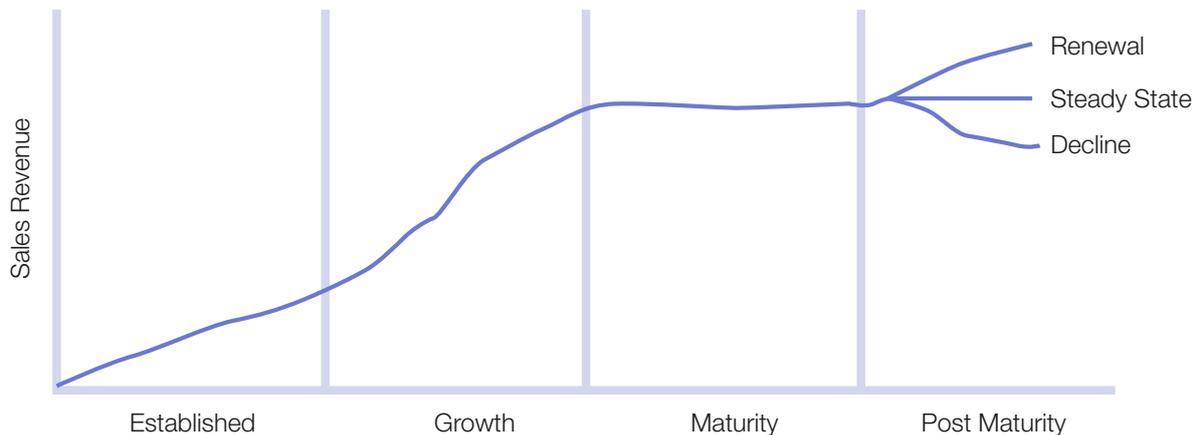


Figure 2.16

Therefore, when forecasting and budgeting accountants must have an understanding of the whole business environment and the variables that can change sales and costs. Fortunately technology has made it easier to prepare and modify budgets. Software packages, statistical programs and spreadsheets can create different scenarios using all the business's data as well as using data from external sources such as Australian Bureau of Statistics (ABS) and the Reserve Bank of Australia (RBA). Variables can be easily changed to see the effect on the budget. A budgeted income statement can be prepared for any period; monthly, quarterly or yearly. However, more frequent reports will make it easier to monitor progress against what was planned and take corrective action sooner.

Steps to preparing a budgeted income statement.

1. Set goals for profit margin and expense ratios
2. Create an income budget by making forecasts about sales volumes and prices
3. Calculate purchases and cost of sales based on the income budget
4. Create an expense budget by setting selling and distribution expenses and spreading administrative costs evenly
5. Using the data from the income, purchases and expense budget, create budgeted income statement

## Case Study

The following case study for Budget Cuts illustrates forecasting and the development of a budgeted income statement.

Tilly Trainer owns Budget Cuts, a small hairdresser specialising in basic cutting and styling. Her business's success is due to having a small range haircuts and offering child cuts at half the price of adult. In an average month the business will provide 558 haircuts, 34% of the customers are children. The business also carries a small amount of hair products for sale; shampoos, conditioner and styling products which represents 10% of total revenue. The business rents its premises in a local shopping centre at a cost of \$600 per week. As well as the owner there is one full time staff member and one casual staff member who works when it's busy. Although people need haircuts all year, there is a seasonal influence on sales. From October until early December adult haircuts increase due to warmer weather. There are fewer customers after Xmas during January. There is a surge in demand in January for children's back to school haircuts.

The owner has noticed that the shop is not as busy as previous year. This is a consequence of lower consumer confidence in the economy so her customers are having their hair cut less often to save money. A competitor Just Cuts is opening in March in the same shopping centre. Tilly suspects that she will lose 20% of her regular clients to Just Cuts and wants to factor this into the April-June Quarter.

At the end of the year Tilly would like a net profit ratio of 30%

### Budget Cuts Ltd

#### Sales Budget

For the year ending 30 June

	Quarter 1	Quarter 2	Quarter 3	Quarter 4	
	Jul-Sept	Oct-Dec	Jan-Mar	Apr-Jun	Annual total
Adult style cut sales					
Number	1,100	1,300	900	880	4,180
Price per cut \$	32	32	32	32	32
<b>Budgeted sales</b>	<b>35,200</b>	<b>41,600</b>	<b>28,800</b>	<b>28,160</b>	<b>133,760</b>
Children budget cut sales					
Number	575	450	700	460	2 185
Price per cut \$	16	16	16	16	16
<b>Budgeted sales</b>	<b>9,200</b>	<b>7,200</b>	<b>11,200</b>	<b>7,360</b>	<b>34,960</b>
Hair products					
Number	260	260	210	208	938
Price per unit	19	19	19	19	19
<b>Budgeted sales</b>	<b>4,940</b>	<b>4,940</b>	<b>3,990</b>	<b>3,952</b>	<b>17,822</b>
<b>TOTAL BUDGETED SALES</b>	<b>49,300</b>	<b>53,700</b>	<b>43,990</b>	<b>39,472</b>	<b>186,542</b>

There is no cost of sales for hair cutting and styling because this is a service.

## Benefits of budgeting

The benefits of budgeting include:

- Managers are more accountable and therefore must plan spending.
- Managers are provided targets and can use variance reports to identify where their attention is needed to reduce spending.
- It helps coordinate each different business department; finance, human resources, marketing, and operations so that there is no 'doubling-up' of spending.

Non-for-profit organisations will also use budgets. This is to ensure that all income is allocated to spending and to prevent the organisation from overspending.

**Budget Cuts Ltd**  
**Hair Product Purchases Budget**  
**For the year ending 30 June**

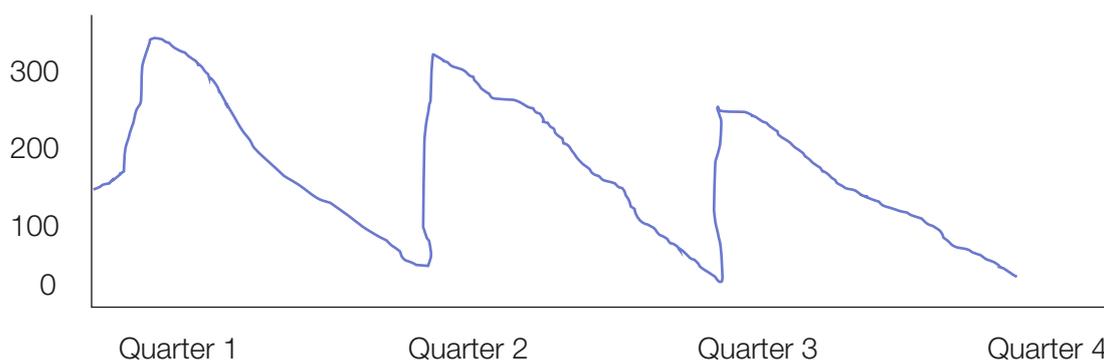
	Quarter 1	Quarter 2	Quarter 3	Quarter 4	
	Jul-Sept	Oct-Dec	Jan-Mar	Apr-Jun	Annual total
<b>Hair products</b>					
Forecasted sales in units	260	260	210	208	938
Desired closing inventory for the quarter in units	70	70	70	70	
Total units needed	330	330	280	278	1,148
Less Beginning inventory	152**	70*	70	70	
<b>TOTAL PURCHASES REQUIRED (UNITS)</b>	<b>178</b>	<b>260</b>	<b>210</b>	<b>208</b>	<b>856</b>

The formula for how many units need to be purchased

= Forecast sales unit + Desired ending inventory – beginning inventory

\*\*From her current balance sheet her opening balance for inventory was 152 units of hair products. Therefore her purchases for the first quarter were much lower. \*On average Tilly sells 70 bottles of hair products a month and has budgeted to have 1 month's supply in stock at the end of every quarter as buffer stock.

Change in inventory is depicted in the diagram below.



This version of the purchases budget converts the units that need to be purchased into cost of sales. The total figure is the cost of sales forecasted for year based on predicted sales.

**Budget Cuts**  
**Purchases Budget \$**  
**For the year ending 30 June**

	Quarter 1	Quarter 2	Quarter 3	Quarter 4	
	Jul-Sept	Oct-Dec	Jan-Mar	Apr-Jun	Annual total
Purchases required units	178	260	210	208	856
Cost of sale per unit \$	10	10	10	10	10
<b>TOTAL PURCHASES</b>	<b>1,780</b>	<b>2,600</b>	<b>2,100</b>	<b>2,080</b>	<b>8,560</b>

The cost of sales is worked out as follows

Opening stock	1,520 (152 units @ \$10 each)
+ Purchases	8,560
– Closing stock	700 (70 units @ \$10 each)
<b>Total costs of sales</b>	<b>9,380</b>

**Budget Cuts****Expenses budget \$****For the year ending 30 June**

	Quarter 1	Quarter 2	Quarter 3	Quarter 4	
Expenses	Jul-Sept	Oct-Dec	Jan-Mar	Apr-Jun	Annual total
Advertising	1,970	1,970	1,970	1,970	7,880
Electricity	650	650	650	650	2,600
Insurance	380	380	380	380	1,520
Rent	7,800	7,800	7,800	7,800	31,200
Staff wages	19,500	19,500	19,500	19,500	78,000
<b>TOTAL EXPENSES</b>	<b>30,300</b>	<b>30,300</b>	<b>30,300</b>	<b>30,300</b>	<b>121,200</b>

The sales budget, purchases budget and expense budget are compiled to create a budgeted income statement. This will produce a Net Profit Ratio for Tilly of 30%

**Budget Cuts****Budgeted Income Statement****For the year ending 30 June**

Sales			186,542
Cost of sales		9,380	
GROSS PROFIT			177,162
Expenses			
Advertising		7,880	
Electricity		2,600	
Insurance		1,520	
Rent		31,200	
Staff wages		78,000	121,200
<b>PROFIT</b>			<b>55,962</b>

**Review Question**

What actions would you recommend Tilly take to counteract the predicted falling profitability?

Answers could include:

- working more hours herself to reduce casual staff wages
- change advertising strategies to less expenses social media
- negotiate a rent reduction
- increase prices
- offer package deals; haircut + product to upsell
- shop around for a cheaper deal for business insurance

## Profitability analysis for companies

The most significant stakeholder in the profitability of a company is the owners who are also the shareholders. Shareholders will be interested in the investment returns available which are based on the profitability of the company. These returns are evaluated according to the potential risk of the shareholder not receiving a return and against other safer investment alternatives such as term deposits and property.

The board of directors may not return all profit to shareholders, opting to invest some or all back into the business. Therefore there may be a difference between company earnings and what is distributed to shareholders. As well as earnings and dividends shareholders need to consider the change in the share market price as this will affect the yield. Simply, rising market values will reduce yields. The analysis tools; earnings per share, earnings yield, dividend per ordinary share, dividend yield, return on equity and their formulas are summarised in figure 2.17.

Owners will be interested in return on equity while shareholders and potential investors in companies will be particularly interested in the return on their investment risk. They will consider how profitable the company is and whether it will be profitable in the future as this will indicate the potential income they will receive from owning shares and the value of their shares.

The following ratio equations are often used to analyse an entity's returns:

### Earnings per ordinary share (EPS)

$$\text{EPS} = \frac{\text{profit for ordinary shareholders}}{\text{number of ordinary shares}}$$

This measures the amount of money each share would receive if all of the profits were distributed. The higher the value the better. This ratio is expressed in dollar terms.

### Earnings yield

$$\text{Earning Yield} = \frac{\text{earnings per ordinary share}}{\text{market price per ordinary share}}$$

This ratio measures the rate of return that an investor will earn at the current market price of the shares. This ratio is expressed as a percentage. A high result would indicate a company that is able to pay a high dividend to shareholders. Note that changes in the share price will significantly change the earnings yield.

### Dividend per ordinary share

$$\text{Dividend per ordinary share} = \frac{\text{total ordinary dividend}}{\text{number of ordinary shares}}$$

This measures the actual dividend paid for each share owned. This ratio is expressed in dollar form so a potential investor can estimate their income from owning shares in the business. A high result would indicate that the managers believe that the business has strong liquidity and cash flow to make dividend payments. However, managers may choose not to pay high dividends, instead reinvesting these funds back into the business in the form of retained profits or reserves to support future growth.

### Dividend Yield

$$\text{Dividend yield} = \frac{\text{dividend per ordinary share}}{\text{market price per ordinary share}}$$

This ratio measures the actual return on investment for a shareholder if they bought the shares at the market price. Dividends are the income from owning shares. This ratio is expressed as a percentage so that potential investors can easily compare different companies and other investments, such as savings accounts or government bonds, to identify the investment with the highest percentage return. However, a company with high profits and a low dividend yield would indicate reinvestment for longer term growth. This may appeal more to some potential investors.

Name	Calculation	Expressed as
Earnings per ordinary share	$\frac{\text{profit for ordinary shareholders}}{\text{number of ordinary shares}}$	\$
Earnings yield	$\frac{\text{earnings per ordinary share}}{\text{market price per ordinary share}}$	%
Dividend per ordinary share	$\frac{\text{total ordinary dividend}}{\text{number of ordinary shares}}$	\$
Dividend yield	$\frac{\text{dividend per ordinary share}}{\text{market price per ordinary share}}$	%

Figure 2.17

Note that in order to work out the yield, the calculation for the earnings or dividend per ordinary share will need to be performed.

### Activity 2.9

1. Refer to the following information.

Profit (after tax)	\$200,000
Total dividends paid	\$180,000
Number of ordinary shares issued	1,000,000
Market price per ordinary share	\$2.50

Calculate the following:

- (a) Earnings per ordinary share  
.. .. .
- (b) Earnings yield  
.. .. .
- (c) Dividend per ordinary share  
.. .. .
- (d) Dividend yield  
.. .. .
- (e) If the market price for the share was \$2.00 1 year ago, how much has the dividend yield changed?  
.. .. .

2. Refer to the follow information

	2021	2020
Profit (after tax)	\$1,200,000	\$900,000
Total dividends paid	\$800,000	\$900,000
Number of ordinary shares issued	750,000	500,000
Market price per ordinary share	\$6.80	\$7.40

- (a) What is the movement in profit?  
.. .. .
- (b) What is the change in earnings yield?  
.. .. .
- (c) What is the change in dividend yield?  
.. .. .



(d) Explain the in dividend yield

.....

(e) Discuss the other non-financial factors potential investors consider before investing in this company?

.....

3. Explain the difference between earnings and yield.

.....

.....

.....

4. Kennerds Ltd. provides equipment hire for building and construction. Net profit for the year was \$2.2 million and the company plans to distribute all of that to its shareholders. Kennerds issued 4 000 000 shares at \$15.00 when the business began 12 months ago. Currently, the share price is at \$18.40.

The industry averages for rental and hiring services are provided.

	Industry averages
Earnings per ordinary share	35 cents
Earnings yield	12%
Dividend per ordinary share	\$1.20
Dividend yield	6.0%

Calculate the following profitability ratios and discuss the results. Advise potential investors about the business.

a) Earnings per ordinary share

.....

b) Earnings yield

.....

c) Dividend per ordinary share

.....

d) Dividend yield

.....

5. Data is provided for two alternative investments. Using ratio analysis recommend the most appropriate company to a potential investor who seeks high returns.

	Company A	Company B
Sales	\$11.6 million	\$1.2 million
Profit (after tax)	\$8.12 million	\$840,000
Total dividends paid	\$1 million	\$600,000
Number of ordinary shares issued	40 million	150,000
Share market price	\$0.05	\$8:34

6. The following information is an extract from the annual report of Walker Ltd. The company has issued 3,200,000 shares. The current market price is \$1.74.



- (a) Calculate the earnings per share  
 .. .....  
 (b) Calculate the dividend per share  
 .. .....  
 (c) Calculate the dividend yield  
 .. .....  
 (d) Calculate the earnings yield  
 .. .....  
 (e) Assess the usefulness of the data to a potential investor.  
 .. .....
7. Lithium resources has been operating a successful lithium mine in South Australia. The share price has tripled in the past 12 months. The CEO's report published in the company's annual report explained that despite high earnings for the past year and anticipated high revenues for the next year, investors would have to be content with low dividend yields on their shares.

Explain why this might be the case – rising share price market price

## Extension reading

# Social and ethical issues and considerations

Australian Accounting Standards require entities to produce a Balance Sheet, Income statement, statement of Changes in Equity and a Cash Flow statement. However, many businesses also produce environmental reports and sustainability reports to inform users. Data as well as qualitative statements about environmental targets, achievements, plans, and initiatives are provided. Businesses may also report on their employment engagement and achievements for inclusion and diversity. Although not required these reports are used in industries where environmental impacts and employee welfare are significant.

Decisions by internal users of accounting information are fundamentally in the interests of owners and shareholders. However, individuals, groups, and society now, and in the future, may be impacted by these decisions. The following are examples of ethical considerations:

- Employee redundancies as a consequence of reducing costs
- Local community impacts from the closure of a division of a business
- A mining company using more water after expansion of operations resources
- Managers disclose non-financial information that can affect the future of the business.

In traditional accounting, the “bottom line” is either the “profit” or “loss”, recorded at the very bottom line on the Income Statement. There is a recognition that there are limited resources being used by businesses which will affect future generations. Businesses are more accountable to society and other external stakeholders who wish to make ethical choices. Therefore, as well as financial statements, many businesses also present additional information outside the scope of the Australian Accounting Standards. This has been called Triple Bottom Line reporting, where managers and owners set targets for a healthy business, people and environment, and report on achieving those targets.

These reports and statements, such as environmental reports and social impact reports are outside the scope of Australian Accounting Standards and therefore do not have to comply with the rules and requirements of the standards. However, they should still be reliable, valid and consistent. Therefore non-financial information must be considered.

There are ethical issues surrounding the creation of non-financial information. Accountants and managers must be careful to not to convert environmental and social activities into arbitrary monetary value. In addition, businesses must not trade-off achievements in one area against failure in another.

The following Australian companies have published detailed sustainability reports and are available online for further reading.

- Toyota Australia
- ANZ bank
- Chevron Australia
- Woolworths Group
- Australian Dairy Industry

Businesses that incorporate practices which protect the environment and improve social well-being should be able to offer higher returns to owners and shareholders through reduced energy costs, more productive employees and higher revenues. Therefore when accounting advice is provided, broader consideration of the ethical implications of this accounting advice on individuals, groups, and/or society now and in the future, should be provided.

**Social issues** are those which relate to individuals, the community and the environment. When making decisions and providing advice accountants should consider the impacts on individuals, the community and the environment.

**Ethical issues** are those which relate to the expectations society has about the way businesses should behave. When making decisions and providing advice accountants need to act ethically, considering their actions would be determined to be honest, morally ‘right’ and with integrity. For example, accountants must keep client information confidential and never have a conflict of interest in their client dealings.

### Analysis activity

The owner of Life's A Bouquet Flower Shop, B Rose, is interested to know how her business is performing and whether it is would be better to close the shop and return to full time work as a pharmacist where she could earn a salary \$72 000. She has provided the following information for your analysis.

Life's A Bouquet Flower Shop  
Income statement  
for the years ending 30 June

	Current Year	Prior Year	2 Years Prior
Sales	180,000	175,000	200,000
Less cost of sales	67,500	52,400	60,000
Gross Profit	112,500	122,600	140,000
Expenses			
Selling and distribution	28,000	27,000	30,000
Administrative	17,200	17,200	17,200
Finance	2,800	2,800	2,800
	48,000	47,000	50,000
Profit	64,500	75,600	90,000

1. If B Rose has objectives for gross profit margin of 70% and a profit margin of 40%, comment on the profitability of the business.
 

.. .. .

.. .. .
2. (a) Using the accounting information explain the change in the business's profitability.
 

.. .. .

(b) Outline other non-financial factors that could explain the change in profitability.

.. .. .
3. B Rose's equity in the business was \$60,000 in the Prior year. What is her Return on Equity for the Current year.
 

.. .. .

.. .. .
4. What other information would be useful to evaluate the performance of the business.
 

.. .. .

.. .. .
5. Recommend one strategy B Rose could use to improve the business's profitability.
 

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# Chapter 3 - Recording and Processing Accounting Transactions

The following chapter explains the steps required to accurately transform raw data and information into accounting entries, and eventually final reports.

## Understanding Accounting Concepts and Conventions

### The Accounting process

The accounting process begins with source documents and concludes with the creation of final reports as illustrated in figure 3.1 and in more detail in figure 3.2. Both figures show the order of steps for a manual accounting system.

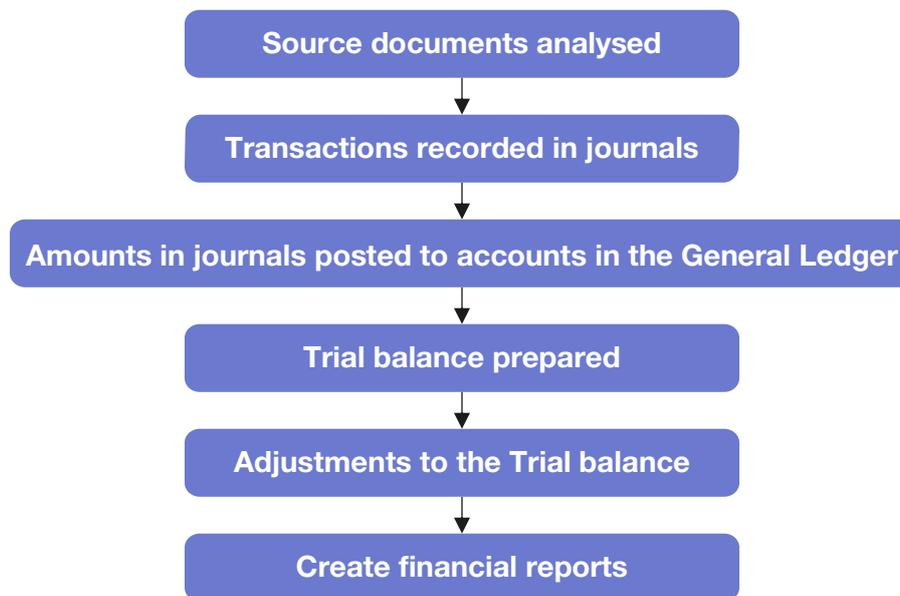


Figure 3.1. The Accounting process simplified

\*Posting is transforming debits and credits recorded in individual journal entries to the specific accounts affected.

- The term, **journals**, comes from the original book in which accounting entries were first recorded. A Journal entry is made in manual accounting systems for each transaction as it occurs so that a chronological record is kept. Recording the full effect of the transaction into a journal is useful to reduce errors.
- There are ledger accounts for each type of asset, liability, equity, income, and expense item. Accounting entries are recorded for each account to show the increases and decreases in value of each item. The **General Ledger** keeps all the ledger accounts in one place.
- The **Trial Balance** is a list of all a business's accounts from the general ledger with their current balance. The total of the debit balance will equal the total of the credit balance.

The accounting process begins with raw data from source documents which are the evidence for a transaction. Accountants can verify quantitative information by directly checking the source documents. This supports faithful representation.

Source documents are:



**Tax invoice**

Windows to Fit Pty Ltd  
ABN: 32 123 456 789  
15 Bursling Road  
Foster NSW 2765

Date: 1 August 2013

To: Building Company  
254 Bursling Road  
Foster NSW 2765

Qty	Description of supply	Unit price	GST	Total
50	Window frames	\$100	\$15	\$6,250
10	Deadlocks	\$40	\$4	\$440
			<b>GST</b>	
<b>TOTAL AMOUNT PAYABLE:</b>				<b>\$6,690</b>

The total price includes GST.

- Cash receipts book
- Cash register tapes record cash received through a register
- Cheque butts
- Purchase orders
- Sales invoices
- Tax invoices sent and received
- Utilities bills; electricity, water, internet plan
- Internet banking records
- Contracts

Figure 3.2 presents a detailed process for the recording transactions. Note that businesses using accounting software will not have to make journals entries. This step is skipped and entries are made directly into the ledger accounts. The computerised accounting system will ensure that each debit has a corresponding credit entry to ensure accuracy.

Note also that Specialised Journals, referred to in the flow chart are explained at the end of this chapter.

**New Journal**

Date: 20 Oct 2017

Reference: 13

Notes: Transfer of funds

Journal Type:  Cash based journal

Currency: AUD - UAE Dirham

Account	Description	Debit (AUD)	Credit
Party Cash	Description	1000	
Office Supplies	Description		1000
<b>Sub Total</b>		<b>1000.00</b>	<b>1000.00</b>
<b>Total (AUD)</b>		<b>1000.00</b>	<b>1000.00</b>

Which file?  Linked file

You can attach a maximum of 5 files, 5MB each.

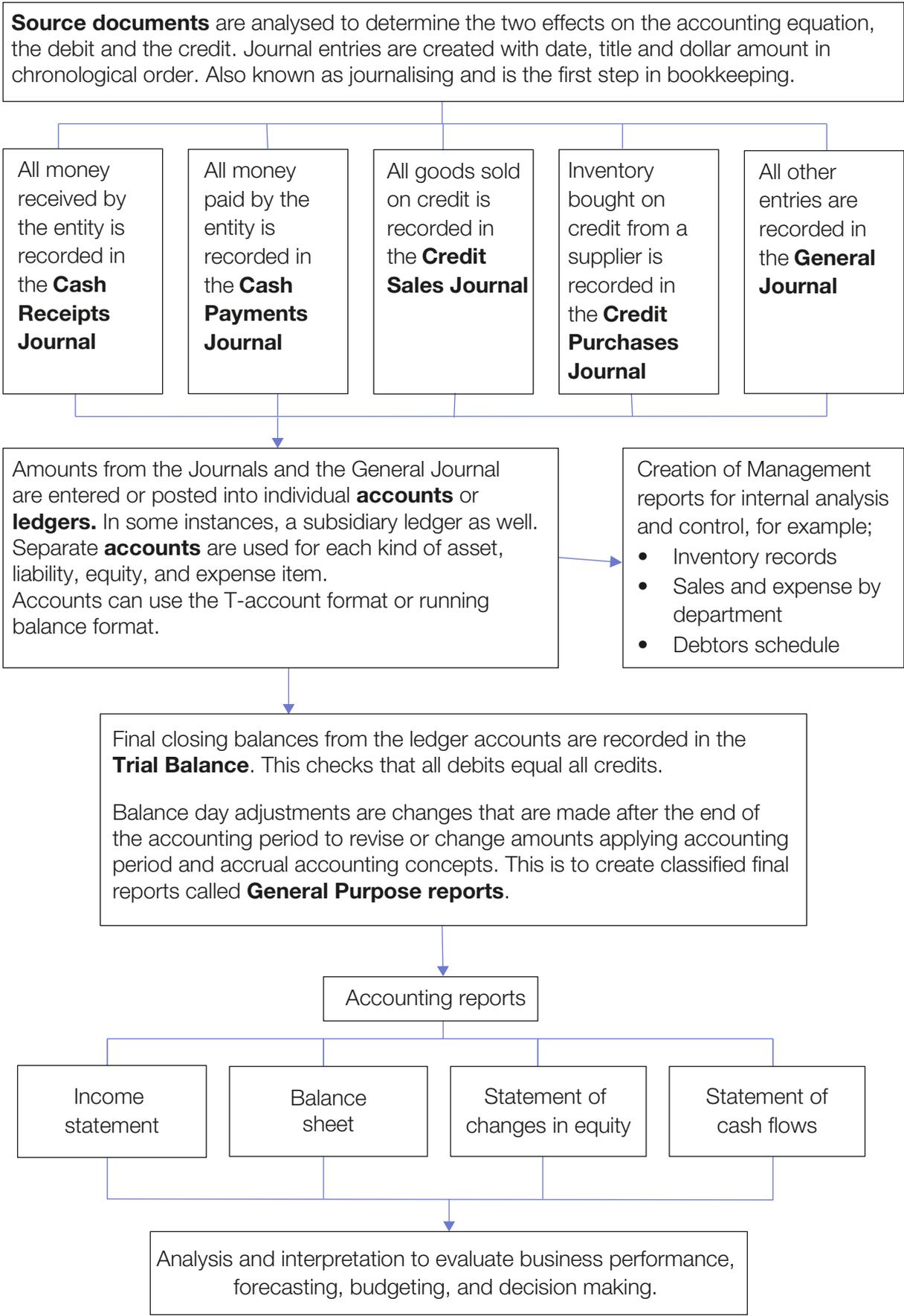


Figure 3.2. The Accounting Process detailed

A common difficulty for many students new to accounting is distinguishing between a journal and a ledger account. Figure 3.3 illustrates the difference for the following transaction for a business receiving \$6 800 in cash from sales on the 3<sup>rd</sup> of July.

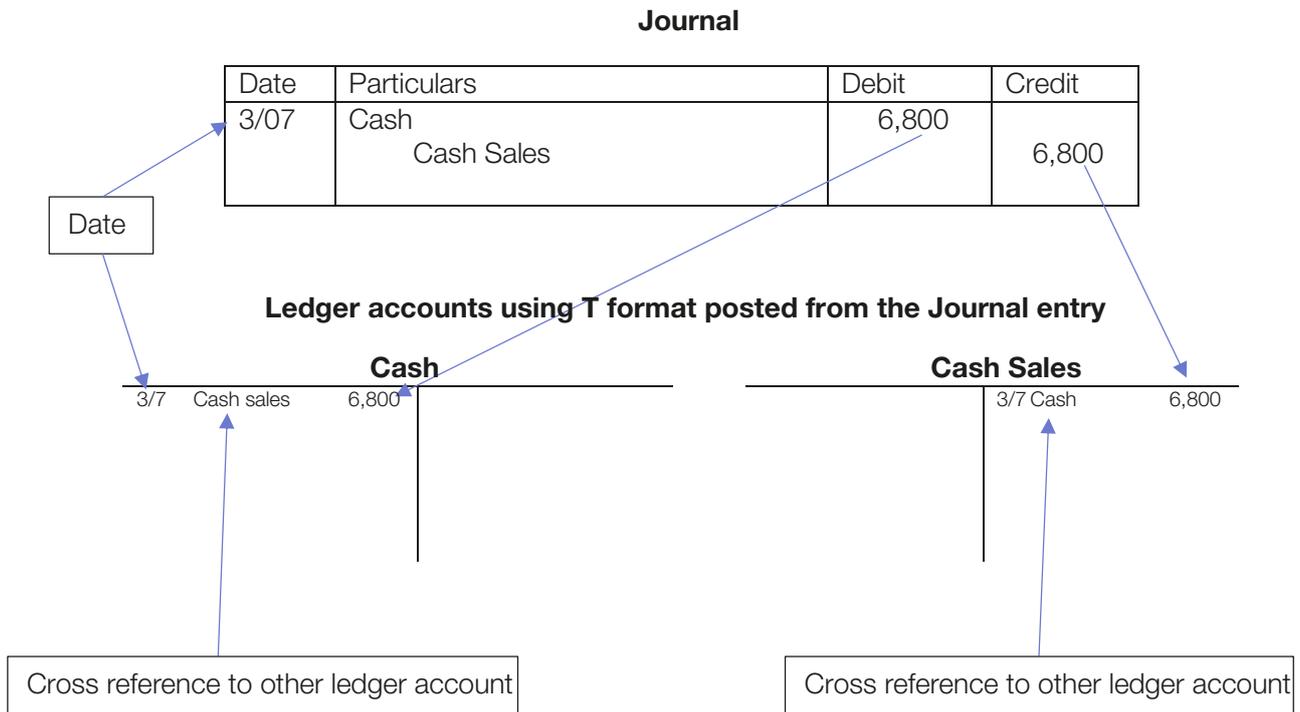


Figure 3.3 Simplified illustration of journal and ledger account.

### General journal

The first step in recording transactions is in the general journal. The general journal is used to record all business transactions in chronological order with a debit and credit entry. However, businesses using a manual accounting system will use specialised journals to separately record cash receipts, cash payments, credit sales and credit purchases to reduce the detail and time required to prepare the general journal. Figure 3.4 shows the detailed format of an individual journal.

When recording in the journal the convention is that the account for debit entry is always listed first and the account for credit entry is indented. The narration in brackets at the bottom describes the transaction.

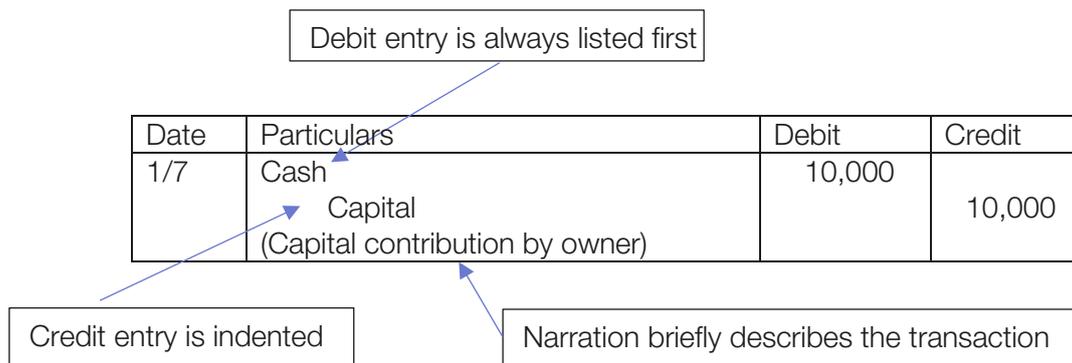


Figure 3.4. Journal format with narration.

### General ledger

The general ledger is the collection of all the individual ledger accounts for assets, liabilities, equity, revenue and expenses. The final or closing balances of each account in the general ledger are used to prepare the trial balance.

Individual accounts can be presented in the T-account format, shown in detail in figure 3.5. In practice there is an additional column for a posting reference to trace the entry back to the original journal.

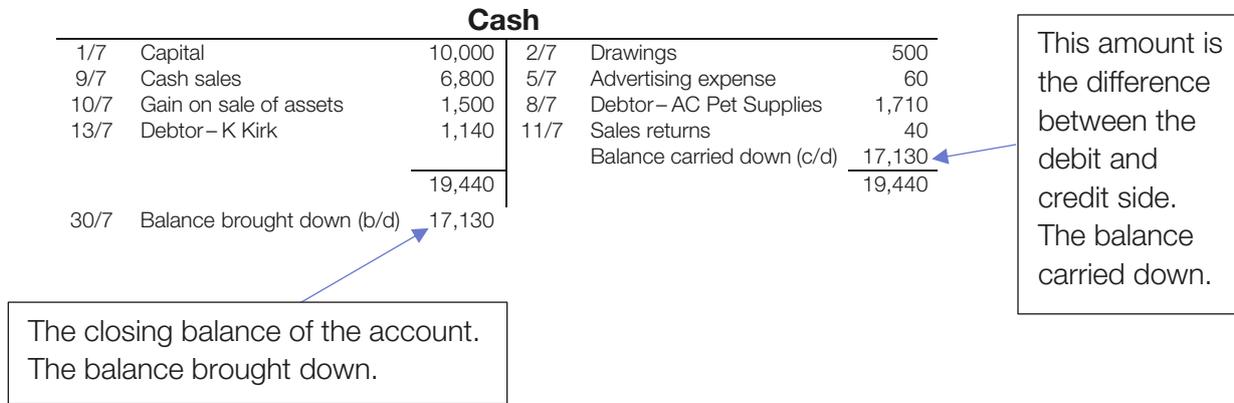


Figure 3.5 T-account format with formal balancing.

Alternatively a business may use the running balance format as shown in figure 3.6. When using this format it is easy to read the change in balance with each transaction. For both formats the convention is that debits are on the left and credits are listed on the right.

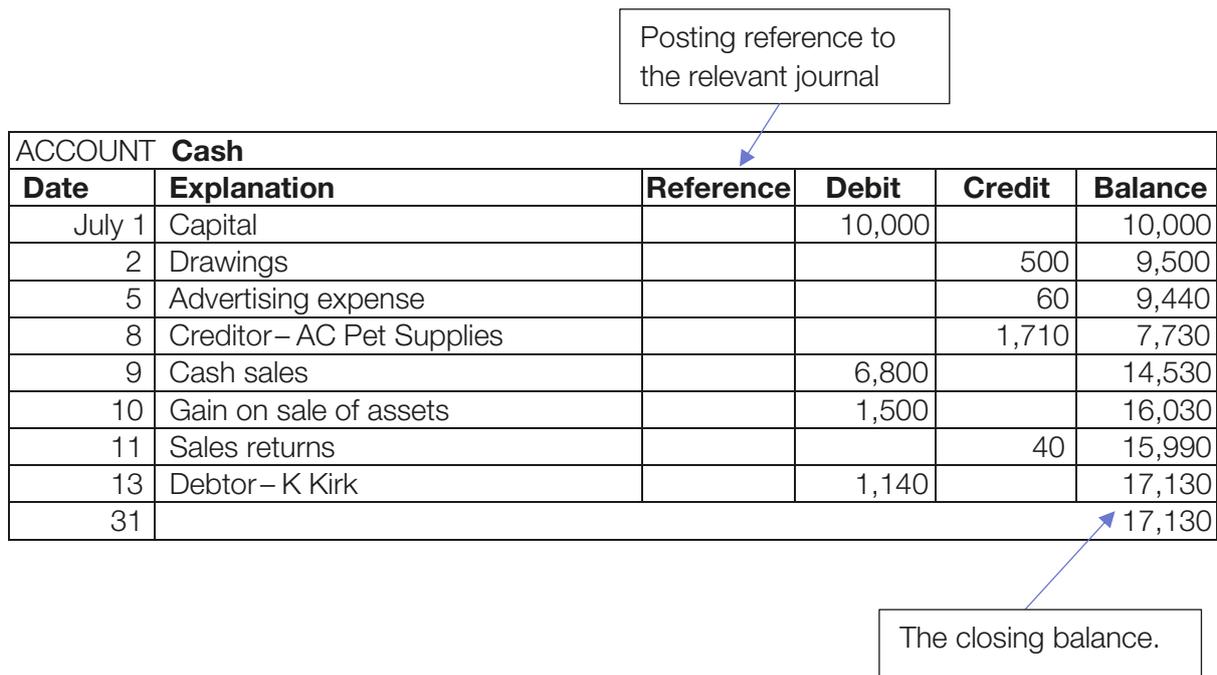


Figure 3.6. Running balance format.

For this text, all examples and activities have used the T-format and posting references have been omitted for simplicity.

# Accounting concepts relevant to recording and processing accounting transactions

## Duality

The Duality concept is applied when analysing each individual business transaction to determine the impacts on the accounting equation. There is a twofold effect of each transaction when they are recorded into journals and ledger accounts. This is also known as the double entry system of bookkeeping. Using this system requires a debit entry to be matched by a credit entry. The rules for analysing transactions correctly is in figure 3.7, the PALER model. The term proprietorship is less commonly used term for equity.

P = Proprietorship / equity

A = Assets

L = Liabilities

E = Expense

R = Revenue

By correctly identifying the type of accounts affected students will be able to determine the debit and credit entry using Figure 3.7. Very simply an increase in the value of an Asset, indicated by the up arrow is recorded as a debit entry. A decrease in the value of an Asset, indicated by the down arrow is a credit entry. The same rule follows for equity, liabilities, expenses, and revenue.

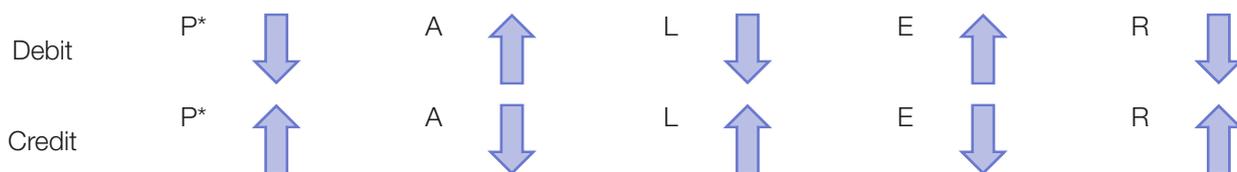


Figure 3.7

\*P is Proprietorship which represents Equity

Another version of the double entry system rule can be summarised in figure 3.8.



Figure 3.8.

Figure 3.9 uses the Accounting Equation method to demonstrate the double entry system



Figure 3.9.

## Grouping together expenses rather than identifying and reporting on each individual expense

A fundamental characteristic of accounting information is that it must be relevant for decision making and anything material must be included because it will make an impact on the decision made.

A difficulty faced by accountants is determining which transactions may not be recorded as some involve very small amounts, or will not impact predictions of future profits, expenses, and return on investment by users. Examples of dealing with items considered immaterial include;

- Not reporting individual minor expenses, instead classifying them together
- Rounding numbers
- The cost in time and effort to correctly process transactions versus the benefit. For example, recording small equipment purchases as expenses rather than assets that will require depreciation entries it will not impact decision making.

When applying the materiality concept accountants must determine which transactions will not influence decision making by a user. This will depend on;

- The size of the entity
- Volume of transactions

For a small business with a low volume of transactions, a few dollars will still be material.

## Monetary unit

It is an assumption that all transactions involve a cash amount and therefore all items are measured and recorded in cash amounts such as dollars. However, a limitation is that some valuable aspects of the business such as the skills of valuable employees or business reputation, are not able to be measured reliably in monetary terms. Therefore some 'assets' are not recorded.

## Relevance

Any information generated by the accounting system that can impact the decision making of stakeholders is considered relevant. The relevance concept refers to both what the information is about and when it is available. Information that is provided to users quickly and at the right time will be more relevant. For example, if a business has experienced recent strong sales and improved profitability this information will be relevant to the bank when considering their decisions to provide a loan to the business and the interest rate to be charged.

## Faithful representation

The faithful representation concept requires that all financial reports are complete, unbiased and free from error. If all source documents and business transactions have been correctly analysed using the principals of double entry and the entries recorded accurately, faithful representation is achieved. Faithful representation is enhanced by consistency. The consistency convention refers to the accountant using the same methods for processing a business transaction from one accounting period to the next. In this way, consistency is achieved over time and the in the preparation of accounting information.

## Processing transactions for inventory purchases

For this chapter all activities will assume that the business is using a periodic system for managing its inventory. This means that when a business purchases supplies, inputs, stock, and inventory the transaction will be considered a purchases expense. There is no entry for inventory as a result of the purchases or sales returns of stock.

### Activity 3.1

1. Bambinos Pizza

For the set of transactions complete the analysis chart. The first is completed for you.

- (a) Owner invested cash into the business
- (b) Owner contributed his personal car to the business to be used as a delivery vehicle
- (c) Bought new pizza oven
- (d) Purchased pizza ingredients for cash. (Treat the purchases of stock as a purchases expense)
- (e) Paid rent
- (f) Paid wages
- (g) Cash sales (ignore the impact on inventory and COGS)
- (h) Purchased drinks, garlic bread and deserts to sell with pizzas

	Identify the 2 accounts affected	Classification P, A, L, E, R	Change
(a)	<i>Capital</i> <i>Cash</i>	<i>Equity</i> <i>Asset</i>	<i>Increase</i> <i>Increase</i>
(b)			
(c)			
(d)			
(e)			
(f)			
(g)			
(h)			

2. Simon's Fishing Rental

For the following set of transactions complete the analysis chart. The first is completed for you.

- (a) Bought new boat to rent to customers using cash
- (b) Received rental fees in cash from customers
- (c) Paid for repairs to a boat
- (d) Paid storage fees to marina
- (e) Took money from the business to buy personal groceries
- (f) Obtained business loan from bank
- (g) Bought fishing supplies on credit from a supplier
- (h) A customer paid the remainder of the account owed from the previous month

	Identify the 2 accounts affected	Classification P, A, L, E, R	Change
(a)	<i>Boat</i> <i>Cash</i>	<i>Equity</i> <i>Asset</i>	<i>Increase</i> <i>Increase</i>
(b)			
(c)			
(d)			
(e)			
(f)			
(g)			
(h)			



## Illustrative examples of the accounting process

The following transactions are typical for a trading business.

- The owner contributes capital to the business in the form of cash (or assets)
- The owner withdraws cash (or assets) from the business
- A loan is used to buy equipment, furniture and fittings, and vehicles
- A mortgage loan is used to buy land and buildings
- Cash is used to pay expenses; advertising, electricity, interest, rates, wages
- Cash is used to purchase inventory which is a cost of sales expense
- The business purchases inventory on credit from a supplier
- Inventory is returned to the same supplier because it is unsuitable
- Cash is used to pay suppliers, repay a loan or other liability
- The business receives a discount from a supplier
- Cash is received from sales
- Sales are made on credit to a customer who becomes a debtor to the business
- Goods are returned by a customer because they were unsuitable or damaged
- A debtor pays their account in cash
- The business allows a discount to a debtor.

An example of each transaction will be processed for Luna's Pet Store to show the analysis required to create the appropriate journal entry. The PALER model will be used to determine the double entry. Each journal is posted to a general ledger account. This is a new retail business and the dates are for July. The business uses the periodic inventory system, so no journal entries are necessary for inventory until the stock take at the end of July is performed. The stocktake revealed \$110 of stock on hand at the end of July. A General Ledger and Trial Balance for the month ending 31<sup>st</sup> of July follows in figure 3.10.

Transaction	July 1. Owner adds capital to the business in the form of \$10,000 cash.															
Analysis	<p>The asset, <b>cash</b> increases in value creating a debit entry of \$10,000. The equity (proprietorship) account, <b>capital</b> increases in value producing a credit entry of \$10,000.</p>															
Journal	<table border="1"> <thead> <tr> <th>Date</th> <th>Particulars</th> <th>Debit</th> <th>Credit</th> </tr> </thead> <tbody> <tr> <td>1/7</td> <td>Cash</td> <td>10,000</td> <td></td> </tr> <tr> <td></td> <td>    Capital (capital investment in the business)</td> <td></td> <td>10,000</td> </tr> </tbody> </table>				Date	Particulars	Debit	Credit	1/7	Cash	10,000			Capital (capital investment in the business)		10,000
Date	Particulars	Debit	Credit													
1/7	Cash	10,000														
	Capital (capital investment in the business)		10,000													
Posting	<p style="text-align: center;"><b>Cash</b></p> <table border="1"> <tr> <td>1/7</td> <td>Capital</td> <td>10,000</td> </tr> </table> <p style="text-align: center;"><b>Capital</b></p> <table border="1"> <tr> <td></td> <td>1/7</td> <td>Cash</td> <td>10,000</td> </tr> </table>				1/7	Capital	10,000		1/7	Cash	10,000					
1/7	Capital	10,000														
	1/7	Cash	10,000													

The arrow shows how the ledger names are switched. The corresponding ledger name is entered into the account to identify the twofold impact of the transaction.

Transaction	July 2. The owner withdraws \$500 cash from the business.							
Analysis	<p>Withdrawals of cash will reduce the owner's investment and therefore their equity in the business decreases. Capital decreases which creates a debit entry for <b>drawings</b>. There is less cash in the business so the value of <b>cash</b> asset decreases producing a credit entry.</p>							
Journal	Date	Particulars	Debit	Credit				
	2/7	Drawings	500					
		Cash		500				
		(Withdrawal of cash by owner)						
Posting	<p style="text-align: center;"><b>Cash</b></p> <table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;"></td> <td style="width: 50%; text-align: right;">2/7 Drawings 500</td> </tr> </table> <p style="text-align: center;"><b>Drawings</b></p> <table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%; text-align: left;">2/7 Cash 500</td> <td style="width: 50%;"></td> </tr> </table>					2/7 Drawings 500	2/7 Cash 500	
	2/7 Drawings 500							
2/7 Cash 500								

Transaction	July 3. A loan of \$35 000 is used to buy equipment.							
Analysis	<p>The business owns more assets, <b>equipment</b>, creating a debit entry and liabilities has also increased as the business has borrowed funds as a <b>loan</b> for the purchase produces a credit entry.</p>							
Journal	Date	Particulars	Debit	Credit				
	3/7	Equipment	35,000					
		Loan		35,000				
Posting	<p style="text-align: center;"><b>Equipment</b></p> <table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%; text-align: left;">3/7 Loan 35,000</td> <td style="width: 50%;"></td> </tr> </table> <p style="text-align: center;"><b>Loan</b></p> <table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;"></td> <td style="width: 50%; text-align: right;">3/7 Equipment 35,000</td> </tr> </table>				3/7 Loan 35,000			3/7 Equipment 35,000
3/7 Loan 35,000								
	3/7 Equipment 35,000							

Transaction	July 4. A mortgage of \$120 000 is used to buy land and buildings.																			
Analysis	<p>As for July 3 the business has increased its assets, <b>land and buildings</b> creating a debit entry. A specific type of loan, a <b>mortgage</b>, has been used to fund the purchase increasing liabilities producing a credit entry.</p>																			
Journal	<table border="1"> <thead> <tr> <th>Date</th> <th>Particulars</th> <th>Debit</th> <th>Credit</th> </tr> </thead> <tbody> <tr> <td>4/7</td> <td>Land and Buildings</td> <td>120,000</td> <td></td> </tr> <tr> <td></td> <td>Mortgage</td> <td></td> <td>120,000</td> </tr> </tbody> </table>				Date	Particulars	Debit	Credit	4/7	Land and Buildings	120,000			Mortgage		120,000				
Date	Particulars	Debit	Credit																	
4/7	Land and Buildings	120,000																		
	Mortgage		120,000																	
Posting	<table style="width: 100%; border-collapse: collapse;"> <tr> <td colspan="4" style="text-align: center; border-top: 1px solid black; border-bottom: 1px solid black;"><b>Land and Buildings</b></td> </tr> <tr> <td style="width: 15%; border-right: 1px solid black;">4/7</td> <td style="width: 40%;">Mortgage</td> <td style="width: 20%; text-align: right;">120,000</td> <td style="width: 25%;"></td> </tr> <tr> <td colspan="4" style="border-top: 1px solid black; border-bottom: 1px solid black; text-align: center;"><b>Mortgage</b></td> </tr> <tr> <td style="border-right: 1px solid black;"></td> <td>4/7</td> <td>Land and Buildings</td> <td style="text-align: right;">120,000</td> </tr> </table>				<b>Land and Buildings</b>				4/7	Mortgage	120,000		<b>Mortgage</b>					4/7	Land and Buildings	120,000
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4/7	Mortgage	120,000																		
<b>Mortgage</b>																				
	4/7	Land and Buildings	120,000																	

Transaction	July 5. \$60 Cash is used to pay advertising expense.																			
Analysis	<p>The <b>advertising expense</b> has been created by the transaction as the expense has been paid. There is an increase in expenses creating in a debit entry. The asset, <b>cash</b>, decreases producing a credit entry</p>																			
Journal	<table border="1"> <thead> <tr> <th>Date</th> <th>Particulars</th> <th>Debit</th> <th>Credit</th> </tr> </thead> <tbody> <tr> <td>5/7</td> <td>Advertising expense</td> <td>60</td> <td></td> </tr> <tr> <td></td> <td>Cash (Payment of advertising expense)</td> <td></td> <td>60</td> </tr> </tbody> </table>				Date	Particulars	Debit	Credit	5/7	Advertising expense	60			Cash (Payment of advertising expense)		60				
Date	Particulars	Debit	Credit																	
5/7	Advertising expense	60																		
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<b>Cash</b>																				
	5/7	Advertising expense	60																	
<b>Advertising expense</b>																				
5/7	Cash	60																		

Transaction	July 6. The business purchases \$1 850 of inventory on credit from a supplier, AC Pet Supplies Pty. Ltd.																			
Analysis	<p>The business has incurred an expense, buying inventory to resell, creating a debit entry for <b>credit purchases</b>. This expense will add to the cost of sales in the income statement. Because the amount is owed to the supplier there is an increase in liabilities as a new <b>creditor – AC Pet Supplies</b> has been created producing in a credit entry.</p> <p>No entry is made for inventory as the business is using the periodic inventory system.</p>																			
Journal	<table border="1"> <thead> <tr> <th>Date</th> <th>Particulars</th> <th>Debit</th> <th>Credit</th> </tr> </thead> <tbody> <tr> <td>6/7</td> <td>Credit purchases Creditor - AC Pet Supplies</td> <td>1,850</td> <td>1,850</td> </tr> </tbody> </table>				Date	Particulars	Debit	Credit	6/7	Credit purchases Creditor - AC Pet Supplies	1,850	1,850								
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Credit purchases																				
6/7	Creditor – AC Pet Supplies	1,850																		
Creditor – AC Pet Supplies*																				
	1/6	Credit purchases	1,850																	

\*Note that this business is using individual creditor accounts for each creditor. Some firms may group all its individual creditors' together into one account.

Transaction	July 7. \$50 Inventory is returned to the same supplier because it is unsuitable.																			
Analysis	<p>The business originally owed \$1 850 to AC Pet Supplies, however because some stock was returned this will reduce the amount owed and therefore decreasing the liability to the supplier. There is a debit entry for the <b>creditor, AC Pet Supplies</b>. The expense of purchases is also decreased producing a credit entry for <b>purchase returns</b>.</p>																			
Journal	<table border="1"> <thead> <tr> <th>Date</th> <th>Particulars</th> <th>Debit</th> <th>Credit</th> </tr> </thead> <tbody> <tr> <td>7/7</td> <td>Creditor - AC Pet Supplies Purchase returns (return of goods to supplier)</td> <td>50</td> <td>50</td> </tr> </tbody> </table>				Date	Particulars	Debit	Credit	7/7	Creditor - AC Pet Supplies Purchase returns (return of goods to supplier)	50	50								
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7/7	Creditor - AC Pet Supplies Purchase returns (return of goods to supplier)	50	50																	
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Creditor – AC Pet Supplies																				
7/7	Purchase returns	50																		
Purchase returns																				
	7/7	Creditor – AC Pet Supplies	50																	



Transaction	July 9. \$6 800 in cash is received from sales.																			
Analysis	<p>Debit      P*      ↓      <b>A</b>      ↑      L      ↓      E      ↑      R      ↓</p> <p>Credit      P*      ↑      <b>A</b>      ↓      L      ↑      E      ↓      <b>R</b>      ↑</p> <p>The asset, <b>cash</b> has increased, creating a debit entry. Revenue has been recognised, so the <b>cash sales</b> account has a credit entry.</p>																			
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Date	Particulars	Debit	Credit																	
9/7	Cash	6,800																		
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9/7	Cash sales	6,800																		
<b>Cash sales</b>																				
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Transaction	July 11. \$40 of goods are returned by a customer because they were damaged.																			
Analysis	<p>Debit      P*      ↓      <b>A</b>      ↑      L      ↓      E      ↑      <b>R</b>      ↓</p> <p>Credit      P*      ↑      <b>A</b>      ↓      L      ↑      E      ↓      R      ↑</p> <p>This transaction is linked to the cash sales made on July 9. It will reverse a cash sale as the customer was given a refund and recorded as a debit for <b>sales returns</b> and a credit entry is recorded for the decrease in <b>cash</b>. Under the periodic system no entry made for inventory. An adjustment to inventory will be made on the balance day to record the disposal of the damaged stock.</p>																			
Journal	<table border="1"> <thead> <tr> <th>Date</th> <th>Particulars</th> <th>Debit</th> <th>Credit</th> </tr> </thead> <tbody> <tr> <td>11/7</td> <td>Sales returns</td> <td>40</td> <td></td> </tr> <tr> <td></td> <td>    Cash</td> <td></td> <td>40</td> </tr> <tr> <td></td> <td>(Goods returned by customer)</td> <td></td> <td></td> </tr> </tbody> </table>				Date	Particulars	Debit	Credit	11/7	Sales returns	40			Cash		40		(Goods returned by customer)		
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11/7	Sales returns	40																		
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	11/7	Cash	40																	

Transaction	July 12. \$1,200 sales are made on credit to a customer, K. Kirk, who became a debtor to the business.																			
Analysis	<p>A new asset, a <b>debtor</b> has been created by the sale creating a debit entry. It is assumed that the debtor will pay their account in the future, within the credit terms. Revenue was recognised when the goods transferred to the customer and a credit entry is recorded.</p>																			
Journal	<table border="1"> <thead> <tr> <th>Date</th> <th>Particulars</th> <th>Debit</th> <th>Credit</th> </tr> </thead> <tbody> <tr> <td>12/7</td> <td>Debtor – K Kirk</td> <td>1,200</td> <td></td> </tr> <tr> <td></td> <td>    Credit sales</td> <td></td> <td>1,200</td> </tr> <tr> <td></td> <td>(Sale of goods on credit)</td> <td></td> <td></td> </tr> </tbody> </table>				Date	Particulars	Debit	Credit	12/7	Debtor – K Kirk	1,200			Credit sales		1,200		(Sale of goods on credit)		
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12/7	Debtor – K Kirk	1,200																		

Transaction	July 13. The debtor, K Kirk paid their account and is allowed a 5% discount for paying within the credit period.																																			
Analysis	<p>This transaction is linked to the sales on credit made to K Kirk on July 12. This transaction has two parts and therefore requires four journal entries. The discount has to be calculated based on the net amount owed by K Kirk which is \$1,200. The discount of 5% of \$1,200 is \$60 which means that K Kirk is only required to pay \$1,140.</p> <p>Therefore the business is paid \$1,140 from cash, creating a debit entry and the debtor, K Kirk is reduced by \$1,140 producing a credit entry. Adding the discount allowed is considered a financial expense creating a debit entry. The amount paid and the discount totals \$1,200 so the debtor has paid in full.</p>																																			
Journal	<table border="1"> <thead> <tr> <th>Date</th> <th>Particulars</th> <th>Debit</th> <th>Credit</th> </tr> </thead> <tbody> <tr> <td>13/7</td> <td>Cash</td> <td>1,140</td> <td></td> </tr> <tr> <td></td> <td>    Debtor – K Kirk</td> <td></td> <td>1,140</td> </tr> <tr> <td colspan="4">(payment of account by K Kirk)</td> </tr> </tbody> </table> <table border="1"> <thead> <tr> <th>Date</th> <th>Particulars</th> <th>Debit</th> <th>Credit</th> </tr> </thead> <tbody> <tr> <td>13/7</td> <td>Discount allowed</td> <td>60</td> <td></td> </tr> <tr> <td></td> <td>    Debtor – K Kirk</td> <td></td> <td>60</td> </tr> <tr> <td colspan="4">(discount for payment of account)</td> </tr> </tbody> </table>				Date	Particulars	Debit	Credit	13/7	Cash	1,140			Debtor – K Kirk		1,140	(payment of account by K Kirk)				Date	Particulars	Debit	Credit	13/7	Discount allowed	60			Debtor – K Kirk		60	(discount for payment of account)			
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<b>Discount allowed</b>																																				
13/7 Debtor – K Kirk	60																																			

Transaction	July 18. \$120 Cash is used to pay electricity expense.																			
Analysis	<p>The <b>electricity expense</b> has been created by the transaction as the expense has been paid. There is an increase in expenses creating in a debit entry. The asset, <b>cash</b>, decreases producing a credit entry</p>																			
Journal	<table border="1"> <thead> <tr> <th>Date</th> <th>Particulars</th> <th>Debit</th> <th>Credit</th> </tr> </thead> <tbody> <tr> <td>18/7</td> <td>Electricity expense</td> <td>120</td> <td></td> </tr> <tr> <td></td> <td>Cash</td> <td></td> <td>120</td> </tr> <tr> <td></td> <td>(Payment of electricity expense)</td> <td></td> <td></td> </tr> </tbody> </table>	Date	Particulars	Debit	Credit	18/7	Electricity expense	120			Cash		120		(Payment of electricity expense)					
Date	Particulars	Debit	Credit																	
18/7	Electricity expense	120																		
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Cash																				
18/7	Advertising expense 120																			
Electricity expense																				
18/7	Cash 60																			

Transaction	July 30. \$400 Cash is used to pay interest expense.																			
Analysis	<p>The <b>interest expense</b> has been created by the transaction as the expense has been paid. There is an increase in expenses creating in a debit entry. The asset, <b>cash</b>, decreases producing a credit entry</p>																			
Journal	<table border="1"> <thead> <tr> <th>Date</th> <th>Particulars</th> <th>Debit</th> <th>Credit</th> </tr> </thead> <tbody> <tr> <td>30/7</td> <td>Interest expense</td> <td>400</td> <td></td> </tr> <tr> <td></td> <td>Cash</td> <td></td> <td>400</td> </tr> <tr> <td></td> <td>(Payment of interest expense)</td> <td></td> <td></td> </tr> </tbody> </table>	Date	Particulars	Debit	Credit	30/7	Interest expense	400			Cash		400		(Payment of interest expense)					
Date	Particulars	Debit	Credit																	
30/7	Interest expense	400																		
	Cash		400																	
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Cash																				
30/7	Interest expense 400																			
Interest expense																				
30/7	Cash 400																			



Credit purchases

6/7	Creditor- AC Pet Supplies	1,850	
30/7	Balance	<u>1,850</u>	

Creditor – AC Pet Supplies

7/7	Purchase returns	50	6/7	Credit purchases	1,850
8/7	Discount received	90			
8/7	Cash	1,710			
30/7	Balance	<u>0</u>			

Purchase returns

			7/7	Creditor-AC Pet Supplies	50
			30/7	Balance	<u>50</u>

Discount received

			8/7	Creditor-AC Pet Supplies	90
			30/7	Balance	<u>90</u>

Cash sales

			9/7	Cash	6,800
			30/7	Balance	<u>6,800</u>

Sales returns

11/7	Credit sales	40	
30/7	Balance	<u>40</u>	

Debtor – K Kirk

12/7	Credit sales	1,200	13/7	Discount allowed	60
			13/7	Cash	1,140
30/7	Balance	<u>0</u>			

Credit sales

			12/7	Debtor- K Kirk	1,200
			30/7	Balance	<u>1,200</u>

Discount allowed

13/7	Debtor-K Kirk	60	
30/7	Balance	<u>60</u>	

		Electricity
18/7	Cash	120
30/7	Balance	120

		Interest
30/7	Cash	400
30/7	Balance	400

## The Unadjusted Trial Balance

To prepare a trial balance the closing amounts from all the ledger accounts are listed in two columns. Figure 3.11 shows the Trial Balance for Luna's Pet Store created by transferring all the closing balances from the general ledger accounts to a single page. At this point in the accounting cycle balance day adjustments have not been made. Final reports can be generated from the trial balance.

### LUNA'S PET STORE

#### Trial Balance

for the year ended 31 July

Account	Debit	Credit
Cash	15,110	
Capital		10,000
Drawings	500	
Loan		35,000
Equipment	35,000	
Mortgage		120,000
Land and buildings	120,000	
Advertising expense	60	
Credit purchases	1,850	
Purchase returns		50
Discount received		90
Cash sales		6,800
Sales returns	40	
Credit sales		1,200
Discount allowed	60	
Electricity	120	
Interest	400	
	<b>173,140</b>	<b>173,140</b>

\*Stocktake reveals \$110 on hand on the 31<sup>st</sup> of July.

*Figure 3.11. Illustrative unadjusted Trial Balance*

A Trial Balance verifies that the transactions have been analysed and processed correctly as the value of all debits equals the value of all credits. However, there can still be mistakes even when debits equal credits owing to;

- A transaction not processed at all
- An incorrect amount entered for both the debit and credit entry
- The debit and credit entry for each account is switched

## The Adjusted Trial Balance

To prepare an adjusted Trial Balance there are additional journal entries recorded on the balance day, the last day of the accounting period. This is to adjust amounts and ensure the Trial Balance is correct under the accrual accounting system. These balance day adjustments will be covered in chapter 5 and typical transactions include;

1. Depreciation expense is recorded
2. The business has paid some expenses in advance creating an asset
3. The business owes money for expenses that have accrued creating a liability
4. The business has received income in advance for work or sales it has not yet made
5. The business is owed income that has accrued and not yet received
6. Amounts owed by some customers are written off as bad debts
7. Once checked, some stock may have been lost, stolen, damaged or spoiled and is written off as stock loss

From the Trial Balance for Luna's Pet Store the Income Statement, Balance sheet, and the Statement of equity have been created.

### Luna's Pet Store

#### Income statement

For the year ended 30 June

INCOME		
Sales	8,000	
Less sales returns	40	7,900
Less discount allowed	<u>60</u>	
Net Sales		
Opening inventory	0	
+ Purchases	1,850	
Less purchase returns	50	
Less discount received	90	
Less Closing stock	110	
Cost of Sales		1,600
GROSS PROFIT		6,300
EXPENSES		
Selling and distribution		
Advertising	60	
Administration		
Electricity	120	
Finance		
Interest	400	
PROFIT/ LOSS		5,720

**Statement of Changes in Equity**  
**Luna's Pet Store**  
**For the year ending 30 June**

Opening Capital	10,000
Profit/ loss	5,720
Less drawings	<u>500</u>
Closing Capital	<b>15,220</b>

**Balance Sheet**

**Luna's Pet Store**  
**As at 30 June**

<i>Current Assets</i>		
Cash	15,110	
Stock on hand	<u>110</u>	
		15,220
<i>Non-current Assets</i>		
Office Equipment	35,000	
Land and Buildings	<u>120,000</u>	
		<u>155,000</u>
<b>Total Assets</b>		<b>170,220</b>
<i>Current Liabilities</i>		
<i>Non-current liabilities</i>		
Loan	35,000	
Mortgage	<u>120,000</u>	
<b>Total Liabilities</b>		<u>155,000</u>
<b>Net Assets</b>		<b>15,220</b>

### Activity 3.2

1. State the normal balance, for each of the following accounts.

Account	Normal Balance	Account	Normal Balance
Creditors		Debtors	
Advertising expense		Cash at Bank	
Drawings		Electricity expense	
Furniture and Fittings		Interest expense	
Interest income		Loan	
Mortgage		Prepaid insurance	
Rent		Sales	
Wages expense		Sales returns	

2. State whether the following statements are true or false.

- (a) A debtor is a customer who still owes the business. ....
- (b) Creditors is a source of finance for a business. ....
- (c) Owners who withdraw money from a business reduce their equity. ....
- (d) Expenses are costs that have been incurred. ....
- (e) Paying liabilities will reduce the value of equity. ....
- (f) Revenue will increase the value of equity. ....
- (g) When a business takes out a loan it is likely to finance the purchase of assets. ....
- (h) Creditors are suppliers who have sold inventory to the business on credit. ....

3. For each of the following journals describe the original transaction. Candice Chang has started a new food truck business. Her legal structure will be a sole trader. Candice has purchased a second hand food truck and hopes to make a good income attending music festivals and sporting events. She will use a casual employee on the weekends.

(a) . . . . .

Date	Particulars	Debit	Credit
1 July	Cash at Bank	15,000	
	C Chang, Capital		15,000

(b) . . . . .

Date	Particulars	Debit	Credit
1 July	Vehicle	6,000	
	Loan		6,000

(c) . . . . .

Date	Particulars	Debit	Credit
1 July	Insurance expense - vehicle	400	
	Cash at Bank		400

(d) . . . . .

Date	Particulars	Debit	Credit
2 July	Purchases expense	1,200	
	Cash at Bank		1,200

(e)

Date	Particulars	Debit	Credit
3 July	Purchases	700	
	Creditors		700

(f)

Date	Particulars	Debit	Credit
4 July	Advertising expense	140	
	Cash at Bank		140

(g)

Date	Particulars	Debit	Credit
5 July	Cash at Bank	1,450	
	Sales		1,450

(h)

Date	Particulars	Debit	Credit
11 July	Wages expense	180	
	Cash at Bank		180

(i)

Date	Particulars	Debit	Credit
14 July	Drawings	1,000	
	Cash at Bank		1,000

(j)

Date	Particulars	Debit	Credit
14 July	Creditors	630	
	Cash at Bank		630

Date	Particulars	Debit	Credit
14 July	Creditors	70	
	Discount received		70

4. Prepare journal entries for the following transactions for MD Comic Book Store.

(a) July 2, M. Davies invested \$12,000 cash into the business.

Date	Particulars	Debit	Credit

(b) July 9, sold goods on credit to R. Pearlman for \$170.

Date	Particulars	Debit	Credit

(c) July 14, paid shop rent \$600.

Date	Particulars	Debit	Credit

(d) July 15, purchased inventory for \$4,000 using cash.

Date	Particulars	Debit	Credit

(e) July 19, M. Davies withdrew \$500 for personal use.

Date	Particulars	Debit	Credit

(f) July 21, paid wages \$500.

Date	Particulars	Debit	Credit

(g) July 22, bought goods on credit from M. Arvel Comics for \$1,500.

Date	Particulars	Debit	Credit

(h) July 25, bought extra display stands for the shop costing \$700.

Date	Particulars	Debit	Credit

(i) July 26, sold goods to S. Man for \$85.

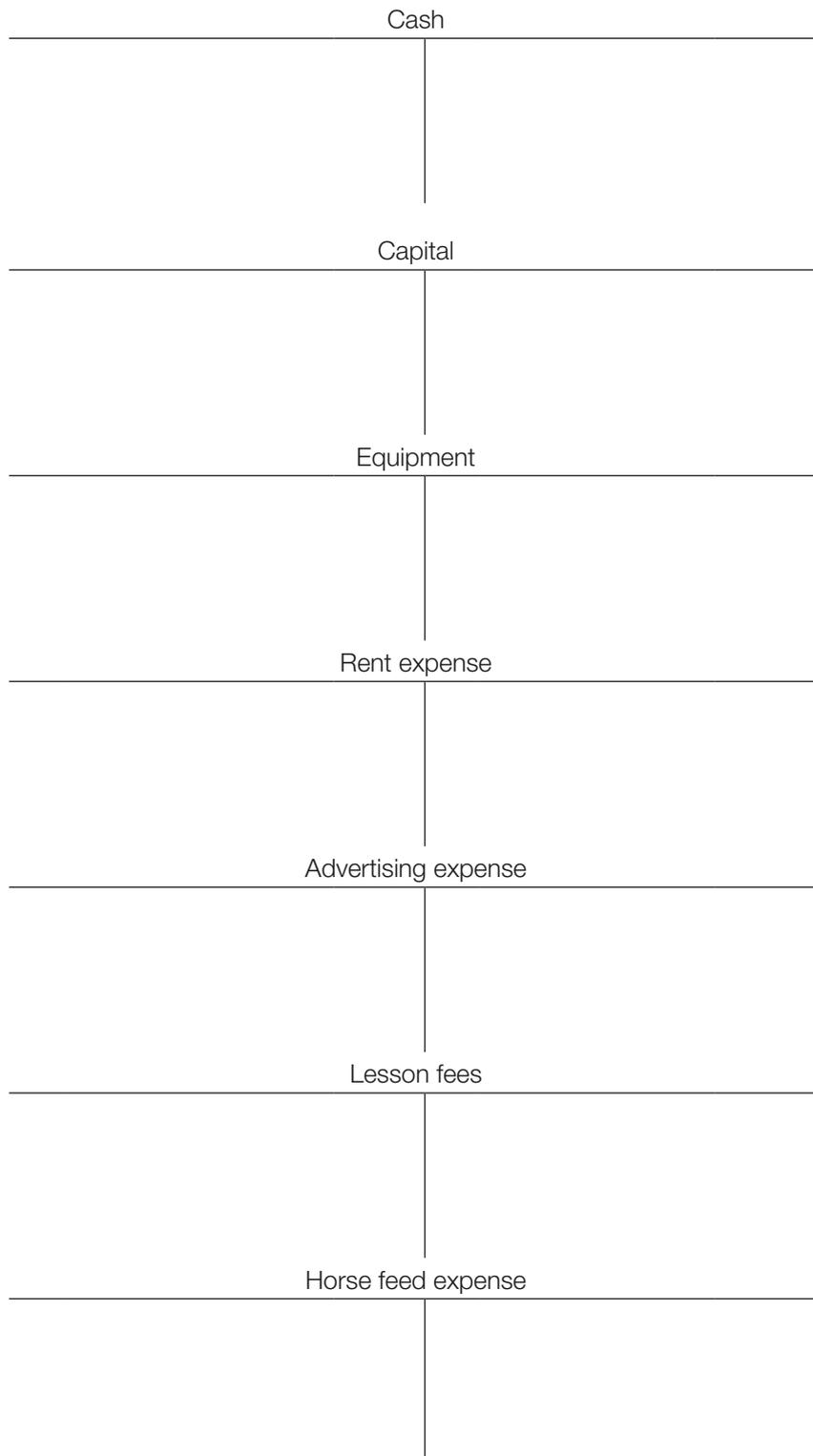
Date	Particulars	Debit	Credit

(j) July 28, R Pearlman paid his account in full.

Date	Particulars	Debit	Credit

5. Enter the following transactions for Amelia’s Horse Riding Lessons.

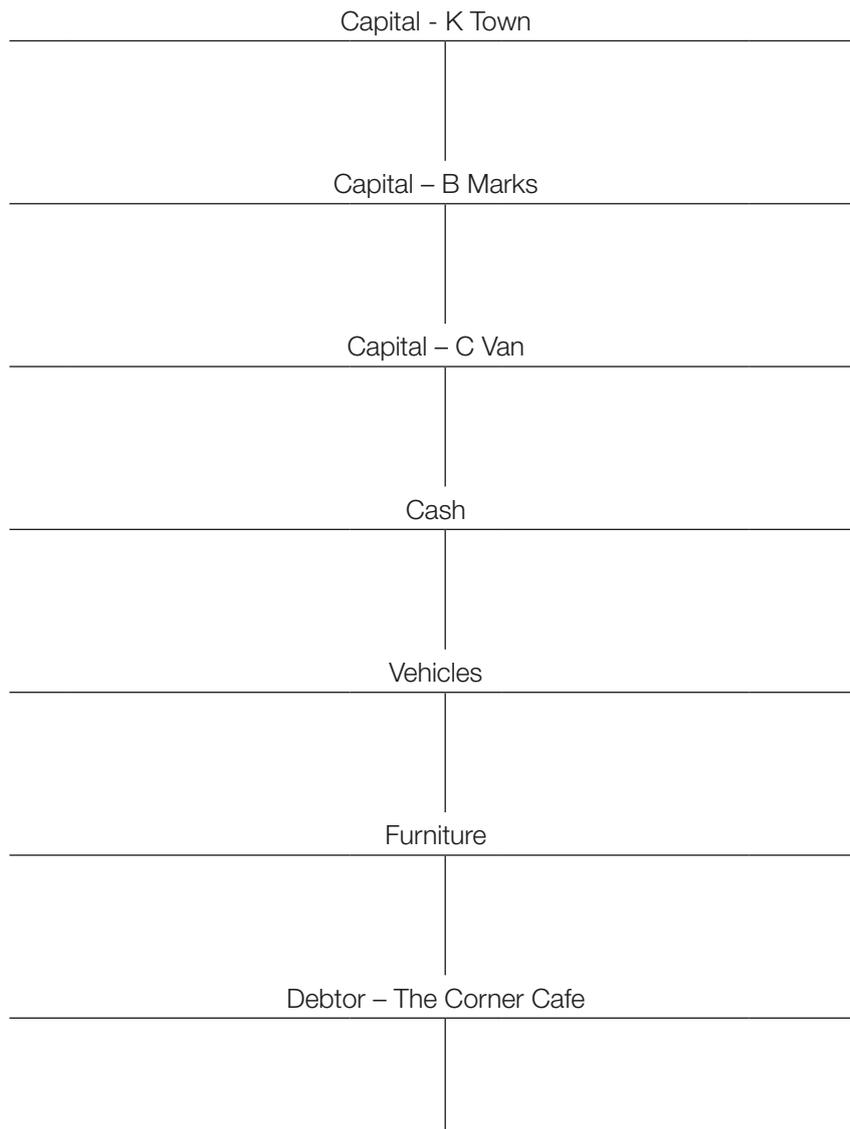
Date	Transaction
1/5	Amelia put \$5,000 into the business’s bank account
3/5	Purchased feed for the horses for \$150
7/5	Paid \$600 for online advertising
13/5	Amelia was paid \$550 by direct deposit for horse riding lessons
14/5	Paid owner of the farm \$300 for rent
22/5	Ordered horse blankets for \$1,250 from supplier
30/5	Received \$850 for horse riding lessons



6. KM Recruitment and Business Consulting is a new partnership owned by Kirk Town and Ben Marks.

Complete a ledger entry for each of the following types of transactions

July 1	Contribution of personal vehicle by Kirk Town as a business vehicle. The vehicle was new 10 months ago and was bought for \$19,990. K Town also contributed \$5,000 in cash.
4	Purchased office furniture from Kesic Furniture for \$5,000. A deposit of \$500 was made with the balance to be paid in 60 days.
9	Paid insurance on the vehicle of \$793 using business credit card.
10	Paid office rent \$1500
12	Fees received for recruitment services \$995
13	Kirk Town transferred \$3,000 to his personal account
15	Purchased office supplies on credit from OEG Supplies for \$355. Returned photocopy paper and received a credit note for \$44 from the supplier.
18	Purchased business vehicle using a loan from Elbans Subaru for \$41,888
21	Sent invoice to client, The Corner Café, for \$3,980
22	Paid electricity bill \$321
24	Kirk town paid for client dinner \$370 using the business credit card
28	An additional partner, Catherine Van contributed \$25,000
29	Received cash from The Corner Cafe of \$2,985 who promised to pay the outstanding amount in two weeks' time.



Creditors – Kesic Furniture
Creditor – OEG Supplies
Credit card
Loan
Rent expense
Electricity expense
Entertainment expense
Insurance expense
Fees
Drawings
Office supplies expense

## Innovation and the Impact of Digital Technologies

Since the inception of the double entry accounting system there has been three phases of innovation that have substantially changed the nature of accounting systems; manual systems, desktop based, and cloud based accounting systems.

### The Manual System

Businesses use a paper based accounting system recording in specialised books. Handwritten entries for cash receipts, cash payments and double entry books are made and financial reports are manually created. Invoices are posted to account customers. The business may use Microsoft Excel to create spreadsheets to record data and make automatic calculations. Microsoft Excel is very useful as formulas built into the spreadsheet can easily calculate budgets, variance reports, depreciation, as well as expense categories and summaries, and quickly identify if debits do not equal credits.

Although this system is very inexpensive and simple to manage there are a number of weaknesses.

- Potential for a high level of human error analysing transactions and recording information
- Spreadsheet programs will not automatically analyse transactions to create journals, post to the general ledger or link to other systems such as email or banking.
- Data in spreadsheets can be easily changed and there is no step by step record of changes to trace back to the original entry.
- Very slow and repetitive data entry
- Limited usefulness of the information as the longer it takes to produce the less relevant it becomes.



Figure 3.13

Owing to these frustrations accountants, have used technology to save time, reduce errors and free up the accountant to work on more important higher value work such as analysing the information. Using specialist accounting software will make significant improvements to the accounting process.

Under a manual system there is a limitation on producing relevant and faithfully representative information. The costs of creating financial information can be greater than the benefit of having the information. Although initially costly, the time and labour saved over the long term easily outweighs the initial cost of converting to desktop and online accounting systems.

## Desktop based accounting systems

Businesses use specialist accounting programs to process and prepare information. The software replaces manual transaction analysis, journalising, posting, and producing reports. The data must be typed in or accessed from other parts of business. From the raw data the software automatically completes many steps of the accounting cycle such as creating a general ledger, trial balance and final reports.

	Bench—bookkeeping done for you.		Chart of Accounts		Transactions		Income Statement				
	A	B	C	D	E	F	G	H	I	J	K
17	<b>Cost of Sales</b>										
18	Cost of Goods Sold		10.00								
19	Cost of Service		180.00								
20	<b>Cost of Sales</b>			190.00							
21	<b>Gross Profit</b>			508.15							
22	<b>Expenses</b>										
23	Bank & Merchant Fees		15.00								
24	Business Meals		97.32								
25	Client Entertainment		10.00								
26	Computers or Equipment		1,360.53								
27	Gas & Auto		10.00								
28	Independent Contractor		35.00								
29	Insurance Payments		130.00								
30	Interest Paid		10.00								
31	Lawyers & Accountants		10.00								
32	Licenses or Fees		10.00								
33	Marketing or Advertising		10.00								
34	Miscellaneous Expenses		10.00								
35	Phone, Internet & Utilities		10.00								
36	Postage & Shipping		40.00								
37	Rent or Lease		10.00								
38	Software & Hosting		10.00								
39	Supplies		35.00								
40	Taxes Paid		10.00								
41	Travel & Transportation		65.00								
42	<b>Total Expenses</b>			1,887.85							

3.14: Although not an accounting software system, some small businesses keep their records in Microsoft Excel spreadsheets

This 'general ledger' software can produce more financial information for internal users such as budgets, expense breakdowns, and interim reports for managers as required.

A basic software package comes with a range of linked programs for sales, purchases, cash receipts and payments, debtors' management, tracking expenses, and tax preparation. The software can be tailored to suit different types of businesses such as agriculture, hospitality, and retail. Other business types may have unique requirements and can have special modifications developed to suit.

Because the program runs on a single computer all the data and records must be saved on an external hard drive at the end of each day, called a backup. The hard drive must be stored in a safe place in case of fire or theft.

Compared to a manual system a dedicated accounting software has a number of distinct advantages.

### 1. Automation of routine and mundane accounting processes

Creating journals, making adjustments, checking the Trial Balance and creating financial statements are all simple tasks that can be completed much faster and with a higher level of accuracy. This routine work is now performed by the software. This achieves accuracy however, it requires correct data entry from source documents. It is possible to save time on data entry by using Apps such as optical receipt readers which take a photo of paperwork and digitalise the information which is automatically uploaded. Apps like Receipt Bank Scanner and Tracker make it possible to take a picture of a receipt using mobile, the information is digitised and automatically entered into the accounting program. Other Apps are available from the Apple App Store and Google Play Store to further increase the software's versatility. There are many other automated features available. For example, the system can automatically email payment reminders to a customer who has reached the end of the credit term period.

### 2. A clear audit trail is available

Users of accounting information need reliable data. A clear audit trail is a step-by-step record of every business transaction and changes to data that has been made. This means data cannot be compromised and creates trust from stakeholders. Accounting software can create historical information to track how a final amount was reached or how a transaction was originally entered.

### 3. Increased relevance and reliability

A strength is in how quickly information can be accessed and how it can be presented for ease of understanding.

These programs present information on a 'dashboard'. The dashboard makes accounting information more visual and understandable, particularly for non-financial experts. Data is summarised into colourful, easy to read charts, graphs and summaries as shown in figure 3.15. Alerts can be added to identify key statistics, risks and problems. Analytics such as ratios can be included. The dashboard makes it easy to gain a clear 'snap shot' of the business's financial position and performance, in real time. A user can get new insights from business information to make better decisions.

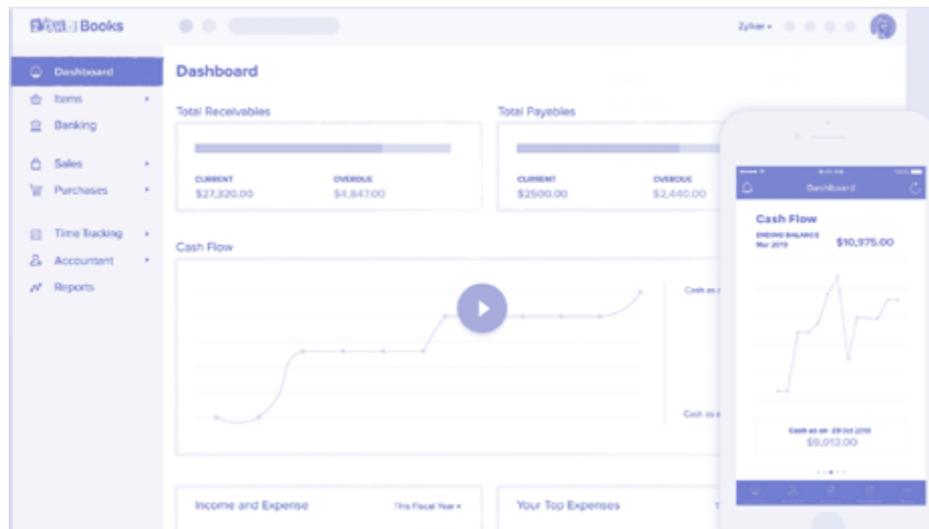


Figure 3.15

### 4. Range of reports

As well as producing financial statements for external users these programs also come ready with a range of reports for internal users to select from. Internal reports / Special Purpose Reports can also be customised to suit the needs of the users. The software is very 'plug and play' and easy to navigate whereby an internal user can get most of the reports they will ever need, with a few mouse clicks. A manager can print off any report as needed such as a weekly sales report, a monthly debtors aging analysis and quarterly income statement. Therefore information is available at any time for decision making accounting information to be more relevant and useful. This leads to better decision making.

Other advantages

- Practice data for training and support from the software's help centre, online courses, blogs, and how-to demonstrations
- Integrate with Apps such as PayPal, 2CHECKOUT
- Synchronise customer contacts, products, transactions and invoices
- Convert estimates into invoices
- Integrate with Point-Of-Sales software
- Improved security.

Despite these advantages over a manual paper based system, there are still limitations.

- Inaccurate inputting of data will create wrong information and reports
- The program only works on the computer it is installed on which limits who and how many users can access information
- Data is kept on the computer's hard drive which is a security risk of losing accounting records as result of theft or loss of the laptop, viruses, malware, corrupted files or power failure
- Software updates can be time consuming and expensive so many small businesses continue to use old versions of the program which may have many bugs and glitches
- Data must be backed-up each day (usually at the end of the day) and the backup stored securely
- To move data to another computer it must be transferred on a USB or hard drive which is risky. If your accountant needed specific numbers, they would need to be emailed back and forth, or saved to USB memory stick

- If a key system operator is absent or leaves the business then others can't find the information they need
- A lot of material must be printed out and manually checked. Slow and not good for the environment. Using professional document destruction is expensive.
- Additional costs such as investment in computers, printers and cabling which must be maintained. Larger businesses may need a server to house the application software and accounting data. An IT expert may need to be employed.
- Fraud can be disguised by a skilled user
- Need to pay ongoing registration fees and software support

## Cloud based accounting systems

### Extension reading

Online accounting, also known as cloud based systems is the most recent digital innovation. The business's computer is no longer the centrepiece of the accounting system. All the advantages of software driven systems are combined with remote access and secure external data storage. The accounting software is accessed by logging in from a web browser. Business's pay a subscription fee to access the software which is housed and managed by specialist organisations such as;

- Xero Cloud Accounting Software
- Zoho Books
- Wave Accounting

The software is automatically updated so the accountant is always working with the most up-to-date version, with all the latest functions. Changes to accounting standards, tax rates and other necessary compliance can also be incorporated into the software. This will add confidence that the business is complying with government regulations and tax law.

There are significant benefits to accounting from cloud based innovations.

### Synchronisation with other applications

Online accounting means that the system no longer operates in isolation. Via the internet accounting software can connect with other programs and applications that support operations, human resources and marketing, accessing the raw information related to the financial performance of these key business functions, such as; inventory movement, employee hours, marketing costs, and production costs. This synchronisation enables accounting processes can be further automated. For example, linking the hours worked from an employee's timesheet to a cost centre and revenue centre, which then generates an invoice to be emailed to the client.

Data can be drawn from external sources, the most significant integration is with banking information such as bank statements which feed directly into the software. Online accounting systems can automatically update cash flow in real-time and instantly identify debtors who have not paid. It is no longer necessary to complete a bank reconciliation to determine the business's precise cash position.

Apps can also read source document data eliminating data entry. This will increase the accuracy and relevance of the information as well as saving considerable time and money. Incoming bills and receipts can be scanned and saved directly with the associated transactions in the accounting software and matched to a customer information automatically. Thus, the accounting system is operating in real-time making it possible to have up to the minute data which is reliable and relevant. This is crucial to monitoring and understanding the business's financial position and performance for better decision making. In addition, accounting and management decisions are based on an overall understanding of the impacts of these decisions on other parts of the business and stakeholders such as employees.

### Impacts of Artificial Intelligence (AI)

Artificial Intelligence (AI) leverages off the existing advantages of cloud based accounting systems adding the ability to summarise, organise and analyse enormous amounts of data enabling accountants to focus on more important tasks. AI will not replace accountants but will impact the book keeping aspect of their role. AI automatically performs time consuming repetitive tasks so that accountants can work in collaboration with others in the business to provide comprehensive advice and financial services.

Accountants can use AI to;

- Forecast sales and expenses using historical data to create a range of scenarios based on different business decisions and other variables such as interest rate changes.
- Analyse all emails to a business's inbox to determine which require urgent attention and by whom.
- Summarise long email chains for easy reading and automatically reply to emails.
- Extract key information from creditors' invoices to ensure they are correct and to approve for payment.
- Reduce errors and fraud by analysing large volumes of transactions, matching data and dollar amounts to the details of the transactions to identify differences and abnormal transactions for investigation.
- Improve the standard of their business communication when writing letters and reports.

It is worth noting that AI has limitations and this is why accountants are still required.

AI tends to be very generalised in its analysis and not able to consider the unique context of the business; its' history, its' trading circumstances, the legal and political environment, industry trends, and the vision of the owners. Decision making is very complex and requires careful judgment and consideration of the whole business as well as the impacts on all stakeholders. AI is not able to reliably interpret financial data and not yet able to fully comprehend qualitative information in addition to the moral and ethical implications in its analysis. All cannot imagine creative solutions to complex financial problems a business may experience.

Accountants ensure that the business is complying with its reporting and legal obligations. For example, the specific financial information government organisations require from businesses varies from country to country. In Australia, section 319 of the Corporations Act requires companies to lodge the complete financial reports. However, some types of companies must lodge reports where "substantial sums of money are involved" according to the Australian Securities and Investment Commission (ASIC). A human accountant would be needed to decide which is considered material and substantial when preparing a report.

The human element in accounting is crucial. Accountants are trusted advisors to owners and managers and need to maintain this relationship. AI cannot replace the personal connection that an accountant needs to have with business owners and decision makers. Being able to translate complex information into what stakeholders can understand will require accountants to have strong interpersonal and communication skills.

## Improved access, information sharing and collaboration

Unlike desktop systems access to the accounting system can be achieved from any device with Wi-Fi. Owners can log-in remotely to view statistics such as daily sales and cash flow, and perform functions such as immediately approve payments, or send out invoices to customers. It also means that if the business's operations are disrupted by fire or blackout, as long as there is access to any computer or mobile device connected to the internet, the financial side of the business can still function.

This feature also means that it is easy to collaborate online with team members regardless of their location. They can all access the same data. The level of access can be controlled using a passwords hierarchy so that specific staff cannot see sensitive data but still do their task. The team can operate in real-time and securely.

In addition, information can be sent to clients, consultants, creditors and government departments securely online. This is important around tax time when data will be shared with an external accountant, financial advisor and the government. In 2019 the Australian Tax Office (ATO) introduced a new requirement for informing the government about employee payments. Businesses must use Single Touch Payroll (STP) and this has impacted the accounting system. Now employers must send employee tax and superannuation information from the accounting software to the ATO each time employees are paid.

Finally, the business's accounting system can gather relevant industry specific information from online sources such as the Australian Taxation Office (ATO). Make comparison to competitors, industry averages and even analyse market and economic trends.

## Other advantages over desk-top based accounting systems

### Enhanced security

Cloud-based software companies ensure the security and privacy of data. No one can access the business's data without the correct login to the online account. All worked is automatically saved as you go therefore end of day back-ups are no longer required.

## Eliminates the need to for expensive hardware and IT staff

Data storage is managed by a cloud service provider and the software also exists in the cloud, therefore there is no need to buy computer hardware, pay for maintenance or organise installation of latest version of the software.

## Less paperwork

It may be possible to eliminate paper from the accounting system. Documents are all digitised and stored in the cloud, there is no need to keep the paper originals which saves on filing storage costs. Printing and postage is not required as invoices and purchase orders are emailed. Keeping receipts this way still complies with tax requirements.

Despite these innovations in accounting systems it is important for business owners to understand how the manual accounting system works. This is because they understand the links between financial statements and recognise when data in reports does not 'look right'. By understanding the relationships between data and reports, better decisions can be made. Overall innovation has provided more timely, reliable and relevant information for better decision making for planning monitoring and controlling.

## Accounting Advice

### Technological innovations

Technological innovations have not only changed how accountants perform their role, it has also broadened what they can do. This has significantly increased the business advisory services they can offer to the business owners and increased the information available to stakeholders. In addition, cloud based software enables the accountant to share more financial information with stakeholders, in different formats, more often, and much more easily. An example is the customer tile below to manager debtors.



## Owners

Using software analytics and Business Intelligence an owner can achieve an overall picture of how the business is going. It is easier to track financial performance and identify the change in financial position in real-time, identify trends, make forecasts, and compare actual results against plans. In addition to a greater range of internal reports, software analytics creates Business Intelligence in an easy to understand format. This information or metrics are available from the 'dashboard' which provides an at-a-glance summary of sales, cash flow, creditors, customers, bank account balances or other key performance indicator (KPI). The data is visual and easy to understand as it is can be presented as;

- Graphs and charts
- Comparisons to previous periods
- Year to date summaries

The software also analyses the data using calculations, ratios and statistics so that a user can gain further insights in business data and make informed decisions.

## Managers

The accounting system can satisfy the increasing data needs of managers. Managers use accounting information to plan, measure, control, and evaluate the strategies used to achieve the business's goals and objectives. Increasingly, decisions are data driven and therefore having access to relevant, reliable and up-to-the minute information will make for better decision making. Managers can respond to change quickly and adjust strategies. For example;

- Finance manager can determine which debtors are at risk of becoming doubtful and choose strategies to prevent bad debts.
- Operations managers can assess input and inventory costs, and advise marketing about pricing
- Sales and marketing managers can use data from Google Analytics, Google AdWords and email software can be reviewed to quickly spot trends in website traffic and develop more effective marketing strategies.
- Human Resources managers can assess employee productivity and make decisions about rewards and promotion.

## Employees

Employees make decisions about their future with a business using accounting information. Access to more detailed information can help them to assess their job security.

Employees can also be owners from share schemes for employees particularly in business start-ups which has encouraged a greater level of interest in accounting information by employees.

## Government and Regulatory bodies

Innovations in accounting systems make it easier to comply with law and share information with government organisations such as the ATO and Australian Securities and Investment Commission. Legal compliance has become a significant part of the accountants' work. Software has made it easier to directly provide government organisations such as the ATO and ASIC with the necessary information. The ATO will make decisions about whether further investigation into the business's accounting information is necessary to verify tax payable.

## Lenders

Leaders have real-time information about the performance and financial position of the business when deciding to offer credit. The level of risk can be more accurately assessed rather than based on old information such as a published balance sheet or income statement.

## Customers

The relationship with customers can be greatly improved which will affect their decision about whether to deal with the business. Customer relationships can be improved as the business can measure and analyse customer interactions with the business. Better communication improves customer satisfaction. For example;

- Automatically generated emails to follow up an inquiry
- Faster response to queries about an invoice or available inventory
- Receiving an online quote and paying online

## Potential investors

Provision of detailed and up-to-date financial information. They can therefore better assess the risk of investing in the business.

## General Public

Businesses have more time to prepare sustainability reports and other records about the business's impacts on the environment and society.

### Activity 3.3

- Outline two advantages of accounting innovations for owners and managers.
 

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.....
- Briefly explain one risk of using accounting software.
 

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- Explain why is it important to complete journals and ledgers when preparing accounting reports.
 

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.....
- 'Debits are good and credits are bad.' – Analyse this statement.
 

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.....
- 'For a small business, a desktop based accounting software program is more trouble than it is worth.' – Evaluate this statement.
 

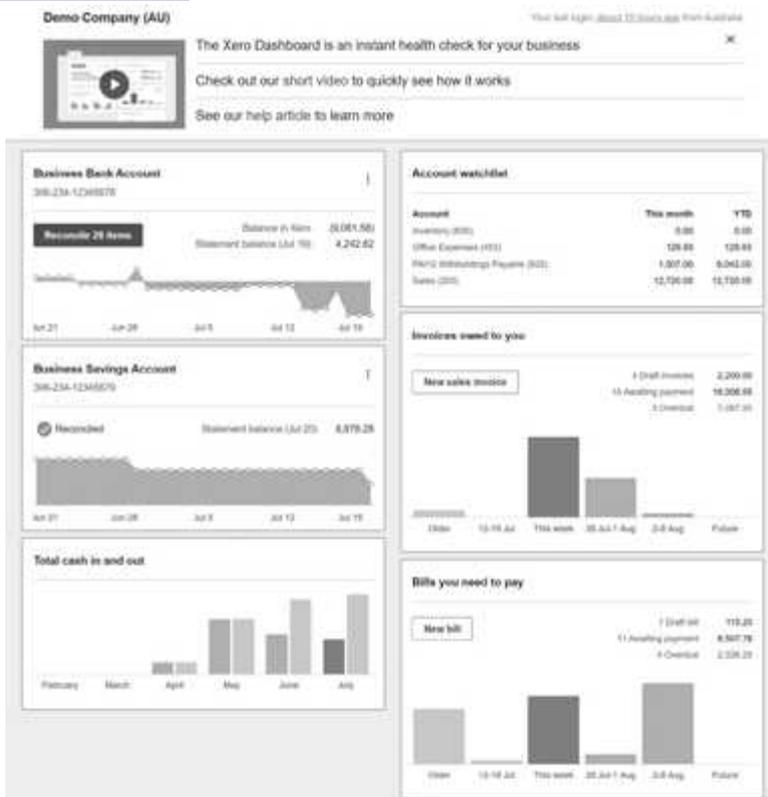
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### Accounting Advice activity

Review the accounting information from the Xero Dashboard. Explain one financial issue for the business and recommend a strategy to support the financial sustainability of the business.



# Chapter 4 - Managing Assets | Inventory Management

## Inventory management considerations

Inventory management refers to the process of ordering, storing, and selling inventory. These include the management of raw materials, components, and finished products, as well as warehousing, processing and recording movements in inventory.

Before investing in new inventory, managers should consider;

### Liquidity

Inventory control directly affects cash flow. Holding too much inventory ties up cash that could be invested in other areas of the business. Furthermore, firms with low inventory turnover may have problems meeting their financial obligations, as they may need to wait for inventory to sell to be able to make payments.

Inventory turnover measures the number of times inventory is sold in a period.

### Warehousing

Warehousing refers to the physical space where inventory is held. Businesses, which hold large stores of stock, may need to lease or purchase a separate storage area. Carrying large amounts of inventory;

- ensures that the business can fill customer orders
- allows business to buy in bulk and therefore may qualify for bulk buying discounts

However, stockpiling can;

- increase the cost of insuring stock
- increase the cost of storage; rent
- increase labour requirements, as the stock needs to be maintained
- increase security requirements
- increased risk of spoilage or obsolescence

### Cost

Several cost factors influence inventory management decisions. The cost of goods may fluctuate, and management may choose to stockpile goods when the purchase price is low or expected to rise in the future.

The business may be able to cut costs by employing the “Just In Time” (JIT) delivery system. This system orders goods just as the organisation needs them. JIT results in low inventory levels thus eliminating costs associated with warehousing and holding stock. However, effectively employing this system relies on efficient inventory information and logistic systems. Poor management can lead to an inability to meet customer demand due to a stockout.

### Delivery time and availability of supply

Some goods may take a long time in transit, particularly if they shipped across international borders. This can also incur customs duty, wharfage and freight expenses. Some products may be difficult to order or have inconsistent supply. These factors will influence management’s decision to stockpile goods, or employ the “Just in Time” inventory system. To employ this system effectively, the business will need a reliable supply chain.

### Decline in value

Management needs to assess how holding inventory affects its value. Some products decline rapidly in value. Management need to consider factors such as;

- are items perishable- these items need to be sold fresh and thus should not be stockpiled
- durability- some items do not keep well and will decline in quality over time
- obsolescence- some goods will become obsolete with time and will be replaced by new technology (e.g. DVD players).
- some products decline in value when a new invention or model is released, e.g. mobile phones.

## Demand

In some markets, customer demand can change quickly and therefore affect inventory management. Reduced demand may force businesses to discount goods and clear inventory before it declines in value. Market demand is influenced by:

- seasons
- fashion and consumer trends
- competition
- economic factors
- innovation and technology

## Inventory Systems

There are two inventory system used to record inventory and cost of goods sold;

- Periodic
- Perpetual

### Periodic

The periodic or physical inventory system does not keep an ongoing count of inventory. A calculation is required to determine stock levels and Cost of Goods Sold. Before this calculation can be performed, a stocktake is required to ascertain closing stock levels. A stocktake involves physically counting all inventory on hand. Stocktakes are a very time-consuming process, and most businesses do not perform them more than once a quarter.

The inventory account is not used throughout the period. New inventory is recorded as a “purchase”. At the end of the accounting period, a stock take is performed; this will enable the Cost of Goods Sold to be calculated. This is calculated in the Income Statement through the following calculation;

$$\text{TOTAL COST OF GOODS SOLD} = \text{Operating Inventory} + \text{Purchases} - \text{Purchase Returns} - \text{Closing Inventory}$$

The Income Statement Chapter assumes businesses use the periodic inventory system.

The periodic inventory system is most useful for small business owners that maintain minimal amounts of inventory. For them, a physical inventory count is easy to complete, and they can estimate Cost of Goods Sold figures for interim periods.

However, there are several problems with the system:

- *minimal information*. It does not yield accurate information about the cost of goods sold or ending inventory balances during interim periods when there has been no physical inventory count.
- *stock loss is unknown*. The calculation assumes that all movements of inventory out is a result of sales. In reality, outflows of stock can result from theft or damaged goods.
- *not scalable*. It is not an adequate system for larger organisations with significant inventory investments, given its high level of inaccuracy.
- not suitable for a business with a fast stock turnover

### Perpetual

The perpetual system keeps a running count of all inventory movements. Thus a stocktake is not required to calculate the inventory balance. However, stocktake is usually performed at the end of the financial year to confirm that records are correct and to calculate the stock loss.

This method requires adjustments to be made to the inventory account when:

- inventory is purchased
- inventory is returned to the supplier
- inventory is sold to the customer
- the customer returns inventory
- stock loss is identified

The perpetual system requires more accounting entries, however, these processes have been simplified through barcoding systems and inventory management software.

This system is widely used because of its many advantages, including;

- assistance in minimising stock-outs; as management can easily monitor inventory levels. Some software systems send notifications when stock is running low.
- gives business owners a more accurate understanding of customer preferences
- provides greater accuracy due to each inventory item being recorded on a separate ledger
- stock loss can be calculated.
- reduces reliance inventory counts

## Accounting and Reporting using the Periodic and Perpetual Systems

Figures 4.1.1 & 4.1.2 outline the different approaches to recording and reporting inventory and cost of goods sold.

Periodic	Perpetual
Purchase of inventory	
Dr Purchases Cr Bank/ Creditors	Dr Inventory Cr Bank/ Creditors
Purchase return	
Dr Bank/ Creditors Cr Purchase returns	Dr Bank/ Creditors Cr Inventory
Sales	
Dr Bank/ Debtors Cr Sales	Dr Bank/ Debtors Cr Sales Dr COGS Cr Inventory
Sales returns	
Dr Sales returns Cr Bank/ Debtors	Dr Sales returns Cr Bank/ Debtors Dr Inventory Cr COGS

Records movement in inventory every time there is a purchase

Records movement in inventory every time there is a sale

Figure 4.1.1: Recording inventory

Periodic	Perpetual
COST OF GOODS SOLD	
Opening Inventory xxx	Cost of Goods Sold xxx
Add Purchases xxx	Add stock loss <u>xxx</u>
Less Purchase returns <u>xxx</u>	xxx
Less Closing Inventory <u>xxx</u>	
xxx	

Figure 4.1.2: Reporting inventory

## Example 1 – Recording transactions for periodic and perpetual inventory systems

The following transactions are to be treated differently under the two different systems

- June 1 Inventories on hand \$5,000  
 12 Sold goods for cash \$4,000, cost \$2,880  
 16 Bought goods on credit from \$6,400  
 19 Sold goods on credit to \$2,600, cost \$1,800  
 30 Returned goods bought on the 16th \$300  
 30 Sold goods on credit to \$3,500, cost \$2,520  
 30 Physical stock take revealed \$3,900 goods on hand

To record these transactions under the **periodic system**:

Date	Particulars	Debit	Credit
12/6	Bank Sales	4,000	4000
	<i>To record cash sales</i>		
16/6	Purchases Creditors	6,400	6,400
	<i>To record credit purchases</i>		
19/6	Debtors Sales	2,600	2,600
	<i>To record credit sales</i>		
30/6	Creditors Purchase returns	300	300
	<i>To records purchase returns</i>		
30/6	Debtors Sales	3,500	3,500
	<i>To record credit sales</i>		
30/6	Stock Trading	3,900	3,900
	<i>To record closing stock</i>		

To calculate COGS:

Opening inventory		5,000
Add purchases	6,400	
Less purchase returns	300	6,100
Less closing inventory		3,900
Total Cost of Goods Sold		7,200

To record these transactions under the **perpetual system**:

Date	Particulars	Debit	Credit
12/6	Bank	4,000	
	Sales		4000
	COGS	2,880	
	Inventory		2,880
<i>To record cash sales</i>			
16/6	Inventory	6,400	
	Creditors		6,400
<i>To record credit purchases</i>			
19/6	Debtors	2,600	
	Sales		2,600
	COGS	1,800	
	Inventory		1,800
<i>To record credit sales</i>			
30/6	Creditors	300	
	Inventory		300
<i>To records purchase returns</i>			
30/6	Debtors	3,500	
	Sales		3,500
	COGS	2,520	
	Inventory		2,520
<i>To record credit sales</i>			

COGS	
12/6 Inventory	2,880
19/6 Inventory	1,800
30/6 Inventory	<u>2,520</u>
	7,200

Inventory			
1/6 Balance	5,000	12/6 COGS	2,880
16/6 Creditors	<u>6,400</u>	19/6 COGS	1,800
		30/6 Creditors	300
		30/6 COGS	2,520
	11,400	30/6 Balance	<u>3,900</u>
1/7 Balance	3,900		11,400

Unlike the periodic system, a calculation is not required to determine COGS, as there is an COGS account.

On the income statement COGS would be reported as;

COGS	7,200
------	-------

**Note** that in this example the COGS is the same using the periodic and perpetual system. If there were a stock loss, the COGS figure would differ.

## Identifying stock loss

One of the benefits of using the perpetual inventory system is that stock loss can be identified and recorded. Stock loss is identified when the stock take count is lower than the recorded amount in the inventory control account. Stock loss can be due to theft, paperwork mistakes or damage to stock.

The following entry records stock loss.

30/6	Stock loss	xx	
	Inventory		xx
	<i>To record stock loss</i>		

## Example

Balance as per Inventory control ledger account 70,000

Balance as per stock take \$69,000

Comparing these to balances identifies a \$1,000 discrepancy. Because the actual count is lower than the recorded amount, we can assume that a stock loss has occurred. The accounts need to be adjusted to show a Inventory balance of \$69,000. The following entry is required:

30/6	Stock loss	1,000	
	Inventory		1,000
	<i>To record stock loss</i>		

## Activities

### Activity 1 – Recording transactions for periodic inventory systems

Visual landscaping supplies uses the periodic inventory system.

The following transactions occurred in February;

- Feb     1   Inventories on hand \$15,000  
           9   Bought goods on credit from Wood Landscaping for \$3,200  
          11   Cash sales \$300  
          15   Sold goods on credit to Better Solutions \$5,200  
          21   Returned goods to Wood Landscaping \$50  
          26   Better Solutions returned goods \$100  
          28   Sold goods on credit to J Jones \$4,700  
          28   Closing inventory valued at \$12,000

(a) Record the transactions in the general journal.

Date	Particulars	Debit	Credit
9/2			
	<i>To record credit purchases</i>		
11/2			
	<i>To record cash sales</i>		
15/2			
	<i>To record credit sales</i>		

Date	Particulars	Debit	Credit
21/2	<i>To records purchase returns</i>		
26/2	<i>To record sales returns</i>		
28/2	<i>To record credit sales</i>		
28/2	<i>To record closing stock</i>		

(b) Prepare the abstract from the Income Statement.

<b>Income</b>			
Sales			
Less Sales returns			
<b>Cost of Goods Sold</b>			
Opening inventory			
Add purchases			
Less purchase returns			
Less closing inventory			
<b>Gross Profit</b>			

(c) Discuss the advantages and disadvantages of using the periodic system. Recommend the system, which would be most suitable for Visual Landscaping.

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## Activity 2 – Recording transactions for perpetual inventory systems

Aaron owns a mobile phone and accessory store. He uses a perpetual inventory management system to account for his inventory.

(a) Record the following transactions in the general journal and post to the relevant accounts.

- Sept
- 1 Inventories on hand \$6,000
  - 12 Sold goods for cash \$5,000 (cost \$4,300)
  - 17 Customer who purchased on the 12th returned \$1,000 goods (cost 800)
  - 19 Sold goods on credit to V Mad \$1,700 (cost \$600)
  - 22 Returned goods purchased for cash \$300
  - 24 Purchased \$40,000 of goods on credit from Bargain supplies
  - 30 Physical stock take revealed \$41,000 goods on hand

Date	Particulars	Debit	Credit
12/9			
	<i>To record cash sales</i>		
17/9			
	<i>To record sales return</i>		
19/9			
	<i>To record credit sales</i>		
22/9			
	<i>To records purchase returns</i>		
24/9			
	<i>To record credit purchase</i>		
30/9			
	<i>To record stock loss</i>		

Inventory Control

---

Sales

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COGS

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Stock loss

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(b) Prepare the abstract from the Income Statement.

<b>Income</b>		
<b>Cost of Goods Sold</b>		
<b>Gross Profit</b>		

(c) On the 24<sup>th</sup>, Aaron purchased a larger order than normal to take advantage of a promotion offered by one of his suppliers. Discuss the potential risks associated with this decision.

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(d) Aaron performed a stock take even though he uses the perpetual inventory system. Are stock takes required to produce interim reports? Describe the benefits of performing regular stock takes?

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**Activity 3 – Recording transactions for perpetual inventory systems**

(a) Record the following transactions in the relevant accounts. Note, some postings are not required.

- June 1 Inventories on hand \$5,000
- 12 Sold goods for cash \$4,000 (cost \$3,200)
- 16 Bought goods on credit from M Jordan \$6,400
- 19 Sold goods on credit to T Woods \$2,600 (cost \$1,800)
- 30 Returned goods to M Jordan \$300
- 30 Sold goods on credit to C Freeman \$3,500 (cost price \$2,000)
- 30 Physical stock take revealed \$3,900 goods on hand

Inventory Control	
Sales	
COGS	



(b) Prepare the abstract from the Income Statement.

<b>Income</b>		
<b>Cost of Goods Sold</b>		
<b>Gross Profit</b>		

(c) Calculate the gross profit margin. Comment on the result compared to the industry average of 50%.

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## Valuation of Inventory

At times, it can be difficult or costly to ascertain the true cost of inventory sold. Cost in relation to inventories is the aggregate of:

- the purchase price
- customs duty and other import duties and taxes
- inward transport and handling costs
- other costs (such as repackaging) incurred in transporting the inventories to the store or storage facility and transforming inventories into a condition ready for sale.

The cost of these items frequently change, further making it difficult to determine the cost of the goods sold. There are two methods widely used to determine the value of inventory:

- Identified cost
- First In First Out (FIFO)

### Identified cost

The identified method of inventory costing attaches the actual cost to an identifiable unit of product. This is the most **accurate** and **objective** method available. However, this method is not realistic for all businesses as specific identifiers such as serial numbers need to be attached to each item of inventory. Firms find this method easy to apply when purchasing and selling large inventory items such as cars or furniture. It is more appropriate for items of high value with low sales volume.

### First In, First Out (FIFO)

FIFO assumes that the oldest (first) items are sold first. Thus, it is assumed the inventory at the end of a year consists of the goods most recently acquired. This assumption is important for determining costs, as the price of the oldest inventory is used for cost of goods sold valuations.

In reality, the flow of goods may not follow this pattern. Not all businesses are able to ensure that oldest items are sold first.

The FIFO method is widely used and is suitable for businesses that carry a large amount of stock which are difficult to identify on an individual basis, such as grocery items. It is more appropriate for items of low value and high volume sales.

## Inventory cards

The inventory account is made up of lots of individual components, or stock lines. It is therefore necessary to keep track of the individual components through a subsidiary ledger. Stock/Inventory cards are used to record the ledger information, the stock cards are then summarised in the Inventory Control account in the General Ledger.

The inventory valuation method, Identified cost or FIFO, will determine how the inventory card is used. The process of recording inventory inflows and outflows using the two methods is outlined in examples 1 & 2.

### Example – Inventory Cards Identified Cost

White Goods Online stocks refrigerators. The business uses the **identified cost method** to measure the cost of inventory sold.

1/4	Balance 15 @ \$300
1/4	Sold 3 @ \$300
5/4	Bought 10 @ \$320
10/4	Returned 2 units bought on the 5 <sup>th</sup>
15/4	Sold 1 unit @ 320 and 5 units @ \$300
17/4	Customer returned 1 unit bought for \$300
20/4	Bought 4 units @ \$330
30/4	Stock take revealed 8 units @ 300, 7 units @ 320 & 3 @ 330

Ref	Date	Purchases (In)		Sales (Out)		Balance		
		Qty	Cost	Qty	Cost	Qty	Cost	Total
Balance	1-Apr					15	300	4,500
Sales	1-Apr			3	300	12	300	3,600
Purchases	5-Apr	10	320			12	300	3,600
						10	320	3,200
Returns	10-Apr	-2	320			12	300	3,600
Purchase						8	320	2,560
Sales	15-Apr			5	300	7	300	2,100
				1	320	7	320	2,240
Returns	17-Apr			-1	300	8	300	2,400
Sales						7	320	2,240
Purchases	20-Apr	4	330			8	300	2,400
						7	320	2,240
						4	330	1,320
Stock loss	30-Apr					8	300	2,400
						7	320	2,240
				1	330	3	330	990

Note: Sales returns are recorded as a negative in the 'out' column. However, it can also be recorded in the 'in' column as the stock is being returned.

Similarly, purchases returned to the supplier are recorded in the 'in' column as a negative. However, this can also be recorded in the as an 'out' as stock is going back to the supplier.

The following entries are made to post the inventory transactions to the Inventory Control general ledger.

Inventory					
1-Apr	Balance	4,500	1-Apr	COGS	900
5-Apr	Creditors	3,200	10-Apr	Creditors	640
17-Apr	COGS	300	15-Apr	COGS	1,820
20-Apr	Creditors	1,320	30-Apr	Stock Loss	330
			30-Apr	Balance	5,630
		<u>9,320</u>			<u>9,320</u>
1-May	Balance	5,630			

## Example – Completing Inventory Cards FIFO

The following is an example showing the completion of a stock card using the FIFO method for White Goods Online. All transactions are made in cash.

- 1/4 Balance 15 @ \$300
- 1/4 Sold 3 units
- 5/4 Bought 10 units @ \$320
- 10/4 Returned 2 units bought on the 5<sup>th</sup>
- 15/4 Sold 6 units
- 17/4 Customer returned 1 unit bought on the 1<sup>st</sup>
- 20/4 Bought 4 units @ \$330
- 30/4 Stock take revealed 18 units

Ref	Date	In		Out		Balance		
		Qty	Cost	Qty	Cost	Qty	Cost	Total
Balance	1-Apr					15	300	4,500
Sales	1-Apr			3	300	12	300	3,600
Purchase	5-Apr	10	320			12	300	3,600
						10	320	3,200
Returns	10-Apr	-2	320	2	320	12	300	3,600
Purchases						8	320	2,560
Sales	15-Apr			6	300	6	300	1,800
						8	320	2,560
Returns	17-Apr			-1	300	7	300	2,100
Sales						8	320	2,560
Purchase	20-Apr	4	330			7	300	2,100
						8	320	2,560
						4	330	1,320
Stock Loss	30-Apr					6	300	1,800
						8	320	2,560
						1	300	1,320

Note: Sales return under FIFO will be from the most recent sale, so the date of sale is irrelevant.

Inventory					
1-Apr	Balance	4,500	1-Apr	COGS	900
5-Apr	Bank	3,200	10-Apr	Bank	640
17-Apr	COGS	300	15-Apr	COGS	1,800
20-Apr	Bank	1,320	30-Apr	Stock Loss	300
			30-Apr	Balance	5,680
		9,320			9,320
1-May	Balance	5,680			

The Inventory card should agree with the balance in the general ledger.

Notes - in this example the Inventory is valued \$50 higher under the FIFO method. This is because it is assumed that the less expensive stock, which was purchased first, was sold first.

Stock loss assumes that it was the oldest unit that was lost.

Sales returns can be listed as a negative in “out” column or be listed in the “in” column.

Purchase returns can also be listed as a negative in the “in” column or placed in the “out” column.

Activities

Activity 4 – Inventory Cards FIFO

Slumber City sells mattresses and bed settings. They use the FIFO method to record movements in stock. Details of Slumber City’s mattress purchases for the month of January are as follows:

Date Purchased	Details	Quantity	Unit Cost (\$)
January 1	Balance	15	180
4	Invoice 321	40	190
15	Invoice 340	50	200
27	Invoice 355	40	205

**Note:** An invoice indicates purchases have been made on credit

**Additional information:**

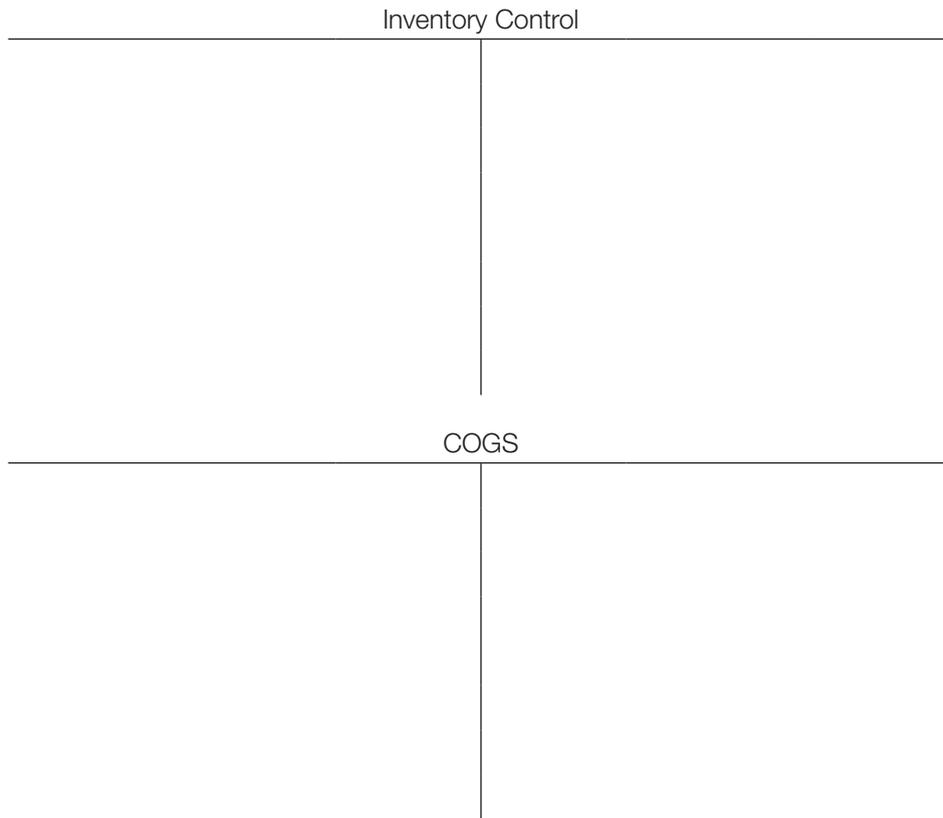
Details of **sales** for the month of January were:

- January 3 Sales 10 at \$250 each
- 9 Sales 22 at \$250 each
- 17 Sales 28 at \$265 each
- 29 Sales 24 at \$265 each

A physical stocktake was conducted on 30 January and revealed 59 mattresses left on hand.

(a) Complete the inventory card, Inventory and COGS general ledger for Slumber City.

Date	Ref	In		Out		Balance		
		Qty	Cost	Qty	Cost	Qty	Cost	Total
1-Jan	Balance					15	180	2,700
3-Jan								
4-Jan								
9-Jan								
15-Jan								
17-Jan								
27-Jan								
29-Jan								
31-Jan								



(b) Prepare the abstract of the Income Statement – The Trading Statement.

**Income Statement**  
**Slumber City**

Sales	
COST OF GOODS SOLD	
<b>Gross Profit</b>	

### Activity 5 Inventory Cards

Harrys Hardware maintains inventory cards to record details of stock movements. Lawn mowers are recorded using the **Identified Cost** method whereas water hoses are recorded using the **FIFO** method.

The following transactions took place in May:

- May 1 cash purchases 3 lawnmowers \$150
- 2 Sold 10 water hoses
- 5 Sold 3 lawn mowers (cost 1 @ \$140: 2 @ \$150) to Vision landscaping on account
- 7 Bought 10 hoses for \$15 per unit from Irrigation Solutions Manufacturing
- 9 Vision landscaping returned one lawn mower (cost \$140) Sold 7 water hoses for cash
- 10 Bought 2 lawn mowers from CT Wholesalers \$160 each
- 12 Bought 5 water hoses @ \$16 each from JT Traders
- 15 Cash sales 4 lawn mowers to (cost: 2 @ \$140: 1 @ \$150: 1 @ \$160).
- 16 Cash sales 7 hoses

Additional information:

- Hoses retail for \$30 each
- Lawn mowers retail for \$250 each
- 1 May: 15 hoses on hand cost \$14, 5 lawn mowers on hand cost \$140
- Physical stock take on 20th May revealed:
- 4 hoses on hand
- 4 lawn mowers on hand.

(a) Complete the inventory cards for the two products:

Inventory Card: Lawn mowers – **Identified Cost**

Date	Ref	In		Out		Balance		
		Qty	Cost	Qty	Cost	Qty	Cost	Total
May-01	Balance					5	140	700



Inventory Card: Water hoses – **FIFO**

Date	Ref	In		Out		Balance		
		Qty	Cost	Qty	Cost	Qty	Cost	Total
May-01	Balance					15	14	210

(b) Show the General Journal Entry to record the 'water hose' Inventory Discrepancy. Include a narration.

GENERAL JOURNAL

DATE	PARTICULARS	DEBIT	CREDIT

(c) Record the information from BOTH inventory cards (include the Inventory discrepancy) in the General Ledger account provided.

Inventory Control		
1-May	Balance	910

(d) Explain why Harrys Hardware may have chosen to use the FIFO method to record water hoses but identified cost to record lawn mowers.

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## Lower of cost rule

Generally, inventory is valued at historical cost, which is the price paid for the inventory plus any costs associated with getting the item ready for sale. However, in some circumstances, the **Net Realisable Value** or **NRV** can be used to value inventory. The NRV is the value of the inventory that can be realized upon sale, less a reasonable estimated selling costs.

NRV = Estimated selling price of the inventory - Selling marketing and distribution costs

The **lower of cost rule** is used to determine the valuation method, which should be applied.

**The lower of cost rule** states that a business must record the value of inventory at whichever cost is lower – the historical cost or net realizable value.

Valuation at NRV is more likely to arise when inventory has deteriorated or has become obsolete, or market prices have declined. This situation is more likely to occur when the business has held inventory for a long time.

### Example – Applying the lower of cost rule

An electronic business sells hard drives. To take advantage of bulk buying discounts, they bought 500 GB hard drives for \$50 each. This item has been slow to sell, and thus they still have a significant amount of inventory two years after purchasing the hard drives. Over the past two years, there have been significant improvements in hard drive technology, resulting in low-cost hard drives, which offer more extensive storage, being widely available on the market. The storeowner estimates that he will need to discount the hard drive selling price from \$80 to \$38. They have 50 items left in stock.



Figure 4.1.3 – Cost or NRV (Net Realisable Value) example

Applying the lower of cost rule, inventory must be valued at the NRV, \$38 per unit. The total value of the inventory recorded will be \$1,900.

Activity

**Activity 6 – Applying lower of cost rule**

Calculate the historical cost and NRV for the following scenarios. Indicate the value of inventory, which would be recorded.

- (a) A firm bought 50 Television units for \$300 each plus delivery cost of \$50. Estimated selling price is \$400 each, with associated total selling costs of \$1,000

Historical Cost = ..  
 NRV = ..  
 Value recorded ..

- (b) A firm bought 40 set top boxes for \$20 each. Estimated selling price is \$25 each with associated selling costs of \$150

Historical Cost = ..  
 NRV = ..  
 Value recorded ..

**Activity 7 – Applying lower of cost rule**

Lily owns a small seaside-clothing boutique, which specialises in beachwear. Last summer, Lily bought 80 tangerine coloured bikinis, the season’s hottest colour, for \$35 each. It is now winter and Lily has 40 bikinis in stock. To encourage sales, she will discount the stock to \$40, a 50% discount. She estimates that she will need to pay \$250 to promote the sale.

- (a) What was the bikinis original selling price?  
 ..

- (b) What is the Historical Cost for the 40 units?  
 Historical Cost = ..

- (c) What is the NRV for the remaining 40 units?  
 NRV = ..

- (d) Applying the lower of cost rule, what is the value of the bikini inventory?  
 ..  
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- (e) Calculate the total gross profit or loss made on the tangerine bikinis, assuming all the stock is sold in the same accounting period.

Total Sales =  
 (Hint) Full Price + Discounted Price

COGS

Gross Profit

## Inventory Turnover

The inventory turnover shows how many times inventory has been sold and replaced in a period.

$$\text{Inventory turnover ratio} = \frac{\text{cost of goods sold}}{\text{inventory}^*}$$

\*Average inventory is to be used.

Note: to be expressed in **times/period**

The inventory turnover indicates the speed at which inventory is sold. Retailers that move inventory out faster tend to outperform their counterparts. High turnovers indicate that stock has been sold and replaced frequently. Low turnovers indicate that inventory has been held for long periods. Low turnover indicates problems with inventory management because the longer an item is held, the higher its holding costs. This ratio is typically compared to industry averages as turnover ratios will vary greatly between industries. Industries that tend to have the highest inventory turnover are those with high volume and low margins, such as retailers of grocery and clothing.

It is useful to convert the inventory turnover ratio into the average number of days it takes to sell inventory.

$$\text{Inventory turn over in} = \frac{\text{days in time period}}{\text{inventory turnover ratio}}$$

## Strategies for improving turnover

Inventory turnover can be improved through activities related to sales and reducing inventory on hand.

**Strategies to improve** the turnover include:

### **Improved forecasting**

Accurate sales forecasting reduces excess inventory on hand, as businesses can predict when stock is going to be in high and low demand. This assists in ordering goods.

### **Increased sales through marketing**

More effective advertising and sales strategies can increase the demand for sales. Lowering prices can increase the rate at which the stock sells, although the gross profit margin will reduce as a result.

### **Eliminate old stock and focus on fast moving stock**

The business can focus on stocking and advertising high demand merchandise.

### **A 'Just in Time' (JIT) ordering system**

JIT refers to having sufficient stock on hand to be able to meet customer demand, without having excess idle stock on the shelves. Businesses will order stock just as they need it. This reduces holding costs. However, if stock forecasting is not accurate, it can lead to stock shortages, and lost sales. Delays in supply chains as a result from the Covid-19 crisis has led to many stores not being able to meet customer demand.

### **Analysis of product lines**

Analysis of the business's product mix can identify slow moving stock lines to delete and focus promotion of fast moving stock lines.

## Example – Calculating Inventory turnover

E Games sells video games and consoles. The owner is interested in comparing the inventory turnover with the industry average of 2 times per month. You have been provided with an extract from the Income Statement for month ending 30 June:

<b>COGS</b>	
Opening stock	10,000
Add purchases	30,000
Less Closing stock	<u>12,000</u>
 Total Cost of goods sold	 28,000

(a) To calculate the turnover the following calculation is performed.

$$\begin{aligned} \text{Inventory turnover} &= \frac{\text{COGS}}{\text{Average inventory}} \\ &= \frac{28,000}{((10,000 + 12,000) / 2)} \end{aligned}$$

Inventory turnover = 2.5 times per month

$$\text{Turnover in day} = \frac{30 \text{ days}}{2.5} = 12 \text{ days}$$

(b) Interpreting the result.

The inventory turnover indicates how frequently stock is sold and replaced in a period. A turnover of 2.5 times per month indicates that E Games replaces their stock every 12 days. This is 3 days (30 days / 2 times = 15 days) less than the industry benchmark. This indicates good management of inventory.

## Activities

### Activity 8 – Calculating Inventory turnover

Daisy runs a florist shop. She would like to analyse her inventory turnover. The industry average is 7 times per month. You have been provided with the following details for the month of May.

Inventory beginning	2,000
COGS	7,000
Inventory closing	1,000

(a) Calculate the inventory turnover.

(b) Comment on the result.

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### Activity 9 – Calculating Inventory turnover

Bill operates a car dealership. He has asked you to analyse the efficiency of his stock control.

He has provided you for the following records for the financial year ending 30 June:

Inventory beginning	500,000
COGS	1,000,000
Inventory closing	400,000
Industry Average	5 times per year

(a) Calculate the inventory turnover.

(b) Comment on the result.

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(c) Suggest strategies for improving stock turnover.

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## Safeguarding Inventory

Stock is a valuable asset and therefore should be protected. **In particular, it is important to protect stock from theft. Safeguard measures include;**

- security alarm devices
- video surveillance
- mirrors in obscure areas
- security personnel
- security tags on products
- dye tags
- electronic security gates
- staff check points
- regular stock takes to identify theft
- limit access to stock by reducing the inventory kept on the retail floor and locking inventory in storage.

### Extended Activity

## Inventory Management

So Fresh, is a convenience store which sell a range of grocery items and prepared meals. Justin, the owner, uses the FIFO system to record movements in inventory. The following transactions relate to the sale of 500ml plain yogurt. He sells tubs of yogurt for \$5 each. All transactions are made in cash.

- 1 March Opening balance 10 tubs purchased for \$2.
- 5 March Purchased 8 more tubs for \$2.20.
- 10 March Sold 11 tubs.
- 22 March Purchased 8 tubs for \$2.30 each.
- 28 March Disposed of 2 tubs which past their expiry date.
- 30 March Stock take revealed 12 tubs on hand.

Date	Description	In		Out		Balance		
		Qty	Cost	Qty	Cost	Qty	Cost	Total
1-Mar	Balance					10	2	20

(a) Explain the entry made on the 28<sup>th</sup>. Suggest strategies Justin could use to minimize **stock disposal**.

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(b) Would it be appropriate to use the identified cost method to record the movements in the yogurt inventory? Justify your response.

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(c) Complete the Inventory account.

Inventory Control		
1-Mar	Balance	20

(d) Calculate the gross profit for March, on the sale of yogurt.

(e) Calculate the Inventory turnover on yogurt for the month of March.

(f) Comment on result. The industry benchmark for dairy products is 3 times per month. Discuss strategies to improve turnover.

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**Extended Activity**

**Statement of Advice – Managing Assets**

Katherine runs, Scandinavian Designs, a home furniture store. She has come to you for some advice about managing her current assets. She has noticed that her sales and cash position have started to decline. She attributes this trend to a new competitor who has recently opened a store in the area. Part of the competitor’s sales strategy includes offering 90-day credit terms to customers. Currently, Katherine does not offer credit to customers. In order to cover operating costs, furniture stores need to apply adequate mark-ups on products. However, as the industry is very competitive, customers are relatively price sensitive, and therefore large mark-ups tend to lower demand for products. The industry benchmark for gross profit is 60%.



Katherine buys furniture in bulk, to take advantage of bulk buying discounts. She maintains a warehouse for excess supplies. She keeps a close track of fashions and trends to ensure that she only stocks goods that will sell. However, due to lower than predicted sales over consecutive periods, the warehouse has stockpiles of old stock. The average inventory turnover for the furniture industry is 14 times per year.

Examine the finances of Scandinavian Designs.

- Assess the financial position of Scandinavian Designs.
- Discuss ways Katherine can improve the competitiveness of her business. In your discussion, consider the impact of offering a similar credit policy to the competition.
- Evaluate the inventory management and the impact it has on cash-inflows.
- Recommend strategies for improving Katherine's inventory control, cash inflow and competitive advantage.

**Scandinavian Designs**  
**Statement of Changes in Owner's Equity**  
**for the year ended 30 June**

Capital	\$208,500	
Less loss	<u>\$ 36,100</u>	
	\$172,400	
Less drawings	<u>\$ 23,400</u>	<u>\$149,000</u>

**Scandinavian Designs**  
**Balance Sheet**  
**As at 30 June**

	Current		Prior	
<b>Current Assets</b>				
Cash at Bank				29,000
Inventory		<u>25,000</u>		<u>25,000</u>
		25,000		49,000
<b>Non-Current Assets</b>				
Furniture & fittings	10,000		10,000	
Delivery Vehicle	50,000		50,000	
Premises	<u>200,000</u>	<u>260,000</u>	<u>200,000</u>	<u>260,000</u>
<b>Total Assets</b>		285,000		309,000
<b>Current Liabilities</b>				
Bank overdraft		2,000		
Creditors		12,000		500
Sales wages payable		<u>2,000</u>		
		16,000		500
<b>Non-Current Liabilities</b>				
Mortgage		<u>120,000</u>		<u>100,000</u>
		<u>136,000</u>		<u>100,500</u>
<b>NET ASSETS</b>		149,000		208,500

**Scandinavian Designs**  
**Income Statement for the year ending**

	Current		Prior	
Sales		\$167,000		\$220,000
Less Cost Of Goods Sold				
Inventory	\$ 20,000		\$ 5,000	
Purchases	\$ 70,000		\$ 80,000	
Cartage	\$ 4,900		\$ 5,600	
Insurance on Inventory	\$ 1,500		\$ 1,000	
Warehouse costs	<u>\$ 15,000</u>		<u>\$ 10,000</u>	
	\$111,400		\$101,600	
Inventory	<u>\$ 25,000</u>	<u>\$ 86,400</u>	<u>\$ 20,000</u>	<u>\$ 81,600</u>
<i>Gross Profit</i>		\$ 80,600		\$138,400
<i>Less Other Operating Expenses:</i>				
Selling				
Advertising	\$ 30,000		\$ 32,000	
Website maintenance	\$ 2,700		\$ 2,700	
Sales wages	<u>\$ 62,000</u>	\$ 94,700	<u>\$ 68,000</u>	\$102,700
Administrative				
Office and compliance expenses	\$ 10,000		\$ 9,000	
Insurance	<u>\$ 5,000</u>	\$ 15,000	<u>\$ 4,900</u>	\$ 13,900
Financial Expenses				
Interest on mortgage	<u>\$ 7,000</u>	<u>\$ 7,000</u>	<u>\$ 8,000</u>	\$ 8,000
		<u>\$116,700</u>		\$124,600
<i>Net Profit/ Loss</i>		-\$ 36,100		\$ 13,800



## 4.2 – Controlling Debtors

The objective of debtor management is to;

- Encourage prompt payment
- Minimise bad debts
- Encourage ongoing sales
- Improve cash inflows

### Control accounts and subsidiary ledgers

To achieve these objectives, managers need current information about each debtor. A firm needs to be able to track credit sales and receipts from each of debtor. Usually, account balances are tracked through the general ledger. However, when there are too many individual debtors to maintain account information in the general ledger, subsidiary ledgers are used.

Firms create subsidiary ledgers whenever they need to monitor the individual components of a controlling general ledger account. A subsidiary ledger stores the details for a general ledger control account. The control will present a summary of the account transactions. This concept is demonstrated in figure 4.2.1.

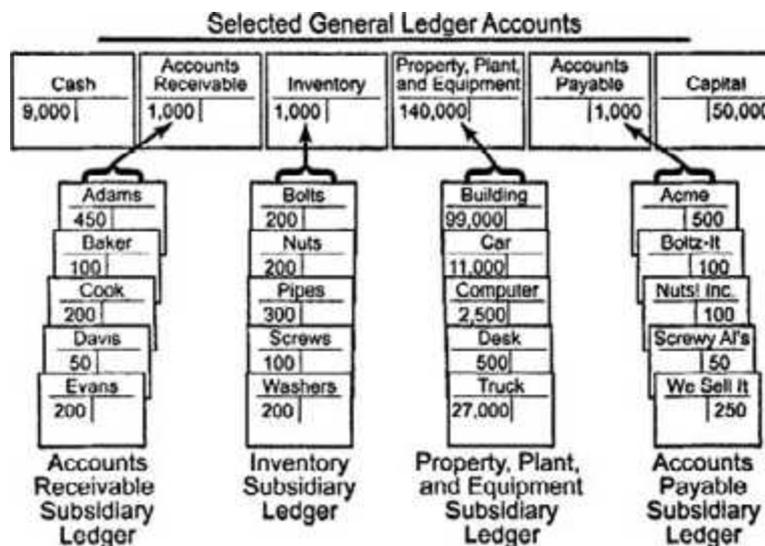


Figure 4.2.1 – Subsidiary ledgers visualisation

Source: <https://www.cliffsnotes.com/study-guides/accounting/accounting-principles-i/subsidiary-ledgers-and-special-journals/subsidiary-ledgers>

The **Debtors Control Account** summarises all debtors accounts movements. It contains **totals** instead of amounts relating to individual debtors or creditors. A Debtor Control Account will include totals of;

- sales
- sales returns
- bad debts
- late fees and delivery charges
- discount
- cash receipts from debtors

These items will appear as the following in the ledger;

Debtor Control			
Balance	xxxx	Discount allowed	xxx
Sales	xxx	Bank	xxx
Late fees	xxx	Bad debts	xxx
Delivery charges	xxx	Sales returns	xxx
		Balance	xxxx
	xxxx		xxxx
Balance	xxxx		

The **Debtors Subsidiary Ledger** provides a ledger account for each separate debtor. This ledger provides all the information about individual debtor transactions.

The total of the Debtor Subsidiary Ledger must agree to the balance of the Debtor Control Account. Each transaction affecting debtors must, therefore, be recorded in **both** the Debtors Control Account and in the Debtors Subsidiary Ledger.

The **Schedule of Debtors** shows the total of all **debtors** in the Subsidiary Ledger, showing their name, account number and the amount owed. The total should reconcile with the balance recorded in the Debtor Control.

Using subsidiary and control accounts has several advantages;

- Removes unnecessary detail from the General Ledger, Trial Balance and Balance Sheet.
- Organises information of each subsidiary account, which allows easy access to information, for example, individual outstanding debtor balances.
- Provides an additional crosschecking mechanism, which reduces errors and the opportunity for fraud and mismanagement (as ledgers can be appointed to different employees, assisting in separating duties).

## Example – Subsidiary Ledger and Debtor Control

Joshuah uses subsidiary and control accounts to record his debtors. He provides you with the following information; Schedule of debtors for the year ended 30 June.

### Schedule of Debtors

D Pardon	1,200
B Knowles	1,700
J Jackson	500
P McCartney	350
	<u>3,750</u>

Total of Schedule of Debtors equals with balance of Debtor Control

Step 1- Record the opening balances in the Subsidiary Ledger and the Debtors Control.

General Ledger			
Debtor Control			
1-Jul	Balance	3,750	

**Debtors Subsidiary Ledger**

D Pardon		
1-Jul	Balance	1,200
B Knowles		
1-Jul	Balance	1,700
J Jackson		
1-Jul	Balance	500
P McCartney		
1-Jul	Balance	350

**Example continued**

The following transactions occurred in the first week of July:

- 1st – B Knowles settles her account in full. She receives a 2% discount for early repayment.
- 5th – Made a credit sale of \$500 to J Jackson.
- 7th – Joshua is informed that P McCartney has filed for bankruptcy. Payment is not expected.

Step 2 – Record the transactions in the Subsidiary Ledger and the Debtors Control.

**General Ledger**

Debtor Control					
1-Jul	Balance	3,750	7-Jul	Discount allowed	34
7-Jul	Sales	500	7-Jul	Bank	1,666
			7-Jul	Bad debts	350

**Debtors Subsidiary Ledger**

D Pardon				
1-Jul	Balance	1,200		
B Knowles				
1-Jul	Balance	1,700		
		1-Jul	Discount allowed	34
		1-Jul	Bank	1,666
J Jackson				
1-Jul	Balance	500		
5-Jul	Sales	500		
P McCartney				
1-Jul	Balance	350		
		7-Jul	Bad debts	350

**Example – continued**

Step 3 – Balance the subsidiary ledger accounts and complete the Schedule of Debtors.

**Debtors Subsidiary Ledger**

D Pardon						
1-Jul	Balance	1,200		7-July	Balance	1,200
		1,200				1,200
8-Jul	Balance	1,200				
B Knowles						
1-Jul	Balance	1,700		1-Jul	Discount allowed	34
				1-Jul	Bank	1,666
J Jackson						
1-Jul	Balance	500				
5-Jul	Sales	500				
		1,000				
P McCartney						
1-Jul	Balance	350		7-Jul	Bad debts	350

Schedule of Debtors

D Pardon	1,200	
J Jackson	1,000	
	2,200	

Balance the Debtor Control Account and reconcile it against the Schedule of Debtors.

Debtor Control						
1-Jul	Balance	3,750		7-Jul	Discount allowed	34
7-Jul	Sales	500		7-Jul	Bank	1,666
				7-Jul	Bad debts	350
				7-Jul	Balance	2,200
		4,250				2,200
8-Jul	Balance	2,200				4,250

## Activities

### Activity 1 – Posting to Debtor Control Account and Subsidiary Accounts

Pete uses the subsidiary ledgers and control accounts to record debtor's information.

Use the following information to prepare the general ledger, the debtor's subsidiary ledger and the debtors' schedule.

Debtors balances at 1 July:

Schedule of Debtors	
J Nile	450
C Mount	1,100
K Kats	750
ABC Enterprise	2,000
	4,300

The following transactions occurred in July;

- 1<sup>st</sup> – ABC Enterprises bought \$700 worth of products on credit.
- 3<sup>rd</sup> – ABC Enterprises returned \$200 of the products bought on the 1<sup>st</sup>.
- 5<sup>th</sup> – Credit sale made to C Mount for \$1,000.
- 10<sup>th</sup> – K Kats paid 500 of the account owing.
- 11<sup>th</sup> – J Nile account is written off due to bankruptcy.
- 15<sup>th</sup> – ABC Settled their account.
- 15<sup>th</sup> – C Mount was charged \$20 in late fees.

Required;

- (a) Record the opening balances in the subsidiary ledger and the debtors control.
- (b) Record the transactions in both the debtor control and subsidiary accounts.
- (c) Balance the debtor control for the year ended the 15<sup>th</sup> of July and subsidiary accounts.
- (d) Complete the schedule of debtors.

**General Ledger**

Debtor Control

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**Debtors Subsidiary Ledger**

J Nile

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C Mount

--	--

K Kats

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ABC Enterprise

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Schedule of Debtors	

## Activity 2 – Posting to Debtor Control Account and Subsidiary Accounts

Naomi uses the subsidiary ledgers and control accounts to record debtor's information for her catering business. Use the following information to prepare the general ledger, debtor's subsidiary ledger and the debtors' schedule.

Debtors balances at 1 August:

Schedule of Debtors	
Entertaining Co	500
Professional Events	10,000
M & D Howards	4,500
D Love	5,000
	20,000

2/8 – Invoiced Mr and Mrs Carlos for a their wedding catering, \$6,500.

4/8 – Entertaining and Co paid their account and were given a 2% discount for prompt payment.

10/8 – M&D Harold were charged an additional \$50 for late payment.

17/8 – D Love were billed \$2,000 for another event.

30/8 – Professional events paid 60% of their outstanding debt.

Required:

- Record the opening balances in the subsidiary ledgers and the debtor control.
- Record the transactions in both the debtor control and subsidiary accounts.
- Balance the debtor control and subsidiary accounts.
- Complete the schedule of debtors.

**General Ledger**

Debtor Control

---

**Debtors Subsidiary Ledger**

Entertaining and Co

---

Professional events

---

M & D Harold

---

D Love

---

Mr & Mrs Carlos

---

Schedule of Debtors	

## Activity 3 – Posting to Debtor Control Account and Subsidiary Accounts from Single Entry Journals

Celine uses subsidiary ledgers to record debtor information.

Use the following information to prepare the general ledger, the debtors subsidiary ledger and the debtors schedule.

Debtors balances at 1 January:

S Violet	2,000
R Rose	3,500
T Lily	800
S Jasmine	1,200
	<u>7,500</u>

### Sales Journal

Date	Debtors	Amount
Jan 6	R Rose	1,500
12	D Daisy	4,000
14	S Violet	1,000
16	S Jasmine	2,000
		<u>8,500</u>

### Sales Returns Journal

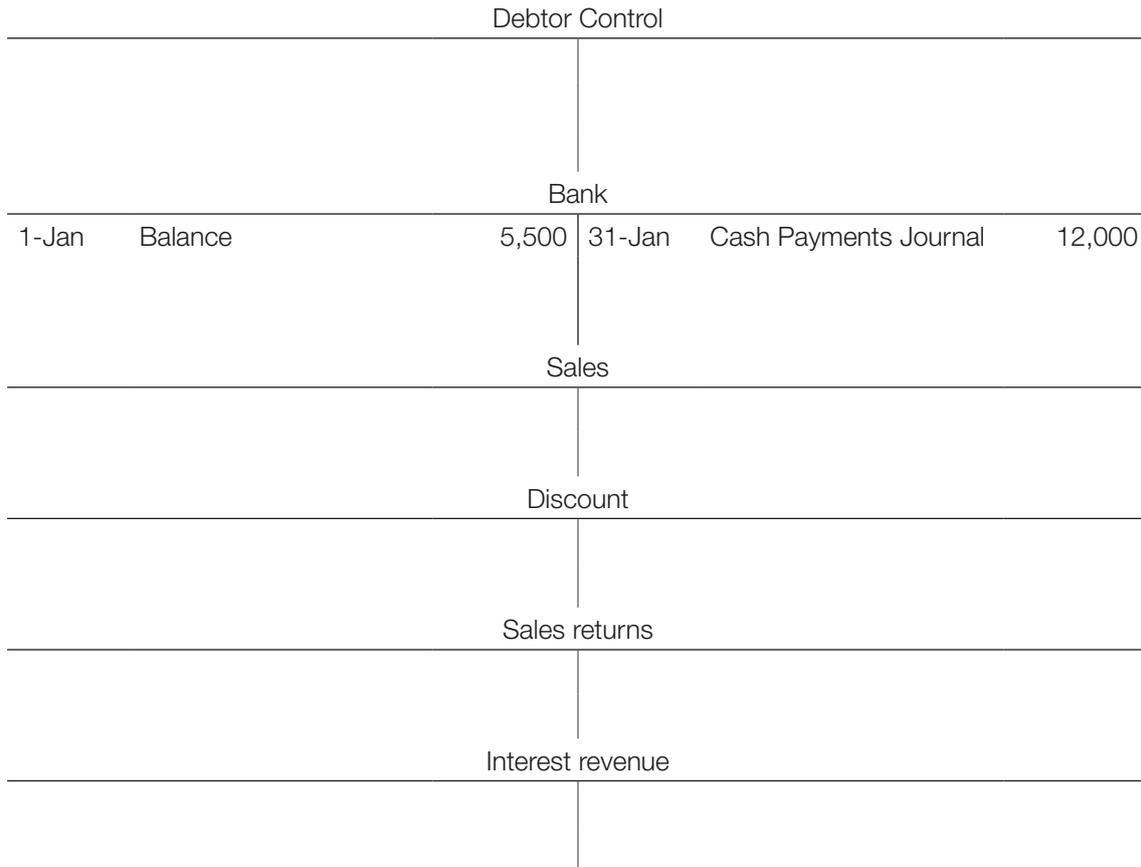
Date	Debtors	Amount
Jan 9	R Rose	250
15	D Daisy	400
		<u>650</u>

### Cash Receipts Journal

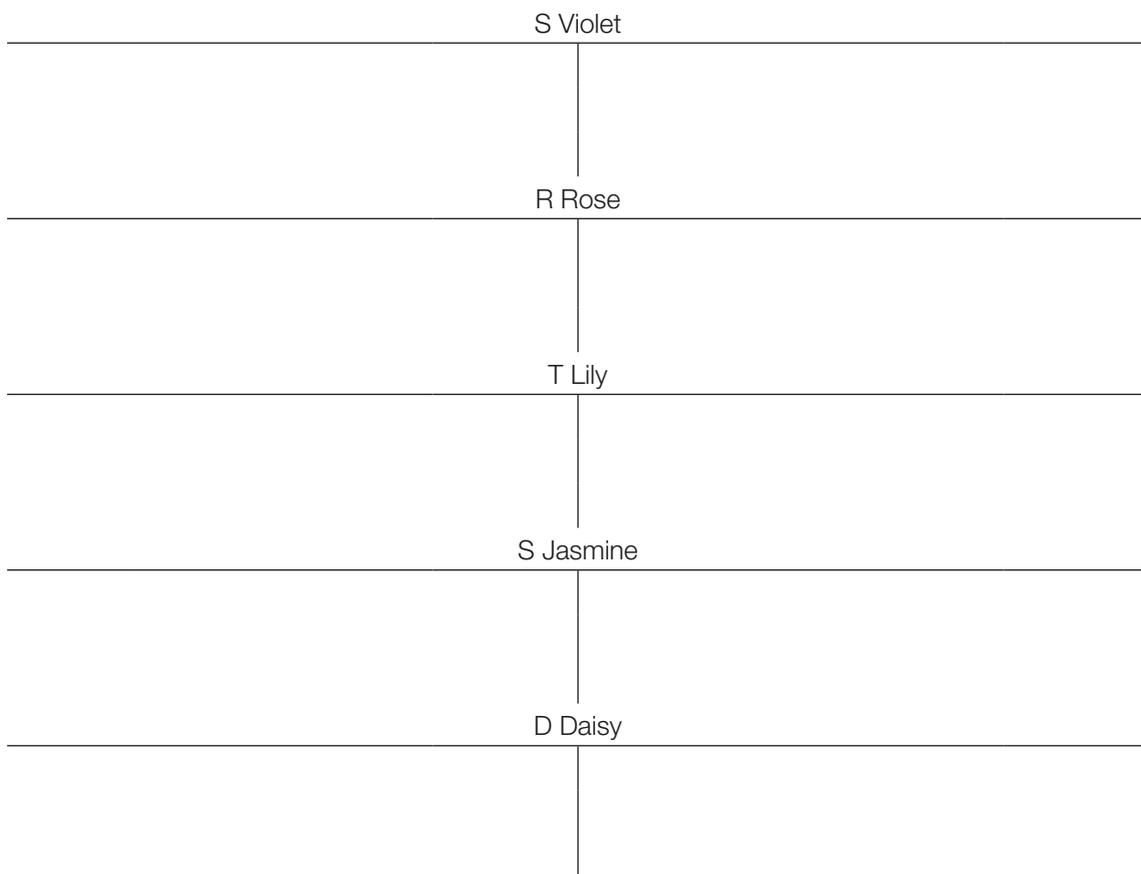
Date	Particulars	Discount	Debtors	Sales	Other	Bank
Jan-01	S Jasmine	100	1,100			
	Sales			400		1,500
4	Interest revenue				200	
	Sales			900		1,100
12	R Rose	50	3,200			
	S Violet		2,000			
	Sales			800		6,000
24	Sales			700		700
28	D Daisy		3,600			3,600
		150	9,900	2,800	200	12,900

- Record the opening balances in the subsidiary ledgers and the debtor control.
- Record the transactions in both the debtor control and subsidiary accounts.
- Balance the debtor control and subsidiary accounts.
- Complete the schedule of debtors.

**General Ledger**



**Debtors Subsidiary Ledger**



Schedule of Debtors	

### Activity 4 Managing Collections from debtors

## Evaluating collections

### Aging Analysis

The Aging Analysis of debtors report displays amounts owed by customers according to the length of time amounts remain unpaid. Figure 4.2.2 provides an example.

**Aging Analysis of Debtors  
Harris and Co  
for the year ended 30 June**

Debtor	Current	31-60 Days	61-90 days	Older	Total
ABC Corp.	1,400				1,400
B Weeks			500	600	1,100
Clear Solutions	1,400				1,400
Luna Barks		2,000		1,000	3,000
	2,800	2,000	500	1,600	6,900

*Figure 4.2.2 – Ageing analysis of Debtors*

### Activity 4

Examine figure 4.2.2.

(a) Which debtors are at the highest risk of default? Explain your answer.

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(b) Discuss the impact late payments can have on a business.

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(c) What does the Aging Analysis report indicate about the effectiveness of the management of debtors by Harris and Co?

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(d) Referring to figure 4.2.2, recommend strategies Harris and Co could implement to improve their debtor collection.

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The Aging Analysis of debtors helps management review the effectiveness of debt collection strategies and screening policies. It assists in identifying debtors who are at high risk of default or require management’s attention as they are doubtful and could become bad debts.

The report indicates:

- overdue accounts, assisting management in determining the debtors who need further action to collect outstanding accounts.
- identifies potential bad debts.
- customers who consistently breach the payment terms. This may result in refusal of future credit.

The Aging Analysis is useful tool for:

- evaluating the effectiveness of collection procedures and screening policies. If the report indicates poor collection results, so that management may enhance the screening of debtors, enforce late fees for late payment or offer a discount for early payments.
- A more accurate calculation of bad and doubtful debts.

## Debtor Turnover

The debtor turnover measures how many times a firm turns its debtors into cash during a period. It shows how long, on average, debtors take to pay. It therefore indicates the efficiency of a firm in issuing and collecting debts. A high debtor turnover indicates better control over debtors. Poor debtor control can lead to problems with cash flow.

$$\text{Debtor Turn Over} = \frac{\text{net credit sales}}{\text{debtors}^*} \text{ expressed in times}$$

\* Debtors should be averaged using the opening and closing figures where available.

A high turnover ratio indicates;

- an appropriate credit policy
- efficient collections department
- responsible customers, who respect the trade terms.

A low turnover ratio represents an opportunity for management to collect excessively old debtors and improve cash inflow.

It is helpful to convert the turnover into average collection days. This allows easy comparison to the firm’s credit terms.

$$\text{Average collection in days} = \frac{\text{days in period}}{\text{debtor turnover}} \text{ expressed in days}$$

Firms should aim for a short average collection period as this indicates quick collection of debtors.

Effective management of debtors should result in the average days for debtor collection being within trade terms. It is important to note that trade terms vary between businesses and industries; however, the standard is 30 days. Some businesses will deliberately offer long trading terms. This strategy can improve a firm’s competitiveness as customers are often attracted to businesses that offer longer trading terms.

## Example – Calculating and Interpreting the Debtor Turnover

Trade terms	15 days
Net credit sales December	2,000
Debtors December	500
Debtors November	600

To calculate the debtor turnover for December.

$$\text{Debtor turnover} = \frac{\text{Net credit sales}}{\text{Average debtors}}$$

$$\begin{aligned} \text{Debtor turnover} &= \frac{2,000}{550} \\ &= 3.67 \text{ times per month} \end{aligned}$$

To calculate the average collection days for December

$$\text{Average collection days} = \frac{\text{days per period}}{\text{debtor turnover}}$$

$$\begin{aligned} \text{Average collection days} &= \frac{31}{3.67} \\ &= 8.45 \text{ days, always round up} \end{aligned}$$

On average, debtors take 9 days to pay their accounts. The trade terms are 15 days; this means that on average, debtors pay 6 days earlier than required. This indicates that management have been very effective in controlling debtors.

4

## Improving Debtor Turnover

There are a number of strategies to improve debtor turnover;

### Screening debtors

- It is important that only reliable, low risk customers are extended credit.
- Customers are screened before being granted credit. Customers judged as high risk are not extended credit, or only extended on a provisional basis. Credit risk can be assessed by reviewing;
  - Credit rating
  - Financial records

Alternatively, businesses can request a reference from another credit provider.

### Retraction of credit

- Debtors who consistently neglect credit terms may have their credit terminated. This strategy needs to be carefully used as it may damage client relations.

### Collection strategies

It is important to provide incentive to customers to pay on time. Strategies may include:

- Reminder letters/ emails
- Early payment discount
- Fees for late payment

### Aggressive strategies

- Businesses may choose to engage in tougher tactics to collect high-risk overdue accounts. They may employ a debt collector to handle collections or threaten legal action to debtors with long outstanding accounts.
- Factoring debtors by selling the debt to a bank or debt collecting agency for a percentage of the debtor value.

Activities

### Activity 5 – Calculating the Debtor Turnover

Harris and Co offer credit to a selected group of customers. Their trade terms are 30 days. Harry, the owner, normally offers the credit facility to his most loyal customers. Normally, he will issue reminders once the debt is 37 days outstanding. He rarely takes an aggressive approach to chasing up outstanding debts, as he believes that it is ‘bad for business.’

He has provided you with the following data;

Net credit sales July	17,000
Debtors June	20,000
Debtors July	22,000

(a) Calculate the debtor turnover for July.

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(b) Calculate the average collection days for July.

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(c) Comment on the results from a & b.

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(d) Comment on Harry’s approach to managing debtors. If required, recommended changes.

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### Activity 6 – Calculating the Debtor Turnover

Jules the Jeweller runs a small service, repairing and making custom jewellery pieces. Typically, all her sales are made on credit as she sends an invoice to clients after they have collected their items. She would like information about the average time it takes for her debtors to settle their accounts because she is considering revising her payment policy. Her trade terms are currently 30 days.

She has provided you with the following data;

Net credit sales current financial year	170,000
Debtors prior	19,000
Debtors current	23,000

(a) Calculate the debtor turnover for the current fiscal year.

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(b) Calculate the average collection days for the year.

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 .. .....

(c) Comment on the results from a & b.

.. .....  
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(d) Jules is considering changing her payment policy to full upfront payment. Discuss the advantages and disadvantages of this strategy.

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### Impact of Innovation

There have been significant developments in the capabilities of accounting software. Many programs automate some of the debtor management processes and provide access to real time data. Debtor management functions include;

- automatic reconciliation of payments
- automatic invoice reminder functions
  - emails to customers who have an overdue invoice
  - users can set the customize the emails' tone and timing.
- access to live, complete, up-to-date data about debtors.

The information in Figure 4.2.3 shows what is presented on a standard Xero dashboard. It provides an up-to-date aging analysis. Furthermore, users can simply click on the summary information for details of the outstanding debtor accounts.



Figure 4.2.3- Xero dashboard summary example



## Accounting for Bad Debts and Doubtful Debts

### Accounting of bad debts

Unfortunately, not every debtor will end up paying their account. When a debt is deemed uncollectable, it is written off as a bad debt. A debt may be deemed uncollectable because:

- The customer has been declared bankrupt or insolvent, and therefore, is no longer responsible for paying the debt.
- Collection efforts have not been effective and/ or the resources required to recoup the debt outweigh the value of the outstanding debt.

### Writing off bad debts

Once a debtor has been recognised as bad, and if a business is using the direct write-off method and does not have an allowance for doubtful debts, the following entry is required.

Date	Particulars	Debit	Credit
xxx	Bad debt expense	xxx	
	Debtor control/ Subsidiary ledger		xxx
	<i>To write off bad debts</i>		

The journal entry reduces the debtor balance, to reflect that the amount is no longer expected to be received from the customer. The bad debt expense is classified as a financial expense because it is an economic loss arising from the financial practice of extending credit to customers.

Note that bad debts are only written off as bad debt expenses if the firm does not have an allowance for doubtful debts.

### Accounting for Doubtful debts

**Bad debts** refers to amounts that have been written off because the debtor is definitely not going to pay. **Doubtful debts** indicate a portion of debtors that are predicted to be uncollectible in the future. Often the bad debts and doubtful debts are grouped together in an account called **bad and doubtful debts expense**.

Firms which account for doubtful debts must also have an allowance for bad and doubtful debts. An allowance for doubtful, or bad debt reserve, is a contra asset account. The allowance for doubtful debts is shown as a negative current asset in the balance sheet. As demonstrated in Figure 4.2.4, deducting the allowance for doubtful debts from debtors produces the net debtors figure, which indicates estimated debtor collections.

Extract from the Balance Sheet

Current Assets			
Cash		10,000	
Debtors	12,000		
Less allowance for Doubtful debts	<u>3,000</u>	9,000	
Inventory		<u>5,000</u>	
Total Current Assets			24,000

*The allowance is deducted* (arrow pointing from 10,000 to 3,000)

*Net debtors are calculated. This indicates the amount expected to be received from debtors* (arrow pointing from 9,000 to 24,000)

Figure 4.2.4 – Presentation of Allowance for Doubtful debts on the Balance Sheet

The concept of prudence requires a conservative approach to be used in the valuation of assets. Accounting for doubtful debts through an allowance account provides a prudent valuation of assets as it recognises that it is not likely to receive the all debtors. Therefore, the Debtor balance is an over-valuation of what will be collected in the future. The net debtor balance provides a more prudent valuation of debtors.

Accounting for doubtful debts through an allowance account also follows the matching principle, by recognising the bad and doubtful debt in the period that relates to the revenue (the credit sales).

To establish a provision for doubtful debts, the following entry is used.

*An end of period adjustment*

**Financial Expense:** The expenses are linked to the credit sales raised this period. Thus recognizes the financial costs of providing credit services to customers.

Date	Particulars	Debit	Credit
xxx	Bad and Doubtful Debts Expense	\$\$\$\$	
	Allowance for Doubtful Debts		\$\$\$\$

*This entry can be used to establish a allowance for doubtful debts for the first time, or to adjust the allowance for doubtful debts at the end of the period.*

*The allowance or provision for doubtful debts is established. When bad debts become certain, they are written off against this allowance.*

The write off an uncollectible bad debt account:

Date	Particulars	Debit	Credit
xxx	Allowance for Doubtful debts	\$\$\$\$	
	Debtor/subsidiary debtor account		\$\$\$\$

Note; A debtor can only be written off to the allowance for doubtful debts, if there is a pre-existing allowance. If there is not, the debt is to be written off through the bad debts account.

### Example – Writing off bad debts with no existing Allowance for Doubtful Debts

Harris and Co has informed on the 15<sup>th</sup> of July that Luna Barks, who owes \$4,000, has filed for bankruptcy. Harris and Co **does not** have an Allowance for Doubtful Debts.

The following entry is required to write off the bad debt.

Date	Particulars	Debit	Credit
15/7	Bad debts	4,000	
	Debtor Control/ Luna barks		4,000

The posting of this transaction to the General Ledger will have the following impact:

Debtor Control			
1/7 Balance	60,000	15/7 Bad debts	4,000
Bad debts			
15/7 Debtor Control	4,000		



## Example – Writing off bad debts with an existing Allowance for Doubtful Debts

Harris and Co was informed on 15<sup>th</sup> of July 2020 that Luna Barks, who owes \$4,000, has filed for bankruptcy. Harris and Co does has an Allowance for Doubtful Debts of 5,000.

The following entry is required to write off the bad debt.

Date	Particulars	Debit	Credit
15/7	Allowance for Doubtful debts	4,000	
	Debtor Control/ Luna barks		4,000
<i>To write off bad debts</i>			

The posting of this transaction to the General Ledger will have the following impact:

Debtor Control			
1/7 Balance	60,000	15/7 Allowance for Doubtful debts	4,000
<hr/>			
Allowance for Doubtful debts			
15/7 Debtor Control	4,000	1/7 Balance	5,000

It is expected that 10% of debtors will go bad. On the 31<sup>st</sup> July the allowance is to be adjusted to this amount.

10% of debtors (56,000 × 10%) = 5,600

The existing balance in the Allowance for Doubtful Debts is 1,000 credit; therefore, 4,600 adjustment is required to bring the account to 10% of debtors.

Date	Particulars	Debit	Credit
31/7	Bad and doubtful debts	4,600	
	Allowance for Doubtful debts		4,600
<i>To adjust the allowance to be 10% of debtors</i>			

Allowance for Doubtful debts			
15/7 Debtor Control	4,000	1/7 Balance	5,000
31/7 Balance	<u>5,600</u>	31/7 Bad and doubtful debts	<u>4,600</u>
	9,600		9,600
		1/8 Balance	5,600

**Activities**

**Activity 7 – Writing off bad debts**

Naomi’s catering clients all pay on credit. Her policy allows customers 30 days to pay after the catering event. As all of her sales are on credit and she periodically needs to write off bad debts. She does not have an Allowance for Doubtful Debts.

Despite her many efforts to recoup D Loves outstanding account, which is 13 months overdue, on the 1<sup>st</sup> of March she has determined the \$5,000 debtor balance is irrecoverable.

(a) Prepare the Journal entry to write off the bad debt.

Date	Particulars	Debit	Credit

(b) Naomi is considering establishing an Allowance for Doubtful Debts. Discuss the advantages of using this approach.

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**Activity 8 – Writing off bad debts and establishing an allowances**

After writing off a number of bad debts in the prior financial year, Celine has decided to establish an Allowance for Doubtful debts for the current fiscal year. In prior years, 5% of her debtors were written off and she predicts future bad debts will follow this pattern. Her closing debtor balance was \$12,000 in July 2020.

(a) Establish the Allowance of Doubtful Debts.

Date	Particulars	Debit	Credit

(b) On August 10, P Evans owing \$1,000 for work performed in July, informed Celine that he is filing for bankruptcy. Write off the bad debt and post it to the Allowance for Doubtful Debts.

Date	Particulars	Debit	Credit

Allowance for Doubtful debts	



- (c) At the end of August the debtors' balance is 15,000. Adjust the Allowance for Doubtful Debts to be equal to 5% of debtors and post the adjustment to the Allowance for Doubtful Debts ledger.

Date	Particulars	Debit	Credit

Allowance for Doubtful debts

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### Activity 9 – Writing off bad debts and adjusting allowances

On the 1 December, Pete had an existing Allowance for Doubtful Debts of \$500. On 17 December, he discovered \$200 of overdue accounts, which need to be written off.

- (a) Write off the bad debts.

Date	Particulars	Debit	Credit

- (b) Pete prepares an adjusting journal every month to allow for 2% of debtors to go bad. On the 31 of December the debtor balance was \$17,000.

Date	Particulars	Debit	Credit

**Extended Activity**

**Debtor and Inventory Management**

Lux Walls Pty Ltd sells paint and wall paper supplies. Robyn, the owner, offers credit to some of her commercial clients. Credit terms are 30 days. The store uses subsidiary ledgers to record debtors and inventory. During **one week** in September, Lux Walls recorded the following transactions:

- 20 September Purchased goods on credit for \$1,000 from Delux.
- 20 September Sold goods to Cherry Constructions on credit for \$300 (cost \$100) and charged \$30 delivery.
- 21 September \$100 of the purchases were returned to Delux
- 21 September Cherry Constructions returned \$50 of goods (cost \$20). They also settled their account, being allowed a \$20 discount.
- 22 September Purchased goods for \$200 cash.
- 23 September Sold \$600 (cost \$200) of products to Lush Design Studio on account.
- 24 September Destroyed damaged stock with a selling price of \$210 (cost \$115).  
Sold goods for \$795 cash (cost \$280).
- 30 September Informed that F Fluro have gone bankrupt. Outstanding bills totaled \$400

(a) Using the information, complete and formally balance the debtors' control account for Lux Walls Pty Ltd for the month of September.

Debtor Control		
20-Sep	Balance	4,000

(b) How can Robin verify the closing balance of the debtors' control account?

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(c) Calculate the debtor turnover. Analyse the results. Recommend strategies for improvement.

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(d) Complete and formally balance the inventory control account.

Inventory Control		
20-Sep	Balance	2,000



- (e) Calculate the inventory turnover for the period. Comment on the results and analyse the efficiency of inventory management. Discuss possible reasons for the results and the implications for the business.

Inventory turnover in days	Industry Average	Period last year
	30	35

Show your calculation for the inventory turnover in days here. (Hint: Be careful with number of days).

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- (f) Lux Walls Pty Ltd records the following transactions:

- 21 Sept \$100 of the purchases were returned to Deluxe
- 23 Sept Sold \$600 (cost \$200) of products to Lush design studio on account.
- 30 Sept Informed that F Fluro have gone bankrupt. Outstanding bills totalled \$400

Show the effect of this transaction on the income statement, and the balance sheet.

Transaction	Balance Sheet			Income Statement				
	Assets	Liabilities	Owners' Equity	Revenue	Cost of goods sold	Selling expenses	Administrative expenses	Financial expenses
21 <sup>st</sup> Sept								
23 <sup>st</sup> Sept								
30 <sup>th</sup> Sept								

- (g) Prepare the abstract of the Income Statement for Lux Walls Pty Ltd for the year ended 30 September.

Income Statement (abstract) for Lux Walls Pty Ltd  
for the period ending 30 September

REVENUE	
COST OF GOODS SOLD	
GROSS PROFIT	

(h) Lux Walls Pty Ltd has provided the following transactions.

- 5 Oct Sold 4 rolls for cash for \$25 per roll
- 10 Oct Purchased 5 rolls for \$11 on credit.
- 15 Oct Sold 8 rolls to Cherry Constructions for \$25 per roll
- 16 Oct Cherry Constructions returned 3 rolls bought on the 15<sup>th</sup>
- 20 Oct Robyn discovered that 2 of the rolls purchased on the 10<sup>th</sup> were damaged. She returned these rolls to the supplier.
- 25 Oct Cherry Constructions settled their account.
- 31 Oct Stock take revealed that there were 2 rolls on hand.

Complete the inventory card for wallpaper for October using the **FIFO method**:

Date	Description	In		Out		Balance		
		Qty	Cost	Qty	Cost	Qty	Cost	Total
1-Oct	Balance					9	10	90

(i) In October, Robyn started to use data analytics to forecast her inventory demand. She has used this information for purchasing. Her aim is to hold lower levels of inventory. Comment on the advantages and disadvantages of using this approach.

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(j) After reviewing her inventory, Robyn discovered 20 rolls of old wallpaper stock. This wallpaper, is now old and out of fashion, making it difficult to sell. She originally bought the paper for \$9 per roll. She has now reduced the selling price to \$6 per roll. State the value of inventory, which should be reported. Justify your answer.

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## 4.3 – Managing Non-current Assets

### Fixed Assets

Fixed assets or non-current assets are purchased for long-term use and are not likely to be converted into cash over the short-term. These assets are held to support the business in generating revenue. Examples include;

- vehicles
- office furniture
- equipment
- fixtures and fittings
- machinery
- buildings
- land

### Valuation of Assets

The valuation of assets can have a significant impact on the representation of the business's financial position on the balance sheet. There are three approaches used to value assets;

#### Historical cost

Under this method, assets are valued at the acquisition cost, plus any additional costs associated with getting the asset ready for use. Additional costs may include:

- installation costs
- modification costs
- customs duties or delivery inwards
- buying expenses

This method of valuation is considered to be the most objective because it is based on documentary evidence, such as invoices, which is free from bias. Faithful representation requires financial information to be unbiased, and it is for these reasons that accountants use this method.

#### Replacement Value

This valuation method uses the cost that the firm would need to pay to replace the asset. This method is not used in accounting because it is not based on objective information. Replacement value is subjective and can produce inconsistent results.

#### Market Value

This method uses the current market price that the assets would be able to be sold for. Advertised prices of similar assets can be used to estimate this value. However, market prices are inconsistent, vary greatly and thus, are based on bias information. Therefore, accountants do not use this method.

### Controlling fixed assets

Management should consider the following when designing strategies for controlling and monitoring fixed assets.

- physical controls to verify the existence and condition of the assets (Asset register)
- safeguarding assets
- accurate record-keeping
- appropriate maintenance

## Depreciating Fixed assets

Most fixed assets, excluding land, depreciate with use and time. Accounting for depreciation recognises that the economic benefits associated with using an asset are consumed over the assets life. Depreciation allocates the cost of the asset over its useful life. The depreciation entry therefore applies the accrual concept.

The general journal entry to record depreciation is;

Date	Particulars	Debit	Credit
30 June	Depreciation expenses	xxx	
	Accumulated Depreciation		xxx
To record depreciation for the period			

The depreciation expenses recognises that the business has consumed economic benefits during the accounting period. The depreciation expense is therefore allocated as an expenses in the income statement.

The accumulated depreciation is a contra asset account. It records the reduction in assets carrying amount.

Balance Sheet Abstract		
<i>Non -Current Assets</i>		
Vehicle	xxx	
Accumulated depreciation on Vehicle	(xxx )	xxx

The asset will be recorded at the original price. This follows the historical cost rule

The accumulated depreciation is a negative figure as it records the reduction in asset value

The carrying amount = Historical Cost – Accumulated depreciation. It is also called the Book Value.

## Calculating depreciation

There are three depreciation methods used to calculate the annual depreciation expense;

- straight line
- diminishing
- units of use

Calculations will use the following information;

- Historical cost – this is the original price paid plus costs associated with getting the asset ready for use.
- Useful life (time) – the estimated number of years that the asset will be used for revenue creation.
- Useful life (units) – the estimated number of units that the asset will be used for revenue creation. Useful life may be measured in kilometres or units produced.
- Book value/ carrying amount – is the historical cost less accumulated depreciation. The amount should always be indicated on the balance sheet.
- Salvage value/ scrap value/ residual value – this is the estimated book value of an asset after it has been fully depreciated, at the end of the assets useful life.
- Depreciation rate – the percentage rate of depreciation allocated to the asset. The depreciation formula requires either the depreciation rate or the useful life.



## Straight-line (on cost) method

The straight-line depreciation is the simplest method to calculate depreciation.

The formula for this method is:

$$\text{Depreciation expenses} = \frac{\text{Historical Cost} - \text{Residual Value}}{\text{Useful life}}$$

Or

$$\text{Depreciation expenses} = (\text{Historical Cost} - \text{Residual Value}) \times \text{rate}$$

This method depreciates the asset evenly through its' useful life. It is appropriate when an asset's benefits are evenly consumed throughout its life. It is commonly used for:

- Fixtures and fittings
- Office furniture

### Example – Straight line

On the 1<sup>st</sup> of July 2020 ABC Learning supplies purchased 20,000 in fixtures and fittings for its office space. The manager estimates that the residual value will be 5,000, at the end of its useful life, which is anticipated to be 15 years.

To calculate the annual depreciation:

$$\text{Depreciation expenses} = \frac{20,000 - 5,000}{15}$$

$$\text{Depreciation expenses} = \$1,000$$

The following entry records the depreciation entry.

Date	Particulars	Debit	Credit
30 June	Depreciation expenses – Fixtures and fittings	1,000	
	Accumulated Depreciation Fixtures and Fittings		1,000

To record depreciation on fixtures and fittings for the periods.

The firm will record \$1,000 depreciation expense every year for the rest of the asset's useful life.

In the Income Statement the following is recorded:

Administration expenses		
Office rent	5,000	
Compliance costs	15,000	
Depreciation on Fixtures and Fittings	<u>1,000</u>	21,000

The name of the account includes the associated asset.

The depreciation account is classified as an administration expense because the asset associated with the depreciation is used for administrative purposes. If the asset is used for selling, then it will appear as a selling expense.

The Balance Sheet will record the total depreciation incurred over the assets life.

	Year 1		Year 2		Year 3	
Non-current assets						
Fixtures and Fittings	20,000		20,000		20,000	
Less Accumulated Depreciation	<u>1,000</u>	19,000	<u>2,000</u>	18,000	<u>3,000</u>	17,000

The asset value remains at historical costs throughout the asset's life

The accumulated depreciation increases throughout the asset's life as depreciation is posted each balance day.

The book value declines as depreciation increases

**Activities**

**Activity 1 – Straight line depreciation**

On the 1<sup>st</sup> of July Dimitri’s Sports Supplies purchased a delivery vehicle for 30,000. The manager estimates that the residual value will be 5,000, at the end of its useful life, which is anticipated to be 7 years.

(a) Calculate the annual depreciation.

(b) Record the depreciation entry.

Date	Particulars	Debit	Credit

(c) Show how the depreciation is recorded in the Income Statement.

Selling expenses		
Store rent	15,000	
Salespersons wages	25,000	

(d) Justify why the depreciation is classified as a selling expense.

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(e) Show how the accumulated depreciation is reported in the Balance Sheet.

	Year 1		Year 2		Year 3	
Non-current assets						



## Activity 2 – Straight line depreciation

On the 1<sup>st</sup> of July Massimo's Deli purchased a new office computer for 2,500. It is anticipated that the computer will be scrapped after 3 years with a nil value.

(a) Calculate the annual depreciation.

(b) Record the depreciation entry.

Date	Particulars	Debit	Credit

(c) Identify how the depreciation expenses on the computer would be classified as in the income statement. Justify the classification.

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(d) Calculate the accumulated depreciation and book value at the end of Year 3.

## Diminished Value/ Reducing Balance Method

The reduced balance method uses the book value to determine the annual depreciation expense. Unlike straight-line, the reducing-balance method will result in a diminished depreciation amount each year. It is for this reasons that this method is used when the majority of the economic benefits of an asset consumed at the beginning of the assets useful life.

**Depreciation expenses = (Historical Cost – accumulated depreciation) × rate**

Note: This method does not take the scrap value into account, when calculating the expense as it is factored into the rate.

## Example – Diminished balance

On the 1<sup>st</sup> of July ABC Learning supplies purchased a computer for 3,000. A 50% depreciation rate has been allocated.

To calculate the first year's depreciation:

$$\text{Depreciation expenses} = 3,000 \times 50\%$$

$$\text{Depreciation expenses} = 1,500$$

Note: In the first year, there is no accumulated depreciation

To calculate the second year's depreciation:

$$\text{Depreciation expenses} = (3,000 - 1,500) \times 50\%$$

$$\text{Depreciation expenses} = \$750$$

Note: the annual depreciation declines every year as the book value decreases.

To calculate the third year's depreciation:

$$\text{Depreciation expenses} = (3,000 - 2,250) \times 50\%$$

$$\text{Depreciation expenses} = \$375$$

The following entry records the depreciation entry for the first year.

Date	Particulars	Debit	Credit
30 June	Depreciation expenses- Computer	1,500	
	Accumulated Depreciation Computer		1,500
	To record depreciation on computer for the periods.		

Note: The accounts used to record this entry will remain same every year, however the depreciation amount will change.

The balance sheet will record the total depreciation incurred over the asset's life.

	Year 1		Year 2		Year 3	
Non-current assets						
Computer	3,000		3,000		3,000	
Less Accumulated Depreciation	<u>1,500</u>	1,500	<u>2,250</u>	750	<u>2,625</u>	375

## Activity 3 – Diminishing Balance

On the 1<sup>st</sup> of July Johny's Fruit and Veg purchased a forklift for 15,000. Johny's Accountant has advised that he apply the reducing balance method at a rate of 20%.

(a) Calculate the annual depreciation for Year 1, 2 and 3.

(b) Show how the accumulated depreciation is reported in the Balance Sheet.

	Year 1	Year 2	Year 3
Non-current assets			

## Partial Year Depreciation

The straight-line depreciation and diminishing value methods calculate the annual depreciation rate. When an asset has been held for less than a year, an adjustment for the length of time is required. This is because the standard depreciation formula assume that the asset has been held for the full year.

The calculate for partial year depreciation is:

### Straight Line

$$\text{Depreciation expense} = \frac{\text{Historical Cost} - \text{Residual Value}}{\text{Useful life}} \times \left( \frac{\text{Months held}}{12} \right)$$

Or

$$\text{Depreciation expense} = (\text{Historical Cost} - \text{Residual Value}) \times \text{rate} \times \left( \frac{\text{Months held}}{12} \right)$$

### Diminishing Balance

$$\text{Depreciation expense} = \text{Historical Cost} - \text{Accumulated Depreciation} \times \text{rate} \times \left( \frac{\text{Months held}}{12} \right)$$

## Example – Partial Year Depreciation

On the 1<sup>st</sup> of April Johnny's Fruit and Veg purchased a new cash register for \$2,000. They have selected to use the diminishing balance method at the rate of 40%. Balance day is 30 June.

To calculate the depreciation for Year 1:

$$\text{Depreciation expenses} = (\text{Historical Cost} \times \text{rate}) \times \left( \frac{\text{Months held}}{12} \right)$$

As at the 30 June the asset has been held for 3 months.

$$\text{Depreciation expenses} = (2,000 \times 40\%) \times \left( \frac{3}{12} \right)$$

$$\text{Depreciation expenses} = 200$$

## Example – Partial Year Depreciation

On the 1<sup>st</sup> of January ABC Learning supplies purchased new equipment for \$5,000. There is no residual value. The firm has 15,000 worth of existing equipment bought in previous years. A 10% straight-line depreciation rate has been allocated to equipment. Balance day is 30 June.

The new and old equipment are calculated separately.

To calculate the depreciation on the new equipment.

$$\text{Depreciation expenses} = (5,000 \times 10\%) \times \left( \frac{6}{12} \right)$$

$$\text{Depreciation expense on new equipment} = \$250$$

To calculate the depreciation on the old equipment:

$$\text{Depreciation expenses} = (15,000 \times 10\%)$$

$$\text{Depreciation expenses} = 1,500$$

$$\text{Total Depreciation for the period} = 250 + 1,500$$

$$\text{Total Depreciation for the period} = 1,750$$

## Activities

### Activity 4 – Partial Year Depreciation

On the 1<sup>st</sup> of July Dimitri's Sports Supplies presents you with the following information. You are to use the information provided to calculate depreciation, prepare the general journal entries and prepare the abstract from the balance sheet.

#### Trial balance as at 30 June

Computers	5,000	
Accumulated depreciation on computers		2,000
Machinery	20,000	
Accumulated depreciation on Machinery		3,000

#### Additional Information

- Computers are depreciated at 30% on the diminished balance. New computers for 2,000 were bought on the 1<sup>st</sup> of November. This amount has been recorded in the above figures.
  - Machinery is depreciated using the straight-line method at the rate of 15%.
  - On the 1<sup>st</sup> of February new Machinery was bought for 5,000. This amount has been recorded in the above figures.
- (a) Calculate the depreciation on computers.

- (b) Calculate the depreciation on machinery.

(c) Prepare the general journal entries to record the depreciation expenses.

Date	Particulars	Debit	Credit
	To record depreciation on computer for the periods.		
	To record depreciation on Machinery for the periods.		

## Units of use

The units of use or production method determines depreciation based on production or use. This method assumes that the consumption of the asset's economic benefits directly relates to the use of the asset.

$$\text{Depreciation expenses} = (\text{Historical Cost} - \text{Residual Value}) \times \frac{\text{Number of units used}}{\text{Useful life (units)}}$$

This method is commonly used to calculate depreciation on:

- motor vehicles
- machinery
- equipment

## Example – Units of use

On the 1<sup>st</sup> of July, Dimitri's Sports Supplies bought a Delivery Vehicle for \$18,000. It is estimated that the vehicle will have a useful life of 300,000 km and a residual value of 3,000. The vehicle has traveled 20,000 kilometers over the financial year.

The annual depreciation calculation is as follows:

$$\text{Depreciation expenses} = (18,000 - 3,000) \times \frac{20,000}{300,000}$$

$$\text{Depreciation expenses} = \$1,000$$

**Activities**

**Activity 5 – Units of Use**

On the 1<sup>st</sup> of February Johnny’s Fruit and Veg purchased a delivery vehicle for \$30,000. Johnny’s Accountant recommended that he use the units of use method. It is estimated that the vehicle will have a useful life of 250,000 km, and a scrap value of \$5,000. Balance day is 30 June.

In Year 1 the vehicle traveled 70,000km

In Year 2 the vehicle traveled 80,000km

In Year 3 the vehicle traveled 92,000km

(a) Calculate the depreciation expense for Year 1, 2 and 3..

Year 1

Year 2

Year 3

(b) How would the depreciation expense be classified in the Income Statement?

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(c) Justify why the units of use is an appropriate method for calculating depreciation on the delivery vehicle.

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## Extended Activity

### Adjusting trial balance for depreciation

Trinity's the owner of Trinity's Trinkets has asked you to prepare an Adjusted Trial Balance, Income Statement and Balance Sheet. She has provided you with the Unadjusted Trial Balance.

#### Trinity's Trinkets As at 30 June

	Debit	Credit
Building	\$ 900,000	
Sales		\$ 80,000
Sales returns	\$ 8,000	
Drawings	\$ 29,000	
Inventories	\$ 30,000	
COGS	\$ 20,000	
Delivery Vehicle	\$ 38,000	
Accumulated depreciation- Delivery Vehicles		\$ 8,000
Land	\$ 150,000	
Advertising	\$ 2,400	
Insurance on building	\$ 1,600	
Internet and Telephone	\$ 1,200	
Compliance expenses	\$ 1,000	
Debtors	\$ 10,000	
Creditors		\$ 13,000
Cash at bank	\$ 5,650	
Store fixture and fittings	\$ 6,000	
Accumulated depreciation- store fixtures and fittings		\$ 1,000
Interest received		\$ 2,000
Office equipment	\$ 5,000	
Accumulated depreciation- Office Equipment		\$ 1,200
Mortgage on land and buildings		\$ 700,000
Capital		\$ 458,650
Salesperson Salaries	\$ 60,000	\$ 4,000
	\$ 1,267,850	\$ 1,267,850

Required Adjustments:

- The depreciation on delivery vehicle is calculated using unit of use. It is expected that the vehicle have a useful life of 250,000 km. It travelled 30,000 during the financial year.
- The store Fixtures and Fittings are depreciated using the straight-line method at the rate of 15%. New Fixtures and Fittings of 2,000 were purchased on the 1<sup>st</sup> of March. This purchase is reflected in the trial balance.
- The Office Equipment are depreciated using the diminishing balance method at the rate of 20%.

(a) Calculate the depreciation.

**Delivery Vehicle**

**Fixtures and Fittings**

**Office Equipment**

(b) Adjust the Trial Balance to reflect the additional depreciation adjustments.

Trinity's Trinkets  
for the year ended 30 June

	Debit	Credit
Building	\$ 900,000	
Sales		\$ 80,000
Sales returns	\$ 8,000	
Drawings	\$ 29,000	
Inventories	\$ 30,000	
COGS	\$ 20,000	
Delivery Vehicle	\$ 38,000	
Accumulated depreciation – Delivery Vehicles		\$ 8,000
Land	\$ 150,000	
Advertising	\$ 2,400	
Insurance on building	\$ 1,600	
Internet and Telephone	\$ 1,200	
Compliance expenses	\$ 1,000	
Debtors	\$ 10,000	
Creditors		\$ 13,000
Cash at bank	\$ 5,650	
Store fixture and fittings	\$ 6,000	
Accumulated depreciation – store fixtures and fittings		\$ 1,000
Interest received		\$ 2,000
Office equipment	\$ 5,000	
Accumulated depreciation – Office Equipment		\$ 1,200
Mortgage on land and buildings		\$ 700,000
Capital		\$ 458,650
Salesperson Salaries	\$ 60,000	\$ 4,000
Depreciation- Delivery Vehicles		
Depreciation- Fixtures and Fittings		
Depreciation- Office Equipment		

(c) Prepare the Adjusted Income Statement and Balance Sheet.

**Income Statement of Trinity's Trinkets**  
**for the year ended 30 June**

<b>REVENUE</b>
COST OF GOODS SOLD
<b>GROSS PROFIT</b>
OTHER REVENUE
EXPENSES
Selling Expenses
Administrative Expenses
Financial Expenses
<b>PROFIT</b>



# Asset Register

To effectively manage assets, managers need to keep sufficient records. The details held in the general ledger do not provide enough details to meet manager’s information requirements. Therefore, businesses are required to maintain an Asset Register to enable sufficient record keeping. An example of an asset register is shown in figure 4.3.1.

Serial No. _____					
Type _____		Manufacturer _____		Account No. _____	
Location _____		Supplier _____		Est. Res. Value _____	
Purchase Date _____		Estimated life _____		Dep'n. Rate _____	
Dep. Method _____		Taxable Rate of Dep'n _____			
Date	Particulars	Original Cost	Annual Accounting Dep'n	Accumulated Depreciation	Tax Depreciation
<b>(Reverse Side)</b>					
<b>Repairs and Maintenance</b>				<b>Remarks</b>	
Date	Repairer	Cost			
<b>Details of Disposal</b>					
Date	Name	Amount	Particulars		

Figure 4.3.1- Asset register

The asset register:

- Increases control over assets. The information in the asset register is crosschecked against the summary information in the General Ledger. This process assists in identifying bookkeeping discrepancies.
- Assists in calculating annual depreciation

# Chapter 5 - Balance Day Adjustments

## Abstract

This chapter explores the accounting principles, which influence balance day adjustments. It outlines the differences between the cash and accrual accounting methods and the adjustment entries required to prepare complete accounting reports under the accrual accounting system.

## Cash Accounting versus Accrual Accounting

The following chapter will explore the types of balance day adjustments (BDA's) that are prepared at balance day. However, it is important to note that not all entities require balance day adjustments. Some small businesses use a simple system called cash accounting, which does not require BDA's. **The cash accounting system records income when money is received and expenses when money is paid out.** Whereas **accrual accounting records income when it earned, and expenses when they are incurred.** The main difference between Cash and Accrual accounting is the timing of when revenue and expenses are recognised and recorded.

Cash accounting does not record:

- Payables
- Receivables
- Prepaid expenses
- Expenses payable
- Unearned revenue
- Revenue receivable

Accrual accounting recognises all of these events.

### Example: Cash versus accruals basis

Liam is the sole proprietor of an Electrical business. He completed a contract in May 2024 worth \$11,000. His client paid the invoice on 10 July 2024. If he uses the:

- cash basis method, he includes the \$11,000 income in July (1/7/24 - 30/6/25 financial year), when cash is received.
- accruals basis method, he includes the \$11,000 in the May 2024 financial year. This is because the services were performed in the financial year ending 2024 and therefore will be recognised as revenue in this period.

Why use the accrual Accounting System?

- It provides better financial information for decision-making and control.
- It provides a more accurate profit figure.

Why use the Cash Accounting System?

- It is simple, inexpensive and not very time consuming.
- It suits an owner-operator of a small business when most transactions are for cash and there are few, if any, credit transactions.
- The final reports are still reasonably reliable and useful for decision-making and control using the cash account system.

Choosing the appropriate system depends on;

- the size of the business
- how complicated the business transactions and processes are
- whether the business has the resources to manage accrual accounting
- whether the business is using a manual or software based accounting system
- the information needs of the entity
- the timing of cash-flow

## Example Cash verse Accrual Accounting Systems

Liam's unadjusted financial reports show the following information;

Account	Year 1	Year 2
	(1 July - 30 June)	(1 July - 30 June)
Income	100,000	110,000
Expenses	40,000	30,000
Profit	60,000	80,000

Show the impact of the following transactions under the cash and accrual systems. Note that these transactions have not yet been recorded;

- (a) In June of Year 1 Liam received \$10,000 for electrical work to be performed in July of Year 2

**Under the Cash Accounting system:**

Account	Year 1	Year 2
	(1 July - 30 June)	(1 July - 30 June)
Income	110,000	110,000
Expenses	40,000	30,000
Profit	70,000	80,000

**Under the Accrual Accounting system:**

Account	Year 1	Year 2
	(1 July - 30 June)	(1 July - 30 June)
Income	100,000	120,000
Expenses	40,000	30,000
Profit	60,000	90,000

- (b) On the 29<sup>th</sup> of June of Year 1, Liam paid \$500 for electrical supplies which he will use on a job to be complete on the 3<sup>rd</sup> of July of Year 2. Ignore impact of (a).

**Under the Cash Accounting system:**

Account	Year 1	Year 2
	(1 July - 30 June)	(1 July - 30 June)
Expenses	40,500	30,000
Profit	59,500	80,000

**Under the Accrual Accounting system:**

Account	Year 1	Year 2
	(1 July - 30 June)	(1 July - 30 June)
Expenses	40,000	30,500
Profit	60,000	79,500

## The purpose of Balance Day Adjustments

**The Accounting period convention** requires that a business's financial records are completely up-to-date at the end of the accounting period. However, not all transactions fit neatly into the accounting period: the business does not always receive money for their services or sales in the same period in which it is earned. The businesses do not pay for the expenses that they used in the accounting period in which they incurred the expense.

**Balance Day Adjustments, or BDA's, are entries that are required at the end of the accounting period in order for the financial records to be accurate, up-to-date, and a faithful representation of the business.**

Other accounting principles also influence when revenue and expenses will be recorded. **The Realisation and the Accrual Accounting Concepts** also create the need for adjustments to be made on balance day. The **realisation** principle is the **concept** that revenue can only be recognised once the underlying goods or services associated with the revenue have been delivered or earned.

The **Accrual concept** requires entities to record transactions in the **period they occur**, not when the cash is transferred. This concept requires expenses to be matched to the **period** they were **used** to **generate revenue**.

In order for these conventions to be adhered to, the following BDA's are required;

- Depreciation entries
- Prepaid expenses
- Expenses payable
- Unearned revenue
- Revenue receivable
- Writing off bad debts and adjusting the Allowance for Doubtful Debts
- Stock loss
- Reversal of errors

The above list are examples of non-cash transactions. Adjustments are necessary to reflect changes in the firm's economic position. This chapter will cover;

- Prepaid expenses
- Expenses payable
- Unearned revenue
- Revenue receivable
- Reversal of errors

Note: Stock loss, writing off bad debts and depreciation entries are covered in other chapters.

## Expenses Payable

Expenses Payable represent **future obligations** for the business. That is, payments for expenses that will be made in the next accounting period, even though they have been incurred in the current accounting period. Therefore, an additional liability needs to be recorded. Examples include;

- Electricity, water and internet costs
- Wages owing to employees
- Interest payable on a loan

The figure below illustrates how an adjustment has to be made for accrued wages as a result of the fortnight pay cycle being split by the end of the accounting period. For the period from the 26<sup>th</sup> until the 30<sup>th</sup> of June the business has incurred a wages expense and owes the employees 3 days' worth of wages at \$960 a day, for a total additional wages expense of \$2,880.

Financial year 1						Financial year 2									
June						July									
Thu	Fri	Sat	Sun	Mon	Tues	Wed	Thu	Fri	Sat	Sun	Mon	Tues	Wed	Thu	
25 <sup>th</sup>	26 <sup>th</sup>	27 <sup>th</sup>	28 <sup>th</sup>	29 <sup>th</sup>	30 <sup>th</sup>	1 <sup>st</sup>	2 <sup>nd</sup>	3 <sup>rd</sup>	4 <sup>th</sup>	5 <sup>th</sup>	6 <sup>th</sup>	7 <sup>th</sup>	8 <sup>th</sup>	9 <sup>th</sup>	
Pay day														Pay day	
Wages expense Recorded \$9,600						Wages expense Recorded \$9,600									
Wages have accrued for the financial year = \$2,880						Wages expense attributable to the financial year = \$6,720									

It may seem not a very significant amount and therefore immaterial. However, for a medium sized business the amount may be \$10,000's. Material adjustments must be made to ensure that the wages expense accurately represents what was actually incurred for the financial year.

On balance day, the accounts need to be adjusted for any expenses incurred but not yet paid. The following BDA recognises expenses payable.

Date	Particulars	Debit	Credit
June 30	<b>Dr Expenses</b> <b>Cr Accrued payable (CL)</b> <i>To record expenses payable</i>	xxx	xxx

**NB: For Expenses Payable, NO cash payment is made in current period**

### Example – Expenses Payable

A firm receives its \$3,000 quarterly electricity bill on the 30th of June. The firm's Balance day is 30 June and the bill covers the period for April to June. Payment is not required immediately as the electricity provider has given the business 28 days to pay.

On balance day, an adjustment is made to recognise that the electricity has been used and there is a **liability** to the electricity company.

This part of the transaction shows that an expense has been **incurred** as electricity has been consumed

Date	Particulars	Debit	Credit
June 30	Electricity expense Electricity Payable (CL) To record the electricity balance day adjustment.	\$3,000	\$3,000

This part of the transaction recognises the **liability**

Dr	Electricity Payable (CL)	Cr	Dr	Electricity Expense	Cr
	30 Electricity June Expense	3,000	30 Electricity June payable	3,000	

### Review Question

1. Explain how the accounting period convention has affected the recording of the accrued expenses.

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### Activity 1

### Expenses Payable

A firm pays its employees fortnightly after they have worked all their shifts for the 2 week period. During this time the business accrues an expense because the labour of employees will be generating revenue. The last payment date was the 25<sup>th</sup> of June and the next payment date is the 9<sup>th</sup> of July. Each fortnight the accountant records a wages expense of \$9,600. The employees have worked 3 standard working days since the payment day.

(a) Calculate the wages owed to employees as at the 30<sup>th</sup> of June.

(b) Prepare the journal entry required to record the outstanding wages.

Date	Particulars	Debit	Credit
	To record the wages balance day adjustment.		

(c) Post the general journal entry to the general ledger accounts.

Dr	Wages Payable	Cr	Dr	Wages Expense	Cr

## Revenue Receivable

Revenue receivable is also known as Accrued Revenue. It is income that the business has earned during the accounting period but has not been paid as at the balance day. Income receivable such as rent that is due, interest on bank deposits and investments, and fees represent a current economic benefit to the firm. These items are classed as a temporary **current asset**.

On balance day, revenue receivable is recorded by posting the following transaction:

Date	Particulars	Debit	Credit
June 30	<b>Dr Revenue Receivable (Current Asset)</b> <b>Cr Revenue</b> <i>To record revenue receivable</i>		

### Example – Revenue Receivable

A firm has a significant investment in term deposits with banks to earn interest. The term deposit generates \$900 a year in interest revenue, payable on the 15<sup>th</sup> of July. To recognise the interest earned during the current accounting period the following journal entry will be made:

Date	Particulars	Debit	Credit
June 30	Interest revenue receivable ( <b>CA</b> ) Interest revenue <i>To record interest receivable</i>	\$900	\$900

This part of the transaction records an increase in **assets**.

This part of the transaction records the **increase in revenue**

Dr	Interest revenue receivable ( <b>CA</b> )	Cr	Dr	Interest Revenue	Cr
30 June	Interest revenue	900	30 June	Interest revenue receivable	900

**NB: For Revenue Receivable, NO cash is received in current period**

### Activity 2

### Revenue Receivable

Lascelle Landscaping group bills their clients in full after a job has been completed. On the 30<sup>th</sup> of June Lascelle finished a job worth \$5,000. He will send the invoice to the client next week, which is the beginning of the following financial year.

(a) Record the general journal entry required to record the Landscaping Fees receivable.

Date	Particulars	Debit	Credit

## Prepaid expenses

Prepaid expenses represent future expenses, which have been paid for in advance. These items have been paid for but have not been used, and therefore, still represent future economic benefits. As, these items represent future benefits for the business they are classed as **current assets**.

Physical items, which are have been bought but not consumed, can be treated in the same way. These items are often small in nature and can be stock-piled. These may include Fuel and stationery. The term 'Stock of' is used instead of 'prepaid' to indicate these assets. E.g. Stock of fuel or Stock of fuel.

The BDA entry adjustment required for these entries will be determined by the way original cash transaction was recorded. There are two methods used to record prepaid expenses, the Balance Sheet approach and the Income Statement approach. Both approaches will have the same impacts after all final Balance Day Adjustments have been made; however, the treatment chosen will affect any interim reports produced. The two treatments are detailed below;

### The Balance Sheet Approach – Prepaid expenses

When the item is paid, it can be recorded initially as an asset, and thus initially impacts the Balance Sheet;

Date	Particulars	Debit	Credit
June 30	<b>Dr Prepaid expense</b> (current asset account) <b>Cr Cash at bank</b> <i>To record prepaid expense</i>		

On balance day, the Prepaid expense (current asset) account will need to reflect what has not been used up yet. Thus, the Prepaid expense asset account will need to be reduced and an expense will need to be recognised for the amount used up, or expensed. To record this adjustment the following transaction is posted:

Date	Particulars	Debit	Credit
June 30	<b>Dr Expenses</b> (to recognise the proportion of the prepaid account used up) <b>Cr Prepaid expense</b> (to reduce the account for the amount used up) <i>To record expenses paid</i>		

**NB: For Prepaid Expenses, cash is paid in current period**

### Example – Balance Sheet Approach-Prepaid Expenses

A firm pays its **annual** insurance bill of \$1,000 on the 1<sup>st</sup> of April. The firm's balance day is 30 June. Under the Balance Sheet method, the transaction to record the original payment is:

Date	Particulars	Debit	Credit
April 1st	Prepaid Insurance ( <b>CA</b> ) Cash at Bank <i>To record the payment of the annual insurance costs</i>	\$1,000	\$1,000

*This part of the transaction records an **increase in assets** Any insurance payments for future periods are considered a future economic benefit and are therefore classified as assets.*

*This part of the transaction records a **decrease in cash assets***

Dr	Prepaid Insurance ( <b>CA</b> )	Cr	Dr	Cash at bank	Cr
1 April	Cash at Bank 1,000		1 April	Prepaid Insurance 1,000	

On balance day, an adjustment will need to be made to recognise the expired portion of the insurance. As at the 30<sup>th</sup> of June, the firm has consumed the economic benefits associated with 3 months insurance. The firm will have 9 months insurance left. A BDA entry is required to show that the firm has incurred an expense of \$250 (3 months insurance). The Prepaid Insurance account must also be reduced to reflect the loss of economic benefits. The following entry is required to adjust the financial records for the expired interest:

Date	Particulars	Debit	Credit
1 April	Insurance expenses Prepaid insurance <i>To record the payment of insurance/expense.</i>	\$1,000	\$1,000

Dr			Prepaid Expense (CA)			Cr		
1 April	Cash at Bank	1,000	30 June	Insurance Expense	250	30 June	Prepaid Insurance	250

**Review Question**

2. Explain how the accrual accounting convention has affected the recording of the insurance expense.

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**The Income Statement Approach – Prepaid expenses**

The alternate approach used to record a prepaid expense is the Income Statement approach. Under this treatment the initial transaction is classified as an expense, thus impacting the Income Statement:

Date	Particulars	Debit	Credit
June 30	Dr Insurance Expense Cr Cash at bank <i>To record insurance expense</i>		

On balance day, the Prepaid expense account is established to reflect the firm has an asset and has not incurred the full value of the expense.

Date	Particulars	Debit	Credit
June 30	<b>Dr Prepaid expenses</b> (to recognise unused benefits) <b>Cr Expense</b> (to reduce the expense account to reflect the actual benefit consumed) <i>To record insurance expense</i>		



## Example – Income Statement Approach – Prepaid Expenses

Using the previous example, of a firm which pays its annual insurance bill of \$1,000 on the 1<sup>st</sup> of April. Under the Income Statement method, the transaction to record the original payment is:

Date	Particulars	Debit	Credit
1 April	Insurance expenses Prepaid insurance <i>To record the payment of insurance/expense.</i>	\$1,000	\$1,000

Dr			Insurance Expense	Cr	Dr			Cash at Bank	Cr
1 April	Cash at Bank		1,000			1 April	Insurance expense		1,000

On balance day, an adjustment will need to be made to recognise that the insurance which has not yet expired, as an asset. As at the 30<sup>th</sup> of June a prepaid insurance asset account will be established to show the 9 months worth of unexpired insurance. The insurance expense is also reduced to reflect that not all the economic benefits associated with the insurance cover have been consumed. The following entry is required to adjust the financial records for the unexpired interest:

***This part of the transaction establishes the Prepaid Insurance Asset account to reflect the future economic benefits associated with unexpired***

Date	Particulars	Debit	Credit
June 30	Prepaid Insurance Expense (CA) Insurance Expenses <b><i>To record the insurance balance day adjustment.</i></b>	\$750	\$750

***This part of the transaction reduces the expense account for the unused portion of insurance.***

Dr			Insurance Expense	Cr	Dr			Prepaid Insurance (CA)	Cr		
1 April	Cash at Bank		1,000		30 June	Prepaid Insurance	750		30 June	Insurance expense	750

## Unused Stock

Unused stock are items that are used in the business but do not directly earn revenue. These items are **not trading stock** and are **not** meant for resale, for example **stationery or fuel**. If the business has a **material** amount of stationery, or fuel, left at the end of an accounting period, then that amount must be included as a **Current Asset** and **not an expense** since it has not been consumed during the current period and has not contributed towards earning revenue for the business. In this sense the approach is very similar to the treatment of a prepaid expenses.

### Balance Sheet approach

If on balance day the Trial Balance shows an existing 'stock of' account, the original transaction was recorded using the balance sheet approach, initially recording all items as an asset. On balance day the following entry will be required:

Date	Particulars	Debit	Credit
June 30	<b>Dr Expense (name)</b> <b>Cr Stock of (Name)</b> <i>To record expenses used</i>		

Example:

On the 30<sup>th</sup> of June the trial balance showed a balance of \$3,000 of stock of stationery. However, a review of the stock levels indicated that only \$1,700 stationery was left on hand.

**The following adjustment will be required.**

Date	Account	Dr (\$)	Cr (\$)
30 June	Stationery expense (income statement)	1,300	
	Stock of Stationery (current asset)		1,300

### Income Statement approach

If on balance day the Trial Balance shows only a expense account related to the item, the original transaction was recorded using the Income Statement approach, initially recording all items as an expense. On balance day the following entry will be required:

Date	Particulars	Debit	Credit
June 30	<b>Dr Stock of (Name)</b> <b>Cr Expense (Name)</b> <i>To record expenses used</i>		

Example:

On the 30<sup>th</sup> of June, the Trial Balance showed a balance a \$3,000 stationery expense. However, review of the stock levels indicated that there was still \$1,700 of stationery left on hand.

**The following adjustment will be required.**

Date	Account	Dr (\$)	Cr (\$)
30 June	Stock of Stationery ( <i>current asset</i> )	1,700	
	Stationery expense ( <i>income statement</i> )		1,700

## Unearned Revenue

Unearned revenue, prepaid revenue or revenue received in advance, arises when payments are received for services not yet performed or inventory has not yet been delivered to the customer. Thus, this category of transactions reflect future obligations to clients and are a **current liability**. Like prepaid expenses, this type of transaction has two approaches; the Balance Sheet approach and the Income Statement approach.

### The Balance Sheet Approach- Unearned Revenue

When the cash is originally received, it can be recorded as unearned revenue by establishing an Unearned Revenue account. This account is a liability and therefore will impact the Balance Sheet. The entry will be recorded as:

Date	Particulars	Debit	Credit
June 30	<b>Dr Cash at Bank</b> <b>Cr Unearned revenue</b> (current liability) <i>To record unearned revenue</i>		

On balance day, an adjustment is made to the Unearned Revenue account to reflect any revenue that has been earned during the period. This adjustment will be reduce the Unearned Revenue liability account to reflect the proportion of revenue which has been earned through either the provision of services or the transfer of inventory. The entry will be as follows:

Date	Particulars	Debit	Credit
June 30	<b>Dr Unearned revenue</b> (reducing the liability) <b>Cr Revenue</b> (increasing the revenue) <i>To record unearned revenue</i>		

**NB: For Unearned Revenue, cash is received in current period**

### Example – Balance Sheet Approach Unearned Revenue

On the 1<sup>st</sup> of May, a building company receives \$15,000 in advance for construction work which is to be performed over the next 6 months (to be completed evenly over this period), the initial transaction will be recorded as;

*This recognises that the firm has received cash*

Date	Particulars	Debit	Credit
May 1	Cash at bank Unearned revenue <b>(CL)</b> <i>To record the receipt of unearned revenue.</i>	\$15,000	\$15,000

*This recognises that the firm has a liability in the form of future labour obligations.*

Dr	Unearned revenue <b>(CL)</b>	Cr	Dr	Cash at Bank	Cr	
	1 May	Cash at Bank	15,000	1 May	Unearned revenue	15,000

On Balance day, the firm will need to recognise the 2 months of construction work performed as revenue earned and reduce the Unearned Revenue liability account to reflect that 2 months of the labour obligations have been rendered. This will be recognised by the following BDA entry;

*This reduces the liability, as the firm has performed part of the services owed. This entry will reduce the unearned revenue account from \$15,000 to \$10,000 on the Balance Sheet.*

Date	Particulars	Debit	Credit
June 30	Unearned revenue	\$5,000	
	Service Revenue		\$5,000
	<i>To record revenue earned</i>		

*This recognises that the firm has earned \$5,000 in revenue for services performed.*

Dr	Unearned revenue (CL)	Cr	Dr	Service revenue	Cr
1	Service revenue	5,000	1	Cash at bank	15,000
May					
			30	Unearned revenue	5,000
			June		

### Review Question

3. Explain how the realisation concept has affected the recording of the insurance revenue.

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### Income Statement Approach – Unearned Revenue

Alternatively, when the cash is originally received it can be recorded as revenue, impacting the Income Statement. The general journal entry will be as follows:

Date	Particulars	Debit	Credit
June 30	<b>Dr Cash at Bank</b>		
	<b>Cr Revenue</b>		
	<i>To record revenue</i>		

On balance day, an adjustment will be made to the revenue account to reflect any revenue, which is not yet earned. This adjustment will reduce the revenue account to reflect the proportion of revenue, which has not yet been earned through either the provision of services or the transfer of inventory. An Unearned Revenue liability account will also be established for the labour or goods owing to the customer. The entry to be as follows.

Date	Particulars	Debit	Credit
June 30	<b>Dr Revenue</b> (reducing the revenue)		
	<b>Cr Unearned revenue</b> (increasing the liability)		
	<i>To record revenue</i>		



## Example – Income Statement Approach Unearned revenue

Applying the Income Statement approach to the previous example; on the 1<sup>st</sup> of May, a building company receives \$15,000 in advance for construction work, which is to be performed over the next 6 months (to be completed evenly over this period), the initial transaction will be recorded as;

*This recognises that the firm has received cash.*

Date	Particulars	Debit	Credit
May 1	Cash at bank Service Revenue <i>To record the receipts from customers.</i>	\$15,000	\$15,000

*This recognises that the firm revenue for the cash payment received.*

	Dr	Cash at Bank	Cr		Dr	Service Revenue	Cr
1 May	Revenue	15,000		1 May	Cash at bank	15,000	

On Balance day, the firm will need to recognise that 4 months of construction work related to this cash payment has not been performed and therefore cannot be recorded as revenue. The revenue account will therefore need to be reduced to reflect the work performed and an unearned revenue liability account will need to be established to reflect the 4months of the labour obligations owing. This will be recognised by the following BDA entry;

*This reduced the revenue to reflect revenue earned. This entry will reduce the revenue account from \$15,000 to \$5,000 on the Income*

Date	Particulars	Debit	Credit
June 30	Service Revenue Unearned Revenue <b>(CL)</b> <i>To record unearned revenue</i>	\$10,000	\$10,000

*This unearned revenue establishes a liability for the labour owed to the client.*

	Dr	Unearned Revenue <b>(CL)</b>	Cr		Dr	Service Revenue	Cr		
30 June	Revenue	10,000		30 June	Unearned revenue	10,000	1 May	Cash at bank	15,000

## Summary – Balance Day Adjustment

All journal entries will require two posts to the General Ledger to show the dual impact each entry has had on the accounts.

With BDA's there is **always one Income Statement account** and **one Balance Sheet account** affected

BDA	Adjusted General Ledger Accounts	Classification	Impact on Account
<p><b>Expenses Payable</b></p> <p><i>Also known as <b>accrued expenses</b>, these adjustments are required when expenses have been incurred but <b>not paid</b> for, therefore resulting in a future economic obligation.</i></p>	[Name] Expenses payable	Current Liability	Increase <b>Credit account</b>
	[Name] Expenses	Expense	Increase <b>Debit account</b>
<p><b>Revenue Receivable</b></p> <p><i>Also known as <b>accrued revenue</b>, these adjustments are required when revenue has been earned, but <b>not yet received</b> or recorded.</i></p>	[Name] Revenue receivable	Current Asset	Increase <b>Debit account</b>
	[Name] Revenue	Revenue	Increase <b>Credit account</b>
<p><b>Prepaid Expenses</b></p> <p>These adjustments arise when expenses <b>have been paid</b> for but not consumed.</p>	Prepaid [Name] Expense	Current Asset	Increase ( <b>Dr</b> ) if initially recorded as Expense (Income Statement approach) Decrease ( <b>Cr</b> ) if initially recorded as an Asset (Balance Sheet approach)
	[Name] Expense	Expense	Decrease ( <b>Cr</b> ) if initially recorded as Expense (Income Statement approach) Increase ( <b>Dr</b> ) if initially recorded as an Asset (Balance Sheet approach)
<p><b>Unearned revenue</b></p> <p>Also known as <b>prepaid revenue</b> or <b>revenue received in advance</b>. These adjustments will arise <b>when money has been received</b> from the customer for work not yet performed or goods not yet delivered.</p>	Unearned [Name] revenue	Current Liability	Increase ( <b>Cr</b> ) if initially recorded as Revenue (Income Statement approach) Decrease ( <b>Dr</b> ) if initially recorded as a Liability (Balance Sheet approach)
	[Name] Revenue	Revenue	Decrease ( <b>Dr</b> ) if initially recorded as Revenue Increase ( <b>Cr</b> ) if initially recorded as a Liability (Balance Sheet approach)

### Activity 3

Identify the adjustment required for the following. Assume the accounting period ends on 30 June.

Number	Event	BDA
Example	Annual insurance is paid on the 30 <sup>th</sup> of March.	Prepaid expense
(a)	\$1,000 is owed to employees, on balance day, for worked performed.	
(b)	Services worth \$1,000 have been performed for a client, who has not yet been billed	
(c)	A client transferred service fee of \$5,000 for work not yet performed.	
(d)	A radio advertising package was bought for \$2,000. The advertisements have not yet aired.	

### Activity 4

Genius IT provides various technical services to its clients. They prepare their accounts on an accrual basis. They have asked for some advice on treating the following balance day adjustments:

- The firm pays a monthly fixed amount of \$3,000 for internet usage. The billing cycle runs from the 15<sup>th</sup> of June to the 14<sup>th</sup> of July. Assume that the internet is evenly consumed through our the period and is paid for at the end on the cycle, on the 14<sup>th</sup> of July.
- They bill their clients on the 20<sup>th</sup> of every month, for services performed throughout the period. As at 30 June Genius IT, had recorded \$17,000 in billable hours, which will be included in the upcoming invoices to clients to be sent out in July.

- (a) Prepare the relevant general journal entries on the 30th of June and post the entries to the general ledger accounts.

Date	Particulars	Debit	Credit
	<i>To record internet expense payable</i>		
Date	Particulars	Debit	Credit
	<i>To record the fee revenue earned</i>		

Internet Expense	Internet expense payable
Service revenue receivable	Service revenue

### Activity 5

A firm pays its annual insurance premium of \$600 on the 1st of May every year. The accountant has chosen to record this original transaction as an **expense**.

- (a) Prepare the general journal entry and post the entry to the general ledger accounts to record the original payment on the 1<sup>st</sup> of May.

Date	Particulars	Debit	Credit
	<i>To record the payment of the annual insurance account.</i>		

Internet Expense	Cash at Bank

- (b) Calculate the amount of prepaid insurance as at the 30<sup>th</sup> of June.

- (c) Prepare the general journal entry required on balance day and post the entry to the general ledger accounts.

Date	Particulars	Debit	Credit
	<i>To record the prepaid insurance.</i>		

Insurance Expense (AE)	Prepaid Insurance (CA)

- (d) Prepare the entries using the balance sheet approach. Hint, the original transaction is recorded as a **prepaid expense**. Record the initial transaction to record the payment.

Date	Particulars	Debit	Credit
May 1			
	<i>To record the payment of the annual insurance account.</i>		

Prepaid Insurance Expense	Cash at Bank

Record the balance day adjustment required on the 30<sup>th</sup> of June.

Date	Particulars	Debit	Credit
	<i>To record the insurance expense.</i>		

Insurance Expense (E)	Prepaid Insurance (CA)

(e) Compare the balance of the Insurance Expense account and Prepaid Insurance account from the income statement approach and balance sheet approach. What do you notice about the balances?

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**Activity 6**

A firm pays for its accounting software fees annually. The \$1,000 fee is paid on the 1<sup>st</sup> of March. The firm originally recognises the fee as Accounting software expenses.

- (a) Prepare the journal entries for the 1<sup>st</sup> of March and 30 of June.
- (b) Post the entries to the relative General Ledger accounts.
- (c) Close the General Ledger accounts.

**General Journal**

Date	Particulars	Debit	Credit
1-March	<i>To record the Accounting software expenses paid.</i>		
Date	Particulars	Debit	Credit
30-June	<i>To recognise Prepaid Accounting software</i>		

Accounting Software Expense (AE)	Cash at Bank
Prepaid Accounting Software	



(b) Prepare and post the BDA entry for the necessary adjustment on the 30<sup>th</sup> of June.

Date	Particulars	Debit	Credit
June 30	<i>To record the unearned revenue</i>		

Dr	Construction fees (R)	Cr	Dr	Unearned construction fees (CL)	Cr

### Activity 9

An online clothing store charges customers in advance for any orders made. However, it takes 5 -7 business days to process and pack the orders before delivery to customers. On the 25<sup>th</sup> of June, the store received \$10,000 from customers for sales orders. Balance day is 30 June. The business uses the Balance Sheet approach to record transactions. On the 30<sup>th</sup> of June they had delivered 80% of these orders to customers.

- (a) Prepare the journal entries for the 25th and 30 of June
- (b) Post the entries to the relative General Ledger accounts.
- (c) Close the General Ledger accounts.

#### General Journal

Date	Particulars	Debit	Credit
25th June	<i>To record the cash received for sales orders</i>		
30-June	<i>To recognise the unearned sales revenue</i>		

Cash at Bank (CA)	Unearned Sales Revenue (CL)

Sales Revenue (R)

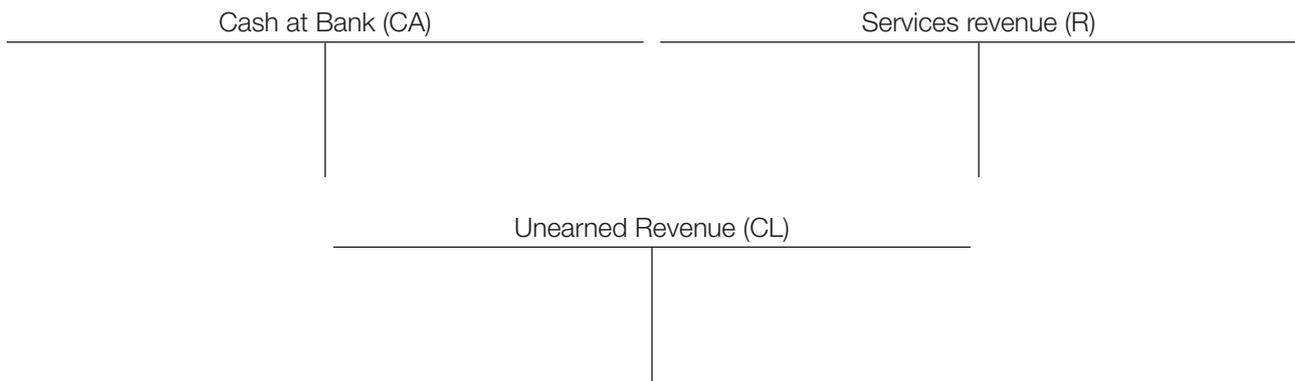
### Activity 10

A landscaping firm requires upfront payment from customers before commencing work and ordering material to complete jobs. On the 1<sup>st</sup> of May the firm received \$9,000 from a customer. Balance day is 30 June. All customer receipts are originally recorded as Income. On the 30<sup>th</sup> of June the job was 70% complete.

- (a) Prepare the journal entries for the 1<sup>st</sup> of May and 30 of June.
- (b) Post the entries to the relative General Ledger accounts.
- (c) Close the General Ledger accounts.

**General Journal**

Date	Particulars	Debit	Credit
1-May	<i>To record receipts from customers</i>		
Date	Particulars	Debit	Credit
30-June	<i>To recognise earned revenue</i>		



### Activity 11

In the Trial Balance for Lincoln Estate there was a stationery expense of \$4,000. However, a physical check revealed \$450 worth of stationery still on hand at the end of the period. The initial purchase of Stationery was treated as an expense.

Prepare the appropriate general journal entries to record adjust the information on balance day:

Date	Account	Debit	Credit
	<i>State the balances in the final accounts</i>		

State the balances in the final accounts:

**Balance Sheet – Current Assets**

Stock of Stationery

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**Income Statement – Expenses**

Stationery

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## Activity 12

The Trial balance (extract) for Roosevelt's New Dealers is:

Accounts	Dr	Cr
Bank	2,400	
Stock	13,650	
Debtors	3,210	
Creditors		4,750
Stock of Fuel	2,000	
Fuel expense	13,420	

Additional information:

- The balance of Stock of Fuel at 30 June is \$1,100

Complete the BDA general journal entries for Fuel:

Date	Account	Debit	Credit
	<i>State the balances in the final accounts</i>		

- (a) State the balances in the final accounts:

### Balance Sheet – Current Assets

Stock of Fuel

### Income Statement – Expenses

Fuel

## Activity 13

Twinkle Toes, sell ballet and dance shoes through two South Australian retail stores and online. In addition to shoe sales, the business also earns revenue for shoe repairs and delivery fees. Twinkle Toes prepares their accounts using the accrual system. Balance day is on **30 June**. The following transactions will need adjusting.

- The business has recorded \$110,000 of sales revenue for the year. However, this figure includes \$2,000 worth of prepaid sales on back order. The customers have paid for these goods; however, these goods will not be delivered until the 14<sup>th</sup> of July.
- Twinkle Toes has a term deposit which generates \$150 per month in interest revenue. The annual interest earned is credited to the firm's bank account on the 5<sup>th</sup> of July.
- On the 1<sup>st</sup> of March, the business paid for advertising images to appear on a range of billboards around the city. These advertisements cost \$12,000 and will appear on the billboards for 6 months, starting in April. The \$12,000 was originally recorded as an expense.
- The business rents their premises which they use for office space. Rent payments are made monthly on the last day of the month for the following month in advance. The annual rental contracts are worth \$30,000, the lease contract is in its first year. Rent is recorded as an expense when paid. (for first year of operations).
- The business pays its sales employees on a weekly basis. Payments for outstanding wages are made every Wednesday, for the week prior. On the 30<sup>th</sup> of June workers had worked 3 days of the next pay cycle. The business pays \$500 a day in wages. Assume Employees work 5 days week, 52 weeks a year.
- The business renews its inventory insurance annually on the 1<sup>st</sup> of February. The insurance cover costs \$1,000 p.a. and is originally recorded as a prepaid expense.
- The business pays for a six monthly magazine subscription to Dance Australia. The \$35 Subscription fee was renewed on the 1<sup>st</sup> of April. It was originally recorded as an expense.
- The shoe repair service requires customers to pay 10%, up front. The standard charge for shoe repair is \$30. On the 30 of June, the business has 40 shoes waiting for repair. Cash receipts were recorded as revenue. Total service revenue was \$30,000 prior to the adjustment.

Complete the table below by analysing each adjustment necessary for each transaction and identify the Final Accounts balances for the Balance sheet and Income statement.

	Balance Sheet			Income Statement		
	Name	Classification	Amount	Name	Classification	Amount
(a) <i>(example)</i>	<i>Unearned sales revenue</i>	<i>Current Liability</i>	<i>\$2,000</i>	<i>Sales revenue</i>	<i>Revenue</i>	<i>\$108,000</i>
(b)						
(c)						
(d)						
(e)						
(f)						
(g)						
(h)						

Complete balance day adjustments for transactions a) – f).

Date	Particulars	Debit	Credit
	<i>To record prepaid sales</i>		
	To record interest receivable		
	<i>To record prepaid advertising</i>		
	<i>To record prepaid rent</i>		
	To record wages owing		
	To record Insurance expense		
	To record prepaid subscriptions		
	To record revenue received in advance		

## Reversal of errors

Errors do occur when processing accounting transactions, entering amounts and making calculations, particularly when using a manual system. Even when using accounting software, if transactions are not entered correctly, it is possible to have a Trial Balance which balances and still contain errors. Typical errors include:

- Transposition errors resulting in an incorrect amount
- Incorrect amount posted to the general ledger from a journal
- Movement of a decimal point (slides)
- Incorrect account debited or credited.

Therefore, it is important to have a thorough understanding of accounting processes to determine if an error has occurred. Errors can be detected by following the transaction backwards using the posting references through the general ledger, the general journal and back to the original source documents. Once the exact nature of the error is determined a correcting journal entry can be made.

### Review Question

4. The following manually prepared Trial Balance has a number of errors. Following analysis, list the 4 errors that could have occurred and need investigation.

<b>Half Moon Film Productions</b>		
Unadjusted Trial Balance		
As at 30 June		
Account	Debit \$	Credit \$
Capital		25,000
Cash at bank/Overdraft	720	
Couriers and deliveries		
Creditors		6,350
Debtors		2,546
Debt collection fees	1,200	
Office equipment	14,276	
Film equipment	41,250	
Entertainment	4,850	
Insurance expense	950	
Internet and mobile plan	620	
Car loan from ANZ	22,000	
Motor vehicle		22,000
Film sales		67,140
Royalties		9,200
Wages	4,000,000	

## Reversing errors

When an error has been made in the journal entries, reversal entries are required to correct the financial accounts. The aim of the entry is to remove the error.

## Example – reversing errors

Review of the financial entries on balance day revealed that an entry was incorrectly processed. \$60 was incorrectly posted to the Motor Vehicle asset account instead of the motor vehicle expense account.

The following entry will reverse the error:

Date	Particulars	Debit	Credit
30/6	Motor Vehicle expenses	60	
	Motor Vehicles		60
	To reverse an entry incorrectly made to the Motor Vehicle account instead of the Motor Vehicle expenses account		

It was also found that the depreciation on office furniture entry was made for \$400 instead of \$40. The following entry will reverse the error:

Date	Particulars	Debit	Credit
30/6	Accumulated depreciation- Office Furniture	360	
	Depreciation expense- Office Furniture		360
	To reverse an error of an additional 360 posted to the depreciation entry		

### Activity 14

## Reversal of errors

Prepare general journal entries to reverse the impacts of the following on balance day:

- A debit of \$40 was accidentally made to administration expenses instead of selling expenses.
- The payment of \$600 wages entry was accidentally reversed, resulting in the debits and credits on the wrong side.

Date	Particulars	Debit	Credit
	<i>Reversal of an incorrect posting to the wrong account</i>		
	<i>Reversal of an incorrect posting to wrong side</i>		

## Extension Activity 1

D. Hound is the proprietor of a pet shop. He presents you with the following information on June 30.

UNADJUSTED TRIAL BALANCE as at June 30th

	Debit (\$)	Credit (\$)
Inventories- Opening	7,500	
Delivery charges on sales	372	
Sales		30,188
Purchases	6,432	
Drawings	1,000	
Fixtures and fittings	20,000	
Bank	2,234	
Debtors	2,420	
Stationery expense	2,224	
Rent revenue		3,000
Sales salaries	4,200	
Prepaid Insurance	650	
Motor vehicles	25,000	
5 year Government Bonds	1,200	
Wages	500	
Discount received		300
Creditors		5,266
Capital		34,578
Interest on government bonds		400
	<b>73,732</b>	<b>73,732</b>

ADDITIONAL INFORMATION:

- A physical stock-take at June 30 revealed merchandise on hand was valued at \$9,588.
- Prepaid insurance of \$200 is remaining.
- \$1,500 of the rent received is in advance
- Wages of \$250 are owing
- Interest of \$300 from the government bonds is owing to the business

- 1) Post adjustment to the general journal.

**General Journal – D. Hound**

Date	Particulars	Debit	Credit



**Income Statement of D. Hound  
for the year ended June 30**

**REVENUE**

COST OF GOODS SOLD

**GROSS PROFIT**

OTHER REVENUE

## EXPENSES

Selling Expenses

Administrative Expenses

Financial Expenses

**PROFIT**

## Extension Activity 2

The following is a trial balance for the period ended 30 June VB Sporting Supplies.

	Debit (\$)	Credit (\$)
Inventory Opening	94,000	
Purchases	372,000	
Purchases returns		5,000
Debtors	56,700	
Sales		648,900
Wages	33,000	
Insurance	7,200	
Advertising	23,500	
Freight inwards	9,000	
Rates	4,800	
Equipment	106,400	
Bank	40,000	
Loan from XYZ (due in 5 years)		45,000
Offices expenses	8,500	
Creditors		70,000
Display shelving	42,000	
Government bonds	8,000	
Capital		36,200
	<b>805,100</b>	<b>805,100</b>

### Additional information available at 30 June:

- Stocktake revealed \$43,000 on hand
- All insurance premiums are for a one-year period. They were renewed on 1 January for \$7,200
- Wages accrued amounted to \$760
- \$2,400 of rates were paid in advance.
- \$400 interest on the loan is owing
- \$700 was accidentally allotted to **Rates** instead of **Office expenses**

### Required:

Prepare general journal entries to record the balance day adjustments required above. Narrations are required. (Note, do not post the journal to record the closing stock)

Prepare properly classified reports for the owner of this business.

**General Journal – VB Sporting Supplies.**

Date	Particulars	Debit	Credit





## Extension Activity 3

Sally Green is the owner of Shoe Barn. A shoe retailer, she has asked you to prepare adjustments to her accounts.

**Trial Balance of Shoe Barn as at 31 of December**

	Debit (\$)	Credit (\$)
Sales Returns	1,000	
Purchase Returns		5,000
Debtors	8,000	
Cash on hand	1,000	
Creditors		10,000
Freight inwards	500	
Cleaning	2,000	
Purchases	20,000	
Display expenses	700	
Sales		45,000
Discounts allowed	1,000	
Wrapping paper expense	800	
Discount received		1,300
Office furniture	4,000	
Investments	10,000	
Interest on overdraft	200	
Bank overdraft		6,000
General expenses	1,000	
Building	23,000	
Fixtures and fittings	3,000	
Customs duty	700	
Drawings	2,000	
Delivery of sales	900	
Bad debts	200	
Traveller's expenses	3,000	
Bank charges	300	
Loan (January next year)		10,000
Government bonds due (mature in 3 years)	5,000	
Inventory Opening	6,000	
Land	33,000	
Capital		49,800
Interest on government bonds		200
	<b>127,300</b>	<b>127,300</b>

### Balance day adjustments:

- Inventory on hand was valued at \$1,000 according to the physical stocktake held on 31 December
- Prepaid expenses: traveller's expenses for employees attending sales seminars \$200, general expenses \$500, and bank charges \$50.
- Interest receivable from government bonds \$400
- Wrapping paper inventory unused \$600
- Interest on overdraft due but not paid \$1,000

### Required:

- Adjust the Trial Balance and prepare properly classified reports for the owner of this business.



**Income Statement of Shoe Barn  
for the year ended December 31**

**REVENUE**

COST OF GOODS SOLD

**GROSS PROFIT**

OTHER REVENUE

EXPENSES

Selling Expenses

Administrative Expenses

Financial Expenses

**PROFIT**

## Extension Activity 4

F Flounder owns Nemo's Aquariums, a business that retails fish, frogs, lizards and aquariums. He is thinking about making some drastic changes to the business and would like an accurate set of accounts to inform his decision-making. He has provided you with the unadjusted Trial balance below.

- (a) Adjust the trial balance with the necessary adjustments, so that it provides a true and fair representation of the business accounts.

### Trial Balance of Nemo's Aquariums

As at 30 June

	Debit (\$)	Credit (\$)
Building	550,000	
Sales		60,000
Sales returns	1,746	
Drawings	3,000	
Inventories Opening	15,240	
Purchases	20,000	
Motor Vehicle	8,000	
Land	15,000	
Freight inwards	246	
Advertising	2,400	
Discount allowed	2,000	
Discount received		1,560
Insurance on building	1,600	
Rates	1,200	
Telephone	235	
Rent from shops		4,600
Debtors	10,000	
Creditors		2,000
Cash at bank	5,650	
Stock of Fuel	6,000	
Interest revenue		200
Goodwill	12,000	
Mortgage on land and buildings		400,000
Capital		242,557
Purchases returns		4,000
Salesperson Salaries	60,000	
Insurance on motor vehicle	600	
	<b>714,917</b>	<b>714,917</b>

### Adjustments:

- Stocktake at 30 June revealed inventories on hand of \$17,000
- Rent from shops received in advance \$100
- Insurance on motor vehicle of \$200 is owing
- Salesperson Salaries still owing, \$640
- Telephone still owing, \$40
- Prepaid insurance on building \$300
- Stock of Fuel at 30 June was \$1,200
- Interest of \$250 has been earned but not yet received.

(b) Prepare properly classified accounting reports.

**Statement of Changes in Owners' Equity**  
**Nemo's Aquariums – for the year ended 30th June**

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**Balance Sheet**

**Nemo's Aquariums–as at 30th June**

ASSETS	
Current	
Non-Current	
LIABILITIES	
Current	
Non-Current	
NET ASSETS	



(c) Comment on the impact of **one** of the adjustments you made in **a)** on the depiction of Nemo’s Aquariums in the Financial Reports.

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(d) With reference to materiality, comment on the impact of the adjustment made to the telephone expense account.

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### Extension Activity 5

Over the last 2 years, Violet has been running a small floristry business from home. Her business started unintentionally, after a friend asked her to help with her floral arrangements for her wedding. The wedding was a success and Violet started to get more requests for floral arrangements. Originally, Violet was able to balance the demands of her floristry business and part-time job. However, recently she has struggled to manage her workload and has decided to quit her part-time job and focus solely on growing her business. She has dreams of expanding her business to the retail market and online. Currently, Violet has been using a simple cash accounting system. In the past, this has suited her needs as she has had very few transactions and has not relied on accounting information to make decisions of large consequence.

(a) Explain to Violet the benefits of the accrual accounting system and the impact this may have on her decision-making in the future.

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(b) Discuss other factors she should consider before expanding her business.

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# Chapter 6 - Managing Cash

## Cash management activities

Cash management refers to a broad area of finance involving the collection, handling, and usage of cash. However, this business function goes beyond these processes and focuses on evaluating the current and future needs of entities by evaluating cash flow, and forecasting cash positions.

The goal of management should be to manage the cash balances to;

- allow sufficient liquidity to avoid the risk of insolvency
- allow the firm to purchase sufficient inventory to meet customer demand
- maintain adequate cash to pursue future investment.

Managing cash includes activities such as;

- managing collections from debtors
- managing payables
- eliminating unnecessary costs
- forecasting future cash needs and cash budgeting
- assessing sources of finance
- monitoring internal controls which safeguard cash assets
- allocating sufficient reserves for unforeseen circumstances.

## Consequences of poor management of cash

Poor cash flow can affect every facet of business:

- Increased interest and bank charges – Many lenders will charge late fees and additional interest for late payments.
- Missed opportunities – Poor cash flow may lead to not having the cash available to take advantage of opportunities. For example, cannot pursue a new business idea, or acquire an asset, which will lead to increased revenues.
- Poor relationships with suppliers – Being consistently late with payments may cause tension; this may lead to poor service, shorter credit period, retraction of credit, or losing a supplier altogether.
- Lowered employee morale –staff, may become worried about the business's long-term prospects, and thus, the security of their job. Leading to loss of motivation, morale and productivity.
- Restricted Growth –Without sufficient cash, the business will not have the resources needed to assist growth.
- Insolvency – The extreme case of lack of cash flow results in the closure of the business.

## Difference between Cash and Profit

### Activity 1

- Identify the impacts these accounts have on cash and profit (consider only impacts on the current accounting period).

Account	Has an impact on the Cash Account	Does not impact on the Cash Account	Impacts profit	Does not impact profit
Cash Sales				
Receipts from debtors				
Cash purchases				
Capital contributions				
Loan repayments				
Wages and Salary expense				
Depreciation expense				
Drawings				
Purchase of equipment				

The terms cash and profit are often misused. Profit refers to the excess revenue generated after expenses are deducted, for the accounting period. Cash is merely the balance in business's cash account.

The calculation of profit will include many accounts, which do not affect cash in the accounting period, such as;

- Credit Sales
- Expenses and revenues accrued but not yet paid or received
- Depreciation

Furthermore, profit only considers transactions that link to the current accounting period.

Many transactions will impact the cash account, some of these will have links to profit, and some will not. The cash account will be affected by;

- receipts from debtors
- cash sales
- cash payments for expenses
- assets purchases and sales (impacts balance sheet)
- loan acquisitions and repayments (impacts balance sheet)
- capital contributions and drawings (impacts statement of changes in equity).

Furthermore, the cash balance is cumulative and is impacted by transactions occurring outside of the accounting period.

## The Statement of Cash Flows

The Statement of Cash Flows is a financial report that indicates the movement of cash receipts and payments. There are three sections in a Statement of Cash Flows.

### Operating Activities

The operating activities represent the principle revenue-generating activities of an organisation. These activities are responsible for internally generating cash from day-to-day operations. These are generally Income Statement items.

They involve a movement of cash that relates to:

- the sale and purchase of goods and services, i.e. receipts from customers and payments to suppliers
- interest paid or received
- dividends received
- payments for expenses such as rent, wages, advertising.

### Investing Activities

Investing activities refers to investments in non-current assets.

They involve a movement of cash that relates to:

- disposal/sale of non-current assets and investments
- acquisition/purchase of non-current assets and investments.

### Financing Activities

These are cash flows that correspond to changes in the financial structure of the business. This section includes cash flows resulting in changes in internal and external finance. These activities involve:

- proceeds from loans
- capital contributions
- repayment of loans
- drawings.

## Example Statement of Cash Flows

Statement of Cash Flows  
for the year ended 30 June

<b>Cash Flows from Operating Activities</b>			
<i>Inflows</i>			
Cash Sales	xxx		
Receipts from Debtors	xxx		
Interest received/ Dividends/ Rent	xxx	xxxx	
<i>Outflows</i>			
Payment to Creditors	xxx		
Cash Purchases	xxx		
Payment to Employees	xxx		
Other Operating Expenses	xxx		
Interest Paid <sup>1</sup>	xxx	(xxxx)	
<b>Net cash from operating activities</b>			xxxxx
<b>Cash Flows from Investing Activities</b>			
<i>Inflows</i>			
Sales of Non-current assets/Investments		xxxx	
<i>Outflows</i>			
Acquisition of Non-current assets/Investments		(xxx)	
<b>Net cash from investing activities</b>			xxxx
<b>Cash Flows from Financing Activities</b>			
<i>Inflows</i>			
Proceeds from loans	xxx		
Capital contributions	xxx	xxxx	
<i>Outflows</i>			
Drawings	xxx		
Loan repayments	xxx	(xxx)	
<b>Net cash from financing activities</b>			xxxx
Net increase in cash			xxxx
Cash balance at beginning			xxxx
Cash balance at end			xxxx

<sup>1</sup> Note that interest is always listed as a separate item in the operating activities section.

The following figure identifies the allocation of Income Statement, Balance Sheet and Statement of changes in owners equity items to the statement of cash flows.

**– Income Statement**

<b>Cash Sales</b> –	<i>Operating Activities</i>
<b>Credit Sales</b> –	<i>Only Receipts from Debtors are included as an operating activity, this is to be calculated</i>
<b>Less Sales Returns</b> –	<i>Non-cash (include in Receipts from Debtors calculation)</i>
<b>Discount allowed</b> –	<i>Non-cash (include in Receipts from Debtors calculation)</i>

**Less Cost of Goods Sold**

Opening Stock	<i>Non-cash (bought in previous periods)</i>
– Cash Purchases	<i>Operating Activities</i>
Credit Purchases	<i>Only Payments to Creditors are included as an operating activity, this is to be calculated</i>
– Customs duty	<i>Operating Activities</i>
– Freight inwards	<i>Operating Activities</i>
Discount Received	<i>Non-cash (include in Payment to Creditors calculation)</i>
Closing Stock	<i>Non-cash (cash payments in this period for stock is reflected in the purchases accounts)</i>

**– Other Revenue**

Interest received	<i>Operating Activities (adjustments made for prepaids, payables and receivables)</i>
– Dividends received	<i>Operating Activities (adjustments made for prepaids, payables and receivables))</i>

**– Less Expenses**

– Telephone	} <i>Operating Activities (adjustments made for prepaids, payables and receivables))</i>
– Wages	
Stationery	
– Rent	
– Interest	

**– Non Cash items:**

Depreciation	<i>Non-cash DO NOT INCLUDE</i>
Bad Debts	<i>Non-cash (include in Receipts from Debtors calculation)</i>
– Bad & Doubtful Debts	<i>Non-cash DO NOT INCLUDE</i>

**Profit / Loss**                    **Do not include as cash movements already considered with the treatment of revenue and expenses**

**Statement of Changes in Owner's Equity****for the year ended 30 June**

<i>Capital (opening)</i>	<i>Non-cash (reflects cash contributions, cash from profit from previous period)</i>
<i>Add Capital contributions</i>	<i>Financing Activities</i>
<i>Less Drawings</i>	<i>Financing Activities</i>
<i>Add Profit</i>	<i>Movement already accounted for through operating activities</i>

**Balance Sheet****as at 30 June****Current Assets**

<i>Cash</i>	<i>Movement reflected in Statement of Cash Flows.</i>
<i>Debtors</i>	<i>Operating Activities – Only include receipts from debtors calculation required</i>
<i>Allowance for Doubtful Debts</i>	<i>Non-cash</i>
<i>Inventory</i>	<i>Non cash – Cash movement reflected in cash purchases and payment to creditors.</i>
<i>Receivable Revenue</i>	<i>Operating Activities – Calculation required</i>
<i>Prepaid Expenses</i>	<i>Operating Activities – Calculation required</i>
<i>Term Deposits</i>	<i>Movement – Investing Activities</i>

**Non-Current Assets**

<i>Equipment</i>	<i>Movement–Investing Activities</i>
<i>Accumulated Depr</i>	<i>Non-cash</i>
<i>Land &amp; Buildings</i>	<i>Movement – Investing Activities</i>
<i>Term Deposits</i>	<i>Movement – Investing Activities</i>

**TOTAL ASSETS****Current Liabilities**

<i>Bank Overdraft</i>	<i>Movement reflected in Statement of Cash Flows</i>
<i>Creditors</i>	<i>Operating Activities – Only payments to suppliers calculation required.</i>
<i>Expenses Payable</i>	<i>Operating Activities – Calculation required</i>
<i>Unearned Revenue</i>	<i>Operating Activities – Calculation required</i>
<i>Short-Term loans</i>	<i>Movement Financing Activities</i>

**Non-Current Liabilities**

<i>Loans</i>	<i>Movement Financing Activities</i>
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**NET ASSETS**

*Movement reflected in Statement of Cash Flows*

# Preparing the Statement of Cash Flows

To prepare the Statement of Cash Flows, the Income Statement, Balance Sheet and the Statement of changes in equity are needed because several calculations are required to determine the:

- cash receipts from debtors
- cash payments to suppliers
- cash payments for expenses

There will be adjustments for each of the following to determine the actual cash movement;

- expenses payable
- revenue receivable
- prepaid expenses
- unearned revenue

The balance sheet will be used to determine:

- movements in non-current assets
- movements in loans

The Statement of Changes in Equity will be used to determine:

- Drawings
- Capital contributions

## Example

The financial reports for Starkeys Gaze will be used to prepare the statement of cashflows.

### Preparing Statement of Cash Flows

**Statement of Changes in Equity for Starkeys Gaze  
for the period ending 30 June**

	Current	
Capital	20,400	
Less drawings	300	<i>The whole figure is to be used for the finance section</i>
Profit	14,200	
Total Owner's Equity	34,300	

**Comparative Balance Sheets for Starkeys Gaze  
as at 30 June**

Current Assets	Current	Prior	
Bank	13,000	8,000	<i>To be used as opening and closing cash balance</i>
Debtors	8,500	4,000	<i>To be used in calculation for cash receipts from debtors</i>
Stock	2,400	1,600	
	23,900	13,600	
Non-Current Assets			
Motor Vehicles	10,000	10,000	<i>No movement, indicating no cash-flows for acquisitions or sales</i>
Equipment	20,000	10,000	<i>Increase indicates purchase of equipment, and therefore cash outflow</i>
	30,000	20,000	
Total Assets	53,900	33,600	
Current Liabilities			
Creditors	3,600	3,200	<i>To be used in calculation for cash payments to suppliers</i>
Non-Current Liabilities			
Loan	16,000	10,000	<i>Increase in loan indicates additional funds being provided by the bank and therefore cash inflow</i>
	19,600	13,200	
NET ASSETS	34,400	20,400	

**Income Statement for Starkeys Gaze  
for year ending 30 June**

<b>Revenue</b>				
Sales (cash)		19,000		<i>Included as an operating inflow</i>
Sales (credit)		5,000	24,000	<i>Part of the receipts from debtors calculation</i>
<b>Less Cost of Goods Sold</b>				
Opening Stock	1,600			
Purchases (cash)	6,000			<i>Included as an operating outflow</i>
Purchases (credit)	2,000	9,600		<i>Part of the payment to suppliers calculation</i>
Less Closing Stock		2,400	7,200	
Gross Profit			16,800	
<b>Less Expenses</b>				
Wages		2,000		<i>Included as an operating outflow</i>
Interest		200		<i>Included as an operating outflow</i>
Promotions		400	2,600	<i>Included as an operating outflow</i>
<b>Profit</b>			<b>\$14,200</b>	

**Additional information:**

- New equipment was purchased on 1 December for \$10,000 with a new loan.
- The owner took drawings of \$300.
- All expenses were paid in cash.

**Calculations for Statement of Cash Flows**

To calculate the receipts from debtors the debtors account in the ledger needs to be reconstructed.

Debtors Control			
30 June Balance	4,000	30 June Cash	500
30 June Sales	5,000		
	9,000	30 June Balance	8,500
1-July Balance	8,500		9,000

*Prior Debtors, Balance Sheet*

*Credit sales, Income Statement*

*Current Debtors, Balance Sheet*

*Calculate the cash figure*  
Total 9,000 – Balance 8,500 = 500

\*Receipts from Debtors is \$500.

Payments to Creditors – We need to reconstruct the creditors account in the ledger to determine the amount of cash paid to creditors.

Creditor Control			
Cash	1,600	30 June Balance	3,200
		Purchase	2,000
30 June Balance	3,600		
	\$5,200		\$5,200

*Prior creditors, Balance Sheet*

*Credit purchases, Income Statement*

*Current creditors, Balance Sheet*

*Calculate the cash figure*  
Total 5,200 – Balance 3,600 = 1,600

\*Payments to creditors \$1,600

STARKEYS GAZE

Statement of Cash Flows  
for the year ended 30 June

<b>Cash Flows from Operating Activities</b>			
<b>Inflow</b>			
* Cash Sales	19,000		
* Receipts from Debtors	500	19,500	
<b>Outflow</b>			
Payment to Creditors	1,600		
Cash Purchases	6,000		
Payments to Employees	2,000		
**Other Operating Expenses	400		
Interest paid	200	(10,200)	
<b>Net cash from operating activities</b>			9,300
<b>Cash Flows from Investing Activities</b>			
<b>Outflow</b>			
Equipment		(10,000)	
<b>Net cash from investing activities</b>			(10,000)
<b>Cash Flows from Financing Activities</b>			
<b>Inflow</b>			
Loan		6,000	
<b>Outflow</b>			
Drawings		(300)	
<b>Net cash from financing activities</b>			5,700
Net increase in cash			5,000
Cash balance at beginning			8,000
Cash balance at end			\$13,000

\* These could be added together as Receipts from Customers, \$19,500.

\*\* Other Operating Expenses for this example only include the Promotions Expenses, \$400, however would often include a number of expenses from the income statement.

The movement in cash equals the Net increase in cash

## Adjustments to expenses

Before preparing the statement of cash flows, adjustments need to be made to isolate cash movements.

### Payables

Payables represent deferred payments. Thus, payables incurred in the current period will represent cash outflows in the next period. Payables outstanding from the previous period will be paid in the current period.

#### Example

- The wages expense is \$50,000
- Wages payable \$1,500
- Last year's wages payable was \$500

To calculate cash outflow for wages;

$$\text{Cash outflow} = 50,000 - 1,500 + 500$$

$$\text{Cash outflow} = 49,000$$

This year's wages payable figure is deducted because it is included in the expenses figure; however, the payment has been delayed until the next period. Last year's wages payable is added as the payment was deferred until the current period and has subsequently been paid.

#### Activity 1

- The electricity expense is \$25,000
- Electricity payable \$800
- Last year's electricity payable was \$900

Calculate cash outflow for electricity:

#### Activity 2

- The Interest expense is \$2,500
- Last year's interest payable was \$100
- Interest payable \$400

Calculate cash outflow for interest:

## Revenue Receivable

Revenue receivable represents future cash inflows. Thus, accrued revenue earned in the current period will represent cash inflows in the subsequent period. Revenues receivable from the previous period is received in the current period.

### Example

- Commission received is \$100,000
- Commission revenue receivable \$2,500
- Last year's Commission revenue receivable \$3,000

To calculate cash inflows from the commission;

Cash inflow=  $100,000 - 2,500 + 3,000$

Cash inflow= 100,500

This year's commission receivable figure is deducted because it is included in the revenue figure; however, the cash inflow will not occur until the next period. Last year's receivable is added as the cash inflow was deferred to the current period.

### Activity 1

- Dividend revenue is \$2,000
- Dividend revenue receivable \$500
- Last year's Dividend revenue receivable was \$600

Calculate cash inflow for dividend revenue:

### Activity 2

- Interest revenue is \$4,000
- Last year's interest revenue receivable was \$250
- Accrued interest revenue receivable \$400

Calculate cash inflow for interest;

## Prepaid Expenses

Prepaid expenses represent payments made for items yet to be expensed. Thus, prepaids incurred in the current period will not be included in the expense account. Last year's prepaid expense will be included in the current year expense; however, the outflow of cash was incurred in the previous period.

### Example

- Wages expense is \$50,000
- Prepaid wages \$1,500
- Last year's prepaid wages was \$500

To calculate cash outflow for wages;

Cash outflow=  $50,000+1,500-500$

Cash outflow= 51,000

Last year's prepaid wages figure is subtracted because it is included in the expenses figure; however, the cash outflow occurred in the previous period. The current year's prepaid wages are added as the payment was made in the current year.

### Activity 1

- Electricity expense is \$25,000
- Prepaid Electricity \$800
- Last year's Prepaid was \$900

Calculate cash outflow for electricity:

### Activity 2

- Insurance expense is \$2,500
- Last year's Prepaid Insurance was \$100
- Prepaid Insurance \$400

Calculate cash outflow for insurance:

## Unearned revenue

Unearned revenue represents inflows for revenue not yet earned, and therefore are not included in the current year's revenue account, even though the cash has been received. Thus, unearned revenue is a cash inflow in the current period. Unearned revenue from the previous period is included in the current year's revenue figures; however, the cash inflow occurred in the last period.

### Example

- Sales revenue \$100,000
- Unearned sales revenue \$2,500
- Last year's Unearned sales revenue \$3,000

To calculate cash inflows from sales;

Cash inflow=  $100,000 + 2,500 - 3,000$

Cash inflow= 99,500

This year's unearned sales revenue is added, as although the sales have not been earned, the cash has been received. Last year's unearned sales revenue was deducted. Although the revenue was earned in the current period, the cash inflow was received in the previous period.

### Activity 1

- Rent revenue is \$2,000
- Unearned Rent Revenue \$500
- Last year's Unearned Rent revenue was \$600

Calculate cash inflow for rent revenue:

### Activity 2

- Sales revenue is \$4,000
- Last year's Unearned sales revenue was \$250
- Unearned sales revenue \$400

Calculate cash inflow for revenue:

## Statement of Cash-Flows Activity 1

Rodrigo Carlos manages a fitness and gym supply retail store. He has asked you to create a Statement of Cash Flows from his Income Statement, Statement of Changes in Equity and Balance Sheet.

**Mad Fit Products**  
**Income Statement**  
**For the year ended 30 June**

Sales		
Cash	480,000	
Credit	<u>220,000</u>	700,000
Less Cost Of Goods Sold		
Opening inventory	100,000	
Purchases	562,000	
Cartage	<u>8,000</u>	
	670,000	
Less Closing inventory	<u>90,000</u>	<u>580,000</u>
<i>Gross Profit</i>		120,000
<i>Less Other Operating Expenses:</i>		
Selling		
Advertising	16,000	
Sales wages	72,000	
Depreciation on delivery vehicle	<u>4,000</u>	92,000
Administrative		
Depreciation on fixtures and fittings	5,000	
Insurance	<u>3,000</u>	8,000
Financial Expenses		
Bad debts	6,000	
Interest on mortgage	<u>19,000</u>	<u>25,000</u>
		125,000
<i>Net profit</i>		<u>-5,000</u>

**Mad Fit Products**  
**Statement of Changes in Owner's Equity**  
**for the year ending 30 June**

Capital	313,000	
Add net profit	- 5,000	
	308,000	
Less drawings	7,000	301,000

**Mad Fit Products**

**Balance Sheet**  
**As at 30 June**

	Current		Prior	
<b>Current Assets</b>				
Cash at Bank				9,000
Debtors	36,000			40,000
Inventory	90,000			100,000
Prepaid insurance	<u>5,000</u>			<u>3,000</u>
		131,000		152,000
<b>Non Current Assets</b>				
Shares, Telstra				50,000
Furniture & fittings	75,000		60,000	
Less Accumulated Depreciation	<u>35,000</u>	40,000	<u>30,000</u>	30,000
Delivery Vehicle	38,000		38,000	
Less Accumulated Depreciation	<u>8,000</u>	30,000	<u>4,000</u>	34,000
Premises		<u>300,000</u>		<u>170,000</u>
<b>Total Assets</b>		501,000		436,000
<b>Current Liabilities</b>				
Bank overdraft		60,000		
Creditors		48,000		20,000
Sales wages payable		<u>2,000</u>		<u>3,000</u>
		110,000		23,000
<b>Non-Current Liabilities</b>				
Mortgage		<u>90,000</u>		<u>100,000</u>
		200,000		123,000
<b>NET ASSETS</b>		301,000		313,000

**Additional Information:**

- All acquisitions and disposals of non-current assets were for cash
- Telstra shares were disposed of at cost price.



(a) Calculate the following:

(i) **Cash Received from debtors:**

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(ii) **Payments to suppliers:**

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(iii) **Other calculations**



(c) Explain the purpose of preparing the statement of cash flows.

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(d) Describe the and impact of the change in cash position for Mad Fit products.

- Operating Activities

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- Investing Activities

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(e) Discuss how Madfit could have improved their cash position.

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## Statement of Cash-Flows Activity 2

Joy runs a homewares store, which sells kitchens and home accessories. She provides you with the following information.

### Modern Homewares Income Statement for year ended 30 June

Sales (credit)	35,000	
Less Discount	<u>70</u>	34,930
<i>Less cost of goods sold</i>		
Inventory (opening)	5,200	
Purchases (credit)	10,900	
Less Discount	<u>60</u>	
	16,040	
Less Inventory on hand	<u>3,400</u>	<u>12,640</u>
<b>GROSS PROFIT</b>		<b>22,290</b>
<b>Other Revenue</b>		
Interest on loan		<u>125</u>
		22,415
<b>Expenses</b>		
Insurance	100	
Rent	730	
Telephone	340	
Wages	12,000	
Bad debts	60	
Interest	445	
Depreciation	<u>150</u>	<u>13,825</u>
<b>PROFIT</b>		<b>8,590</b>

**Modern Homewares**  
**Statement of Changes in Equity**  
**for the year ending 30 June**

Capital	10,220	
Net profit	8,590	18,810
Drawings (cash)		<u>-2000</u>
		<u>16,810</u>

**Modern Homewares**  
**Comparative Balance Sheets as at 30 June**

<b>Current Assets</b>	<b>Current year</b>	<b>Prior year</b>
Cash at bank	3,600	800
Debtors	400	700
Inventory	3,400	5,200
Prepaid insurance	<u>240</u>	-
	<u>7,640</u>	<u>6,700</u>
<b>Non-current Assets</b>		
Shop fittings	16,065	12,915
Accumulated depreciation	-765	-615
Display equipment	8,800	4,800
Loan to N. Smart	2,000	-
Shares in AMP		<u>600</u>
	26,100	17,700
<b>TOTAL ASSETS</b>	<b>33,740</b>	<b>24,400</b>
<b>Less Current Liabilities</b>		
Creditors	4,695	3,180
Wages Payable	1,235	-
Loan	<u>11,000</u>	<u>11,000</u>
	<u>16,930</u>	<u>14,180</u>
<b>Net Assets</b>	<b><u>16,810</u></b>	<b><u>10,220</u></b>

### Other information

- All acquisitions and disposals of non-current assets were for cash.

(a) In order to prepare a statement of cash flows for Modern Homewares, calculate:

(i) receipts from debtors.

Debtors

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(ii) payments to suppliers.

Creditors

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Use the space below for any other calculations.



(c) With reference to the Statement of Cash Flows for Modern homewares, describe the effect on the change in cash position caused by the firm's:

(i) Operating activities.

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(ii) Investing activities.

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**Statement of Cash – Flows Activity 3**

Elise runs the Clean Kitchen Café. She provides you with the following information.

**Clean Kitchen  
Income Statement for year ended 30 June**

	\$	\$
Sales (cash)	70,000	
Sales (credit)	<u>45,000</u>	115,000
<i>Less cost of goods sold</i>		
Opening Inventory	1,000	
Purchases (credit)	46,000	
Less Discount	<u>600</u>	
	46,400	
Less Closing Inventory on hand	<u>1,400</u>	<u>45,000</u>
<b>GROSS PROFIT</b>		<b>70,000</b>
<i>Other Expenses</i>		
Rent	11,000	
Administration expenses	4,000	
Wages	50,000	
Bad debts	500	
Interest	1,200	
Depreciation	<u>1,509</u>	<u>68,209</u>
<b>PROFIT</b>		<b>1,791</b>



**Clean Kitchen**  
**Statement of Changes in Equity**  
**for the year ending 30 June**

Capital	24,309	
Profit	1,791	26,100
Drawings (cash)		<u>(10,000)</u>
		<u>16,100</u>

**Clean Kitchen**  
**Comparative Balance Sheets as at 30 June**

<b>Current Assets</b>	<b>Current year</b>	<b>Prior year</b>
Cash at bank		800
Debtors	10,000	9,000
Inventory	1,400	1,000
	<u>11,400</u>	<u>10,800</u>
<b>Non-current Assets</b>		
Restaurant fittings	12,000	10,000
Accumulated depreciation	(4,500)	(3,000)
Vehicle	10,000	18,000
Accumulated depreciation	(6,000)	(4,000)
<b>TOTAL ASSETS</b>	<hr/> 22,900	31,800
<b>Less Current Liabilities</b>		
Overdraft	1,900	
Creditors	4,500	5,000
Wages Payable	400	500
	<u>6,800</u>	<u>5,500</u>
<b>Net Assets</b>	<b><u>16,100</u></b>	<b><u>26,300</u></b>

### Other information

- All acquisitions and disposals of non-current assets were for cash.

(a) In order to prepare a statement of cash flows for Clean Kitchen calculate:

(i) receipts from debtors.

Debtors

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(ii) payments to suppliers.

Creditors

--	--

(iii) payments to employees.

Use the space below for any other calculations.

- (b) Using your calculations and other relevant information, prepare a Statement of Cash Flows for Clean Kitchen for the year ended 30 June.

**Clean Kitchen**  
**Statement of Cash Flows for year ended 30 June**

CASH FLOWS FROM OPERATING ACTIVITIES

Net cash flows from operating activities

CASH FLOWS FROM INVESTING ACTIVITIES

Net cash flows from investing activities

CASH FLOWS FROM FINANCING ACTIVITIES

Net cash flows from financing activities

NET INCREASE/DECREASE IN CASH HELD

CASH AT BEGINNING OF PERIOD

CASH AT END OF PERIOD

- (c) With reference to the statement of Cash Flows for Clean Kitchen, discuss the impact the investing activities had on the cash flows. Evaluate whether the business can rely on investing activities for future cash inflows.

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## Internal controls to guard cash asset

Cash is one of the firm's greatest assets, but also one of the most vulnerable. Thus, proper safeguards, or internal controls, need to be put into place. Good internal control practices can help minimise the risk of misuse or misappropriation of cash;

When cash is kept on the premise, it is important to;

- lock cash in a secure location like a safe or locked storage facility.
- regularly bank cash receipts.
- minimise the funds held overnight.
- count cash in a non-public area not easily visible to others.

Lack of controls around access to cash can lead to employee embezzlement. The following employee controls are recommended:

- conducting the proper background checks on prospective cash handlers.
- providing combinations, passwords only to authorised personnel.
- change combinations, passwords annually, or when an account access holder leaves.
- using a 'buddy system' when taking funds from one location to another.
- restricting access of cash to as few people as possible.

One of the most effective controls is the separation of duties. This refers to the separation of cash handling duties among different people. With the proper separation of duties, no single person has control over the entire cash process.

Finally, reviewing and reconciling. It is essential to keep track all transactions coming in and out of the bank account. To reconcile means to agree the business's cash records with the bank's records. All entities should perform monthly reconciliations of cash records and bank account statements to provide proper checks and balances.

## Bank Reconciliations

Performing regular bank reconciliation used to be a long and arduous process. However, cloud-based accounting software has drastically innovated this process. With most online cloud-based accounting programs, bank transactions arrive automatically load into the accounting software daily. Many of these programs will automatically match the bank transactions to any corresponding ledger transactions; the bookkeeper just needs to approve the recommended match. However, there may still be some discrepancies due to timing. Some transactions such as cheques payments, international transfers and PayPal transactions can have a payment lags, and this may cause differences between the businesses records and the bank records. However, recent developments in the bank system have significantly reduced pay lags.

## The Bank Reconciliation process

The bank reconciliation process is the process confirms the firm's records match the bank records. It is essentially a completeness check. The only discrepancies left after the bank reconciliation process has been performed are differences due to timing, such as deposits not yet recorded and unpresented cheques. An unpresented cheque is one that has not yet been presented by the payees bank and therefore the business's bank has not released the funds. There may also be a delay between when the cheque is written by the business and the time it takes for the payee to receive it and take it to their own bank for deposit.

The process of preparing the bank reconciliation is summarised in Figure 6.2.



Figure 6.2: Steps in the bank reconciliation process.

## The Bank Reconciliation Report

Figure 6.3 provides an example of a Bank Reconciliation Report.

Balance as per bank statement	1,850 Cr
Add deposits not yet recorded	250
Less unpresented cheques	(50)
Balance as per the firm's records	2,050 Dr

Always start with the bank balance

Add deposits that do not show up on the bank statement

Subtract cheques, which have not been presented to the bank.

If the reconciliation has been performed correctly, the reconciled bank records should match the firm's bank records.

Figure 6.3: Example Bank Reconciliation

Note: These processes will be swapped if the bank statement is in overdraft (Dr).

**Example**

**Preparing Bank Reconciliation**

At the end of December, Louis's Cafe's bank statement shows a balance of \$9,000 credit.

When Louis checked the bank statement against the business's cash records, he noted the following differences:

- Government charges in the bank statement totalling \$50.
- Deposits not presented to the bank totalling \$900.
- Bank fees received totalling \$15 were not recorded in the business's records.
- Cheques written for the month totalling \$4,000, but only \$3,400 of this total appears in the December bank statement.

Update the firm's records and prepare a bank reconciliation statement as at 31 December.

Cash at Bank			
31-Dec	Balance	9,365	
31-Dec	Gov. Charges		50
31-Dec	Bank fees		15
31-Dec	Balance		9,300
		9,365	9,365
1-Jan	Balance	9,300	

These two entries are made to update the firm's records

**Louis's Cafe Bank reconciliation statement as at 31 December**

The total equals the firm's records

Balance as per the Bank Statement		9,000 Cr
Add deposits not yet reconciled		900
Less unpresented cheques	4,000 - 3,400 = 600	(600)
Balance as per the bank statement		9,300 Dr

It is important to note that the bank statement is written from the banks perspective, and thus a customer with a savings account is a creditor for the bank. That is why businesses with a positive bank balance will be in credit on the bank statement.

## Activity 1

### Preparing Bank Reconciliation

At the end of June, RC Accountants bank statement shows a balance of \$5,000 credit.

When Richard checked the bank statement against the business's cash records, he noted the following differences:

- Deposits not yet recorded by to the bank totalling \$1,500
- Bank interest received totalling \$25 was not recorded in the firm's records.
- Unpresented cheques totalled \$800

Update the firm's records and prepare a bank reconciliation statement as at 30 June.

		Cash at Bank
30-June	Balance	5,675

#### RC Accountants Bank reconciliation statement as at 30 June

Balance as per the Bank Statement
Add deposits not yet presented
Less unpresented cheques
Balance as per the bank statement

## Activity 2

### Preparing Bank Reconciliation

At the end of June, The T-shirt company's bank statement showed a balance of \$2,000 debit. Evan, has asked you to prepare a bank reconciliation.

After checking the records, you find the following discrepancies;

- Deposits not yet recorded by the bank totalling \$500
- Bank fees totalling \$100 were not recorded in the firm's records.
- Unpresented cheques totalled \$300

Update the firm's records and prepare a bank reconciliation statement as at 30 June.

Cash at Bank	
	30-June Balance 1,700

#### RC Accountants Bank reconciliation statement as at 30 June

Balance as per the Bank Statement
Add deposits not yet presented
Less unpresented cheques
Balance as per the bank statement

## Sources of finance

Cash forecasting can reveal the need for additional finance to ensure that the business does not face any short-term liquidity problems. Figure 6.4 and 6.5 outline a number of short and long-term financing options that managers can consider.



Figure 6.4: Sources of finance

Note that any increase in the amount of debt a business acquires increases the business's level of gearing. Gearing the level of funding from owners capital as opposed to external debt funding. The higher the gearing, the more risk, as the higher the debt and interest burden on the business.

Types of Finance	Advantages	Disadvantages
<p><b>Retained Profits</b></p> <p>Residual profits kept in the business after drawings have been allocated to the owners.</p>	<ul style="list-style-type: none"> <li>• Does not require repayment</li> <li>• Does not increase gearing and therefore increase risk.</li> </ul>	<ul style="list-style-type: none"> <li>• Only available if profits are made and cash is available.</li> </ul>
<p><b>Additional Capital</b></p> <p>The owner contributes further investment into the business.</p>	<ul style="list-style-type: none"> <li>• A inexpensive source of finance as interest is not charged and does not require repayment</li> <li>• Lowers the gearing, and therefore the business risk. The lowered gearing also makes the business more attractive to potential lenders.</li> </ul>	<ul style="list-style-type: none"> <li>• Owners do not always have funds available to contribute.</li> <li>• May take time for owners to recoup their investment.</li> </ul>
<p><b>Trade Creditors</b></p> <p>Suppliers who have extended credit for purchases. Credit is typically extended for 30 days.</p>	<ul style="list-style-type: none"> <li>• An easily obtained source of finance</li> <li>• Typically, no extra charges are applied, unless charged fees for late payments.</li> </ul>	<ul style="list-style-type: none"> <li>• If the business is unreliable and late with payments this may lead to loss of credit facilities and may impact the credit rating</li> <li>• Only suitable to fund the purchase of supplies/inventory</li> </ul>
<p><b>Bank Overdraft</b></p> <p>This facility allows the business' bank account to go into negative up to an agreed-upon limit.</p>	<ul style="list-style-type: none"> <li>• Interest is paid only on the amount used</li> <li>• Flexible source of finance. It can be accessed when needed. Credit can be useful for businesses that experience seasonal changes or fluctuations in demand and thus variations in cash inflows</li> </ul>	<ul style="list-style-type: none"> <li>• Only suitable as a short term source of finance</li> <li>• Interest rates are relatively high and subject to change</li> <li>• While in practice, the bank will not recall an overdraft at short notice, it is able to do so. It may also lower the overdraft limit.</li> </ul>
<p><b>Debt factoring</b></p> <p>Factoring involves selling unpaid customer invoices, Debtors, to a debt factoring provider. The debt factor provider has the authority to collect the outstanding amounts from the debtors.</p>	<ul style="list-style-type: none"> <li>• Generates cash quickly</li> <li>• Frees management from the responsibility of managing debtors</li> </ul>	<ul style="list-style-type: none"> <li>• A relatively more expensive source of finance as debtors are sold at a discount</li> <li>• The firm loses contact with its credit customer, and this may influence future revenue.</li> </ul>
<p><b>Loans</b></p> <p>Loans come in different forms and can be short, medium or long term. The debt requires repayment with interest as well as the principle borrowed.</p>	<ul style="list-style-type: none"> <li>• Requires set regular repayment, which can assist in cash flow planning.</li> <li>• The bank cannot demand repayment until the instalment is due.</li> <li>• Unlike equity finance, this form of finance does not relinquish control of the business.</li> </ul>	<ul style="list-style-type: none"> <li>• May require security/ collateral</li> <li>• Variable interest rates are subject to market fluctuation.</li> <li>• Increases gearing, which increases business risk and makes the business less desirable to lenders, if seeking future loans.</li> </ul>
<p><b>Mortgages</b></p> <p>A mortgage is a long-term source of finance secured by a property—usually land and/or premises.</p>	<ul style="list-style-type: none"> <li>• Lower interest rates due to large loan amount and security.</li> <li>• The other advantages associated with loans apply</li> </ul>	<ul style="list-style-type: none"> <li>• The bank can possess property used as security upon default. The other disadvantages associated with loans apply</li> </ul>
<p><b>Leasing</b></p> <p>Leasing is used for assets such as property, vehicles and equipment. The lessor (who provides the asset) allows the lessee to use that asset for a specified period. The lessee must make regular payments.</p>	<ul style="list-style-type: none"> <li>• Unlike the purchase of an asset, leasing does not require a cash outlay thus funds are not tied up in assets</li> <li>• The lease payments are a tax deduction</li> <li>• Not subject to interest rate fluctuation</li> <li>• Often, the asset leased is 'maintained' by the lessor. Thus, they cover some maintenance expenses.</li> <li>• Does not impact on gearing.</li> <li>• Upgrading assets may be available.</li> </ul>	<ul style="list-style-type: none"> <li>• Can be more expensive over the life of the lease.</li> <li>• The lessor retains ownership of the asset.</li> </ul>

Figure 6.5: Types of finance

## Selecting appropriate sources of finance

Inappropriate financing can lead to excessively high gearing, problems meeting debt repayments, excessive exposure to changes in variable interest rates and expensive repayments. All these factors can increase the risk of financial distress and bankruptcy. Managers should consider several factors before choosing a source of finance;

- **Matching principle:** Involves using the appropriate finance for purchasing an asset by matching the term of the finance to the life of the asset. Current assets should be bought with short-term finance while non-current assets should be purchased with long-term finance. Preventing the business from repaying the debt, long after the benefits of the asset have been consumed.
- **The risk involved in repayment:** Will the repayments put excessive burden of the firm's cash flows. The firm should also consider the timing of repayments. Some seasonal businesses can struggle to meet their debt obligations during their slow season.
- **Impact on gearing;** High gearing not only increases the risk of bankruptcy but also reduces the chance of the business acquiring future debt financing.
- **Overall cost;** Sometimes it is more beneficial to finance purchases through equity, as external finance can be excessively costly, particularly considered all the costs included over the life of the debts agreement.
- **Security;** If no security is given, the interest rate will be higher. However, offering security means that there is a risk that the lender will take the asset if the borrower defaults.

## Budgets

### Cash budgets

One method of identifying the need for additional finance is to prepare a Cash Budget. A Cash Budget is a report made to estimate the future cash position of the firm. The report predicts the future cash inflow, outflows, and therefore overall cash position.

Budgeting involves;

- **Planning:** Management will firstly review the firm's goals and objectives. They will then devise financial tactics and plan the assets required to achieve the goals and objectives. Planning assists in identifying future finance needs.
- **Control:** The budgeted figures provide a standard against which the actual performance can be measured. Budget targets help control costs and reduce unfavourable budgeted variances, as early corrective action can be taken before the budget is exceeded.
- **Evaluating:** The performance of the firms can be evaluated by comparing the actual performance with budgeted performance.

Preparing a budget assists in management decision making. The budget clarifies the firm's plans in financial terms, assisting managers in making decisions which are consistent with the firm's objectives.

Overall, the act of budgeting better prepares the business for the future. A business which takes a proactive approach to cash management rather than reactive approach will be more likely to sustain financial stability.

Furthermore, cash budgets can assist in;

- identifying future cash shortages. The business can, therefore, arrange appropriate finance to ensure that it remains liquid.
- identifying idle cash which could be more efficiently used to generate revenue.
- indicating when funds will be available to purchase inventory or other assets.

### Budgeted Statements of Cash flow

Some firms will also prepare a Budgeted Cash-Flow Statement. This statement is very similar to a Cash-Flow statement; however, like a Cash Budget, it is based on estimated cash inflows and outflows. However, it is a more comprehensive statement, as it estimates the movement of cash according to activity (operating, investing or financing). It is useful in forecasting whether the business will rely on internal or external sources of funds. It is often prepared with a budgeted Income Statement and Balance Sheet.

## Example

### Preparing Cash Budgets

Before preparing the Cash Budget, the timing of cash inflow and outflows need to be determined. This process will involve:

- estimating and mapping when receipts from debtors will occur
- estimating and mapping when payments to creditors are required
- adjustments for prepayments, payables, unearned revenue and accrued revenues
- making any other changes required to isolate cash movements.

To map out the receipts for debtors, the accountant will prepare a schedule of debtors. Credit sales result in future cash payments. The schedule of debtors will predict when the firm will receive payments from debtors.

## Example

Bill runs a small Chiropractic practice. He has asked his accountant to prepare a Cash Budget for March, April and May.

### Mapping receipts from debtors

- He receives payment in cash and on account (credit).
- Actual and estimated credit sales;

	Actual	Estimated
	\$	\$
January	3,000	
February	2,000	
March		3,300
April		4,000

- Clients pay 80 per cent of their accounts in the month following their purchase and 15 per cent in the second month. 5% of debtors go bad and therefore are written off.
- Bill can expect that he will receive:
  - 80% of the January bills in February and therefore is not included in the budget.
  - 15% of the January bills \$450, in March
  - 5% will never be received, and therefore, are excluded as bad debts

The timing of receipts for debtors is mapped out on the debtor schedule.

Collection from Debtors	March	April	May
January	\$450		
February	\$1,600	\$300	
March		\$2,640	\$495
April			\$3,200
Total	\$2,050	\$2,940	\$3,695

## Mapping payments to creditors

Payments to suppliers will result in future cash outflow. The timing of the cash outflows needs to be estimated.

### Example

Bill sells products to assist his clients in their treatment, such as, muscle exercise bands and massage rollers.

- Estimated purchases. All purchases are made on credit. Payments are made in full the month following to take advantage of the 5% discount. Expected purchases are as follows:

February	300
March	200
April	500

- Therefore, Bill will pay the February bill in March. However, he will only pay \$285, as he will receive a 5% discount. The payments have been mapped out below.

		Payment		
		March	April	May
Bill				
February	300	285		
March	200		190	
April	500			475

It may be required to adjust revenue and expenses to determine the cash outflow and inflows.

#### Prepaid expenses

- Prepaid expenses are not included in the associated expenses account. However, they need to be added as they represent additional outflows of cash.
- However, prior year prepaid's were paid in the previous period, but are included in the current year expense account. These amounts are to be subtracted as they do not represent cash outflow for the current period.

Unearned Revenue has a similar treatment as for Prepaid expenses

- Unearned revenue are not included in the associated revenue account. However, they need to be added as they represent additional inflows of cash.
- However, prior year's unearned revenue were received in the previous period, but are included in the current year revenue account. These amounts are to be subtracted as they do not represent cash inflows for the current period.

#### Payables

- Payables are included in the expense account but have not been paid. They need to be subtracted from the expenses.
- Last periods payables are paid in the current period and therefore should in added to the cash outflows.

#### Revenue Receivable

- Revenue receivable is included in the revenue account but have not been received. They need to be subtracted from the revenue account.
- Last period's revenue receivable are collected in the current period and therefore should in added to the cash inflows for the revenue

Figure 4 summarises the adjustments for revenue and expenses

	Current year	Previous year
Prepaid expenses	Add to cash outflows	Take from cash outflows
Unearned revenue	Add to cash inflows	Take from cash inflows
Payables	Take from cash outflows	Add to cash outflows
Revenue receivable	Take from cash inflows	Add to cash inflows

## Example

Bill has the following monthly payments and expenses:

- Rent

Rent	\$800
Assistant wages	\$1,000
Insurance	\$40
Sundry expenses	\$300
Drawings	\$500
Depreciation	\$400

- All expenses are expected to remain consistent, except for rent, which will raise by 10% in April.
- At the end of May, bill owes \$100 in wages payable.

To calculate the cash outflows for operating expenses the following adjustments are required:

	March	April	May
Rent	800	880 <i>(Increase by 10%)</i>	880
Assistant wages	1,000	1,000	900 <i>(decrease by 100)</i>
Insurance	40	40	40
Sundry expenses	300	300	300
Drawings	500	500	500
Depreciation	N/A	N/A	N/A
Total Cash outflows	2,640	2,720	2,620

## Treatment of non-cash items

All non-cash items should be excluded from the Cash Budget, such as:

- Depreciation
- Doubtful debts expense
- Other items

	Estimated \$
March	4,000
April	4,400
May	4,500

- On the 28<sup>th</sup> of February, the business had \$5,500 in the bank.
- Product sales average at \$500 per month. Payment is required at the time of sale.

**Cash Budget for 'Feel Good Chiro'**

<b>Estimated Cash Receipts</b>	March	April	May
Fees – Cash	\$ 4,000	\$ 4,400	\$ 4,500
Receipts from debtors	\$ 2,050	\$ 2,940	\$ 3,695
Product sales	\$ 500	\$ 500	\$ 500
<b>Total Estimated Cash Receipts</b>	<b>\$ 6,550</b>	<b>\$ 7,840</b>	<b>\$ 8,695</b>
<b>Estimated Cash Payments</b>			
Payments to suppliers	\$ 285	\$ 190	\$ 475
Rent	\$ 800	\$ 880	\$ 880
Assistant wages	\$ 1,000	\$ 1,000	\$ 900
Insurance	\$ 40	\$ 40	\$ 40
Sundry expenses	\$ 300	\$ 300	\$ 300
Drawings	\$ 500	\$ 500	\$ 500
<b>Total Estimated Cash Outflows</b>	<b>\$ 2,925</b>	<b>\$ 2,910</b>	<b>\$ 3,095</b>
Balance at bank – opening	\$ 5,500	\$ 9,123	\$ 14,063
Receipts – Payments	\$ 3,625	\$ 4,930	\$ 5,600
Balance at bank – closing	\$ 9,123	\$ 14,053	\$ 19,653

*Opening balance is the previous months closing balance*

*Total Estimated Cash Receipts – Total Estimated Cash Outflows*

## Activity 1

### Preparing Cash Budgets

- Steve and Angela are the owners of Succulent City, a specialty cactus and succulent plant garden centre. They have noticed that their sales have recently dropped, despite the large market demand for succulents. They are suspecting that the increase in competition may be a contributing factor. They have also experienced a rise in some of their costs, and this has contributed to declining cash reserves. They have asked you to prepare a cash budget and to help forecast the financial position at the end of the next quarter. They have also asked for some advice regarding strategies that will help them manage the sustainability of the centre. The following information is to be used in the preparation of the cash budget.
- The bank balance at December 31, was \$3,000 (Dr) according to the bank statement.
- In-store sales are generally made in cash, and the majority of cash sales are to non-commercial consumers. Estimated cash sales:

	\$
January	4,500
February	4,000
March	3,300

- The garden centre has recently started to supply to commercial clients. These clients buy on credit. Estimated credit sale;

	Actual	Estimated
	\$	\$
November	5,000	
December	5,100	
January		5,200
February		5,200
March		5,400

- Customers pay 75% of their accounts in the month following their purchase and 20% in the next month. 5% of debtors go bad and therefore are written off.
- Estimated purchases. All purchases are made on credit. Payments are made in full the month following to take advantage of the 5% discount

	\$
December	3,000
January	2,900
February	2,500

- Estimated expenses for each month (all expenses requiring payment are paid in the month in which they are incurred)

	\$
Wages	3,000
Interest on loan	1,000
Advertising	400
Depreciation on equipment	300
Website maintenance	400
Administrative expenses	500
Rent	1,500

- The employees are due for their annual pay rise of 3%, starting the beginning of March.
- Steve and Angela have received notice that the rent will rise by 10% on the 1<sup>st</sup> of February
- They are also planning to contract a social media consultant in March to design and administer a new social media campaign. The contract is for \$7,000.

(a) Prepare the schedule of debtors and the cash budget;

Collection from Debtors	Jan	Feb	March

(b) Cash Budget for the months of January, February and March

Estimated Cash Receipts	Jan	Feb	March
Total Estimated Cash Receipts			
Estimated Cash Payments			
Total Estimated Cash Payments			
Balance at bank – opening			
Receipts – payments			
Balance at bank – closing			

(c) Discuss the impact the projected cash position may have on the sustainability of the business.

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(d) Recommend two options for improving the firms projected cash position.

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(e) Discuss the potential strategies Steve and Angela could use to improve their competitive position.

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**Activity 2**

**Preparing Cash Budgets**

The following details outline the expected cash inflows and outflows for Solutions Consultancy for the quarter ending 30 June.

- All sales are made on credit and sales charged to debtors during the previous three months were as follows:
  - January - \$8,000.
  - February - \$9,000
  - March - \$10,000
- Debtors are expected to continue to settle their accounts as in the past. Records show:
  - 30 per cent pay in the month following the sale
  - 60 per cent pay in the second month following sale
  - 10 per cent pay in the third month following sale.
- Expenses are paid in the month in which they are incurred

	Sales	Wages	Administrative Expenses	Sundry Expenses	Depreciation
April	\$ 9,000	\$ 6,000	\$ 2,000	\$ 1,100	\$ 1,000
May	\$ 10,000	\$ 6,000	\$ 2,200	\$ 1,400	\$ 1,000
June	\$ 12,000	\$ 6,000	\$ 2,500	\$ 1,500	\$ 1,000

- The business plans to custom build an app for their clients at the cost of \$30,000. 20% upfront payment required in April when the project begins. The remainder is due when the project is completed. Estimated completion date is the end of June.
- Estimates of expected sales and other expenses are as follows:
- Due to timing of the pay cycle, the expense figure includes \$1,000 wages payable at the end of June.
- The bank overdraft on 31 March was \$1,000. The bank has advised the company that it would impose an overdraft limit of \$3,000 until further notice.



(a) Prepare the schedule of debtors and cash budget.

Cash Budget for the months of April, May and June

Collection from Debtors	April	May	June

Estimated Cash Receipts	April	May	June
Total Estimated Cash Receipts			
Estimated Cash Payments			
Total Estimated Cash Payments			
Balance at bank – opening			
Receipts – payments			
Balance at bank – closing			

(b) Explain what effect the overdraft limit will have on the financing of the business's operations over the three months.

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Statement of Changes in Equity  
Fresh Choice Super Markets  
for the period ending 30 June

<i>Owner's Equity</i>				
Capital		\$ 41,252		
Less Drawing		\$ 100,000	-\$ (58,748)	
Add Profit			\$ 831,400	
<b>Total Owners Equity</b>				\$ 772,652

Balance Sheet

Fresh Choice Super Markets  
as at 30 June

ASSETS				
Current				
Cash at bank		\$ 149,652		
Debtors		\$ 87,000		
Inventory		\$ 11,000	\$ 247,652	
Non-Current				
Fixtures and fittings	\$ 100,000			
Less acc dep	\$ 25,000	\$ 75,000		
Premises		\$ 800,000	\$ 875,000	
<b>TOTAL ASSETS</b>				\$ 1,122,652
Current Liabilities				
Creditors			\$ 30,000	
Non-current Liabilities				
Mortgage			\$ 320,000	\$ 350,000
<b>Net Assets</b>				\$ 772,652

## Other Information

### Sales Budget

July	\$ 130,000
August	\$ 140,000
September	\$ 150,000

Note: Actual sales for May and June were \$150,000 and \$140,000 respectively.

## Expense budget

	July	August	September
Purchases	\$ 52,000	\$ 56,000	\$ 60,000
Sales staff salaries	\$ 16,000	\$ 15,000	\$ 20,500
Advertising	\$ 3,000	\$ 5,000	\$ 5,000
Office expenses	\$ 417	\$ 417	\$ 417
Finance expenses	\$ 1,250	\$ 1,250	\$ 1,250
Drawings	\$ 8,500	\$ 8,500	\$ 8,500

## Capital Expenditure Budget

	July	August	September
New trucks		200,000	
Website and app design	100,000		

## Additional information:

- Purchases are paid using 50 per cent cash and the other 50 per cent on the usual trading terms of 2 per cent/30 days and payment is made in the month following the purchase
- Sales are 70 per cent cash. Average collection from debtors, 70 per cent pay in the month of sale, 20 per cent collected the month following the sale and 10 per cent in the second month after sale.
- All expenses are paid for in the period in which they are incurred. It is also to be assumed that the owner's withdrawals are to be treated in a similar fashion each month.
- The owners are planning to create a new online delivery service. The business will need to redesign their website and buy a truck to facilitate this project. The service will commence in September. Additional labour and advertising resources have been allocated to promote and staff this service.
- In addition to the expected sales for September, the owner expects to receive an additional 10 per cent in online sales. Online orders require upfront payment.

(a) Calculate the payments to suppliers

Credit Payment Schedule			
Cash payment for purchases	July	August	September
July			
August			
September			

(b) Calculate cash and credit sales and collections from debtors.

	May	June	July	August	Sep
Cash					
Credit					

Collection from Debtors	July	August	September
May			
June			
July			
August			
Total			

(c) Prepare the Cash Budget for the months of July, August and September

Estimated Cash Receipts	July	August	September
Total Estimated Cash Receipts			
Estimated Cash Payments			
Total Estimated Cash Payments			
Balance at bank – opening			
Receipts payments			
Balance at bank – closing			

(d) Discuss the impact of the owners' decision to take out the drawings.

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(a) Prepare the schedule of debtors for April, June and July.

Collection from Debtors	April	May	June
February			
March			
April			
May			
Total			

(b) Prepare the cash budget for April, May and June.

Estimated Cash Receipts	April	May	June
Total Estimated Cash Receipts			
Estimated Cash Payments			
Total Estimated Cash Payments			
Balance at bank – opening			
Receipts – payments			
Balance at bank – closing			

(c) Comment on the timing of the planned purchase of the tractor.

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## Variance Analysis

A comparison of budgeted figures with actual figures is known as variance analysis and is part of the **control phase** of the budgeting process. Variances can be either favourable or unfavourable:

Favourable

- Actual cash inflows are higher than budgeted.
- Actual cash outflows are lower than budgeted.

Unfavourable

- Actual cash inflows are lower than budgeted.
- Actual cash outflows are higher than budgeted.

Significant budget variances should be investigated. Budget variances can be caused by:

- **Inaccurate budget estimates** can cause variances. In these cases, the assumptions the budgeted figures were based on should be re-examined. Future budgets should be based on adjusted assumptions.
- **A lack of control** can also cause variances. It can reflect that management has not adequately controlled discretionary spending on expenses.
- **Uncontrollable external factors** may also contribute to variations. Such as changes in economic conditions or global events, which may lead to changes in revenue, costs and cause disruptions in supply.

The following Cash Budget includes actual spending and variances calculation. Identify the variances, which are favourable and unfavourable.

	January				February			
	Budget	Actual	Variance	Favourable/ Unfavourable	Budget	Actual	Variance	Favourable/ Unfavourable
<b>ESTIMATED RECEIPTS</b>								
Receipts from debtors	56,000	40,000	- 16,000		50,000	53,000	3,000	
Sales	100,100	90,000	- 10,100		97,000	100,000	3,000	
<b>Total estimated receipts</b>	<b>156,100</b>	<b>130,000</b>	<b>- 26,100</b>		<b>147,000</b>	<b>153,000</b>	<b>6,000</b>	
<b>ESTIMATED PAYMENTS</b>								
Payments to creditors	40,000	40,000	-		41,000	43,000	2,000	
Purchases	43,000	37,000	- 6,000		42,000	44,000	2,000	
Utilities	2,000	2,500	500		21,000	24,000	3,000	
Wages	50,000	50,000	-		49,000	50,000	1,000	
Advertising	800	400	- 400		800	900	100	
Rent	10,000	10,000	-		10,000	10,000	-	
<b>Total estimated payments</b>	<b>145,800</b>	<b>139,900</b>	<b>- 5,900</b>		<b>163,800</b>	<b>171,900</b>	<b>8,100</b>	
Cash at beginning	55,500	55,500			65,800	45,600		
Receipts-payments	10,300	- 9,900			- 16,800	- 18,900		
Cash at end	65,800	45,600			49,000	26,700		

Which variances would the accountant be most concerned about? Why? Suggest an appropriate course of action.

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## Chapter 7 - Providing Accounting Advice

This chapter provides a range of scenarios for students to analyse and evaluate, and therefore, propose authentic accounting advice for a variety of stakeholders.

### The evolving role of the accountant

The practice of accounting has evolved. The communication and control aspects of accounting have increased significantly as accounting software manages the recording and reporting processes. Accountants must analyse financial information to examine and evaluate risks, threats and opportunities. They calculate costs and benefits of planning decisions, diagnose financial problems and suggest solutions. They must think critically and creatively to make forecasts and provide advice to stakeholders to inform decision-making.

Accountants do not work in isolation from the rest of the business and the environment it operates in. They must have an understanding of all key business functions; marketing, operations, and human resources to understand the broader impacts of their advice. In addition to using financial information accountants also incorporate non-financial information when providing advice and proposing financial solutions. Non-financial information includes aspects from the business environment such as government policy, economic growth, competitors, social attitudes, technology, the law and global factors.

*Non-financial information includes aspects from the business environment such as government policy, economic growth, competitors, social attitudes, technology, the law and global factors.* A PESTLE analysis is a well-known tool used to analyse changes in the business's operating environment that may present new threats, opportunities, and could impact decisions. This analysis will be considered in conjunction with financial information when making plans such as; changing the product mix, expanding into online operations, financing investment in new technology, changing the business model, and increasing returns to investors. As a mnemonic PESTLE represents; Political, Economic, Social, Technology, Legal and Environmental factors. The following table illustrates examples of questions used in a PESTLE analysis.

<b>P</b>	What are the potential government policy decisions that could impact overall economic growth as well as specific changes to tax rates and business support programs?
<b>E</b>	What are the trends in economic growth, inflation, and unemployment that could impact forecasts of revenue and borrowing costs?
<b>S</b>	How are social attitudes, demographic trends and cultural changes affecting sales of the business's products?
<b>T</b>	What innovations could offer gains in efficiency and reductions in costs for the business?
<b>L</b>	Are there changes to laws that will impact the costs of the business; employee expenses, compliance costs for safety and quality?
<b>E</b>	How will Climate Change potentially impact the business?

Through the focus area of managing financial sustainability students will develop a deep understanding of business issues and challenges, and the costs and benefits of the decisions made to ensure that a business remains profitable and financial stable.

Students must be able to demonstrate;

- Insightful interpretation, analysis and evaluation of accounting information
- Critical thinking and problem-solving skills to propose accounting solutions
- Ability to create highly relevant and useful information for effective decision making by stakeholders
- Evaluation of options to make recommendations and communicate these in a clear and understandable manner

Finally, when providing advice accountants must consider the different uses of accounting information by different users and tailor their advice accordingly. Therefore, as well as helping owners achieve the objectives of their business, accounting information must be relevant and understandable for different stakeholders.

## Communicating to different stakeholders

Students will also need to be able to apply a variety of communication skills in an accounting context. Different stakeholders will have different needs and require information and advice in a suitable format. Not all stakeholders possess a deep technical understanding of accounting practice and terminology. Therefore advice and strategies must be communicated in a manner that is appropriate to the needs of particular stakeholders and replicates what is occurring in the real world. Possible examples include:

- a individualised report for a stakeholder
- a face to face meeting
- emails
- a media release
- a blog post
- advice article for digital publishing
- a letter
- a combination of written and multimedia formats.

Sustainability reports are a relatively new aspect of communicating with the business's community and the general public. The information needs of this group of users will concern the environmental and social impacts of a business's activities. Data tends to be presented visually using tables, graphs, charts and diagrams. In addition, qualitative information is summarised using language that is understandable for individuals without an accounting background. All claims made in the sustainability report must be supported by evidence, and it can be part of the role of the accountant to collect and keep this evidence. Key data and information for sustainability reports can include:

- Environment – CO<sub>2</sub> emissions, water and energy use, waste and recycling
- Products and processes – sustainable sourcing of inputs, product safety and quality, packaging and waste minimisation
- Communities – partnerships with supplies, charities and support programs, health and wellbeing of staff

When preparing sustainability reports the information must still be free from bias, relevant and useful for decision making. It should faithfully represent the business's broader impacts of its activities. Figure 6.1 provides an example of information provided in a sustainability report.

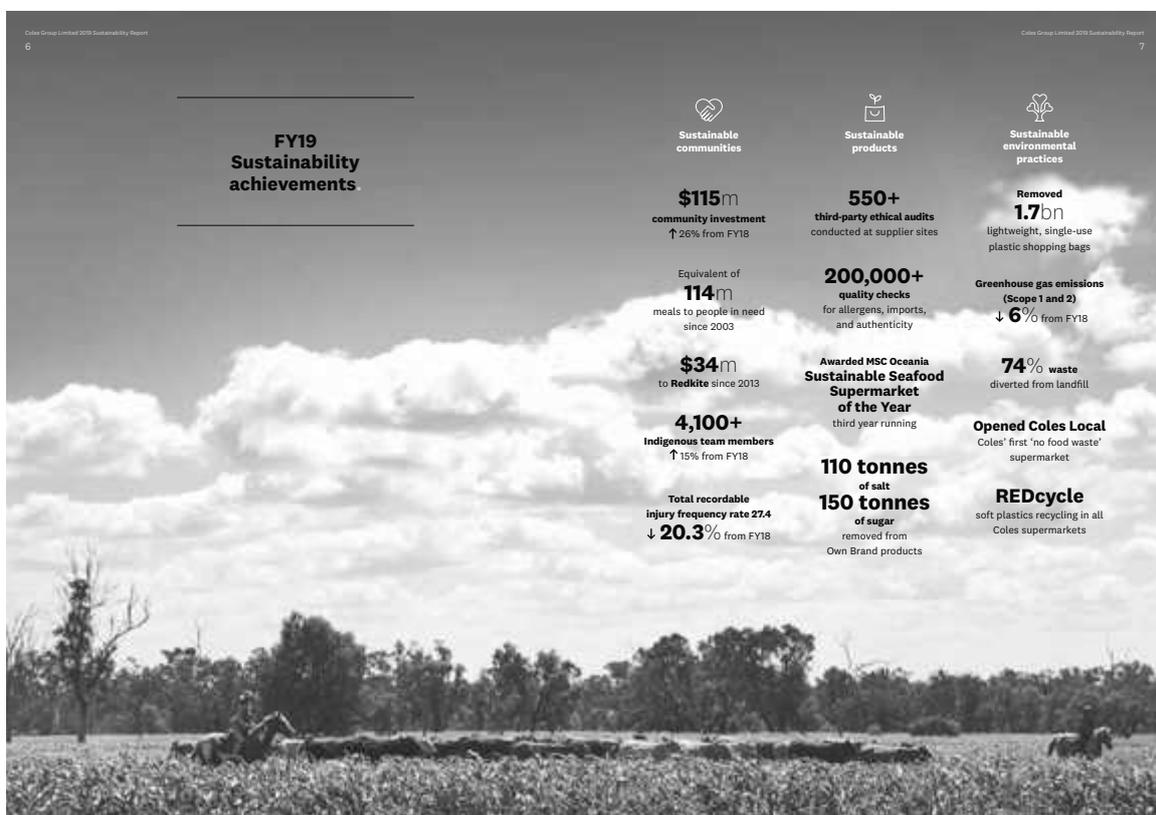


Figure 6.1. Source: Coles Sustainability Report 2019.

## Financial Ratios

Ratio analysis is a helpful tool for accountant to assess the financial performance, risk and long-term sustainability of a business. The table below outlines the key ratios which can be used when evaluating a firm's financial position.

Name	Calculation	Expressed as	Definition	Interpretation
<b>Profitability</b>				
Return on equity	$\frac{\text{profit}}{\text{owner's equity}^*}$	%	Measures the return on the owners' investment in the business.	The higher the better. Best analysed against industry averages and returns from alternative forms of investment.  Can be improved through increasing profits (increasing margins, reducing costs) or reducing owners' investment in the business.
Return on total assets	$\frac{\text{profit} + \text{interest expense}}{\text{total assets}^*}$	%	Indicates how effectively assets have been used to generate returns/ profits.	The higher the better. Best analysed against industry.  Can be improved through: <ul style="list-style-type: none"> <li>• Selling off unproductive assets</li> <li>• Utilising assets more effectively (e.g. leasing unused land assets)</li> <li>• Reducing excess cash and inventory and investing in revenue generating assets.</li> <li>• Increasing profits.</li> </ul>
Profit margin	$\frac{\text{profit}}{\text{revenue}^\dagger}$	%	Measures the percentage of sales that converts into profit.	The higher the better. Best analysed against industry averages and past periods.  Can be improved by: <ul style="list-style-type: none"> <li>• Increasing sales</li> <li>• Decreasing COGS</li> <li>• Decreasing expenses</li> </ul>
Expense	$\frac{\text{individual expenses}}{\text{revenue}^\dagger}$	%	Shows the proportion of the expense category to revenues.	Generally indicates how effectively management have controlled the expense.  Interpretation of results depends on the type of expense. Some expenses if reduced excessively can have an adverse impact of sales. e.g Marketing.
Gross profit margin	$\frac{\text{gross profit}}{\text{revenue}^\dagger}$	%	Indicates the mark-up applied on products sold.	Best compared to industry averages. High GPM indicates a good capacity to cover operating expenses.  Can be improved by increasing prices or decreasing cost of goods sold.

Name	Calculation	Expressed as	Definition	Interpretation
<b>Financial Stability (Risk)</b>				
<i>Short Term (Liquidity)</i>				
Quick ratio (acid test)	$\frac{\text{cash assets} - \text{receivables}}{\text{current liabilities}}$	ratio	An indication of immediate liquidity, within the 90 days.	Recommended to be between 1 : 1 2:1. Results of less than 1 indicate problems meeting immediate bills as they fall due. Can be improved by selling inventory and acquiring external financing.
Working capital (current ratio)	$\frac{\text{current assets}}{\text{current liabilities}}$	ratio	An indication of short-term liquidity, within the year.	Recommended to be between 1.5:1 2.0:1 Results of less than 1 indicate the firm may experience problems meeting obligations within the next year. Can be improved through increasing sales, reducing current liabilities and seeking external finance.
Debtors' turnover	$\frac{\text{net credit sales}}{\text{debtors}^*}$	Times per period	Indicates how quickly the credit sales are converted into the cash, or how many times over in a period debtors repay their debts.	Recommended for average days be within the payment terms. To improve encourage prompt payment through discounts for early payment and fees for late payment.
Debtors turnover in days	$\frac{\text{Days in the period}}{\text{Inventory turnover}}$	Days	An indicator of effectiveness of debtor management and debt collection policies and procedures.	
Inventory turnover	$\frac{\text{cost of goods sold}}{\text{inventory}^*}$	Times per period	Indicates how quickly stock is sold with in a period. A fast turnover indicates high sales volume and effective control of inventory.	To improve this ratio management should focus on strategies which increase sales. More effective control over inventory will improve stock turn over and lower costs associated with holding excess inventory. Such as focusing on fast-moving inventory lines.
Inventory turnover in days	$\frac{\text{Days in the period}}{\text{Inventory turnover}}$	Days		
<i>Long Term (Solvency)</i>				
Debt ratio	$\frac{\text{total liabilities}}{\text{total assets}}$	%	Indicates to what extent assets have been leveraged or purchased using debt finance.	Lower ratios indicated lower levels of gearing and therefore risk. Can be improved by using more equity as a source of finance.
Debt/equity	$\frac{\text{total liabilities}}{\text{owner's equity}}$	%	An indication of the business's gearing. Show the how much of the business has been financed through debt compared to internal equity finance.	Ratios of under 100% indicate lower levels of gearing and therefore lower risk. Ratios of over 100% indicate the business is highly geared and therefore has been financed mainly through debt. Can be improved by using more equity as a source of finance
Times interest earned	$\frac{\text{profit} + \text{interest expense}}{\text{interest expense}}$	Times per period	Shows the business's ability to pay its interest obligations on debts based on its current income.	A high ratio indicates a strong ability to cover interest on debt. Can be improved by obtaining lower interest rates on debt.

† Net sales should be used, except in the case where a business only provides service.

\* Averages are used for these values. However, the availability of information may necessitate the use of opening or closing values.



## Using Break-even analysis

- Financial decisions are usually based on costs versus the benefits. When implementing any significant change in a business a key question is; when will the business make a profit? A Break-even analysis is a useful tool to determine how many items need to be sold to cover the fixed costs of the business and the cost of the goods sold, and therefore when the financial benefits will be realised. The first item sold after this amount has been reached will generate a profit. Break-even analysis can also be used to determine how many items need to be sold to achieve a certain profit target. When calculating the breakeven amount it is important to round up the figure as a business will not sell a fraction of an item. The relevant formulas are;

$$\text{Break even quantity} = \frac{\text{Total Fixed costs}}{\text{Selling price per unit} - \text{variable cost per unit}}$$

$$\text{Quantity required to be sold to achieve a profit target} = \frac{\text{Total Fixed costs} + \text{Profit target}}{\text{Selling price per unit} - \text{variable cost per unit}}$$

- Fixed costs are those which the business has to pay regardless of how many items sold.
- Variable costs can be thought of as the wholesale cost or inventory purchase price of each item that is sold. Therefore as more sales are made, more variable costs are incurred.
- Sometimes the denominator (Selling price – Variable cost) is called the contribution margin.

However, to determine when the business make a profit will also require consideration of non-financial information. The economy, consumer attitudes and confidence, market share trend, strength of competition, and stage of business life cycle will impact how quickly a business can reach the break-even point.

## Providing Authentic Accounting Advice

The following scenarios are designed for students to develop and practice their skills in;

- analysing and evaluating accounting information and non-financial information to manage the financial sustainability of a business
- analysing and evaluating accounting information and non-financial information to develop and propose authentic accounting advice that informs good decision-making
- applying communication skills in an accounting context considering the needs of a variety of stakeholders and users

Just as in the real world there is no single right answer for each of the following scenarios. Students are encouraged to undertake additional research when exploring possible recommendations and advice. Possible solutions are provided in the suggested solutions chapter.

## Scenario 1. Calvin's Electronics

Calvin Zu owns and operates Calvin's Electronics, a medium sized retailer of computers, televisions, telecommunications products and accessories. 60% of total sales revenue is always earned in October, November and December. For the most recent financial year he was anticipating strong trading conditions and positive consumer confidence.

However, cost of living pressures, and high interest rates caused sales in the lead up to Christmas to be slow and the business became overstocked with an enormous variety of electronic goods. A sales promotion of 15% off the price of everything in the store was only partially successful at clearing stock. As a result, Calvin's business still held excess stocks of superseded TV's computers and mobile phones which have a very low net realisable value.

Calvin has provided the following information, which may be helpful in assessing the business.

### CALVIN'S ELECTRONICS Comparative Balance Sheets as at 30 June

	Current Year	Previous Year
<b>ASSETS</b>		
<b>Current assets</b>		
Cash at bank	84 100	85 400
Debtors	28 200	3 800
Inventory	125 000	60 000
<b>Non-current assets</b>		
Building	1 900 000	1 900 000
Furniture and fittings	389 900	338 400
<b>Total assets</b>	<b>2 527 200</b>	<b>2 387 600</b>
<b>LIABILITIES</b>		
<b>Current Liabilities</b>		
Creditors	220 000	140 000
Accrued wages	8 400	7 600
<b>Non-current liabilities</b>		
Loan	300 000	300 000
<b>Total liabilities</b>	<b>528 400</b>	<b>447 600</b>

### CALVIN'S ELECTRONICS

#### Statement of changes in equity as at 30 June, Current Year

Opening Capital- Calvin Zu	1 940 000
Less drawings	50 000
Add Profit	58 800
Closing Capital- Calvin Zu	1 948 800

## CALVIN'S ELECTRONICS

## Comparative Income Statements for the period ending 30 June

		Current Year		Previous Year
INCOME				
Net sales revenue		\$840 000		\$854 000
Less: Cost of sales		525 000		501 000
GROSS PROFIT		315 000		353 000
EXPENSES				
Selling and distribution	202 500		207 100	
Administrative	42 300		73 600	
Finance and other	11 400	256 200	12 200	292 900
PROFIT		58 800		60 100

## CALVIN'S ELECTRONICS

## Sales report (internal) most recent Quarter

Product Line	October			November			December		
	Budget (\$000)	Actual (\$000)	Variance (\$000)	Budget (\$000)	Actual (\$000)	Variance (\$000)	Budget (\$000)	Actual (\$000)	Variance (\$000)
Car gear 5%	7 500	6 100	(1 400)	8 500	2 100	(6 400)	11 000	4 100	(6 900)
Cameras 5%	7 500	3 900	(3 600)	8 500	1 300	(7 200)	11 000	2 600	(8 400)
Computers and tablets 15%	22 500	20 250	(2 250)	25 500	22 900	(2 600)	33 000	31 350	(1 650)
Gaming 15%	22 500	22 000	(500)	25 500	24 000	(1 500)	33 000	29 500	(3 500)
Headphones and speakers 10%	15 000	6 000	(9 000)	17 000	6 200	(10 800)	22 000	9 000	(13 000)
Home appliances 10%	15 000	7 400	(7 600)	17 000	10 200	(6 800)	22 000	2 800	(19 200)
Mobile phones 12.5%	18 750	15 000	(3 750)	21 250	18 000	(3 250)	27 500	22 200	(5 300)
Music 2.5%	3 750	1 600	(2 150)	4 250	1 700	(2 550)	5 500	900	(4 600)
Movies and TV (DVD, Blue ray)15%	22 500	12 350	(10 150)	25 500	5 900	(19 600)	33 000	4 550	(28 450)
Televisions 20%	30 000	27 800	(2 200)	34 000	32 000	(2 000)	44 000	24 000	(20 000)
Total	165 000	122 400	(42 600)	187 000	124 300	(62 700)	242 000	131 000	(111 000)

Write a letter, report, or email that provides the owner with detailed accounting advice which addresses:

- an analysis of the external factors affecting the business. (5 marks)
- the current financial performance of the business (by referring to relevant ratios and reports). (5 marks)
- the current liquidity position and suggested strategies to improve inventory turnover. (10 marks)
- changes that the owner could make to the business to improve its financial sustainability. (5 marks)

Answers demonstrating clear and concise communication and containing only relevant information earn up to an additional 5 marks.

## Scenario 2. Adam Ant's ARB PUBLICATIONS

### Business background

Adam Ant owns ARB PUBLICATIONS, a retailer of antique and rare books. He believes that personalised service and satisfied customers will lead to repeat business. In the store he only offers cash sales. He is reluctant to use credit card facilities because of the additional bank fees. He has found a growing market selling out of print text books to universities and colleges. His customers are researchers, professors and lecturers. For these customers he posts the book to them with a written invoice. He offers credit terms of 30 days. Clients can pay by depositing money into the business's bank account or sending a cheque. These credit sales represent 65% of total yearly sales and amounted to \$194,000 for the 2021-2022 financial year.

Adam studied accounting at school and manually creates an income statement and balance sheet each financial year. Overall the business is profitable. However, he is unable to predict cash inflow from debtors and is not certain as to how much is owed by individual customers. Adam realises his debtors management is poor. He has records but creating internal reports is too time consuming. He suspects that quite a lot of his customers forget to pay their invoice.

### The task

Advise Adam about how to improve the effectiveness of his debtors' management and the benefits of introducing point of sale and credit payment facilities.

Specifically;

- Analyse and evaluate Adam's current debtors' management system.
- Create a cash budget for the months July, August and September and compare this against a cash budget for the same period after implementation of a Point of Sale and credit card payments system.
- Discuss the impacts of updating the accounting system for managing the business.

Use accounting and non-financial information to support your response.

To assist Adam has provided the following information including emails he has written to his friend Barry Gibb, an accountant, for advice.

Date July 1 2022.

To: BarryGibb@gmail.com

CC:

Subject: Accounting advice, please help!

Hi Barry,

Business is good, sales are great but I have worries about all these customers that either take months to pay their invoices or forget completely. Truth is, I don't think I can work out who has paid and who hasn't and I just end up writing off lots of accounts. Any ideas about how to get these clients to pay! I'll send over a box of my copies of the invoices – can you see if you can do something with them please.

Secondly, I've been thinking about getting a Tap and Go machine for the business, you know what I mean. Also, lots of customers want to order and pay with a credit card. Any ideas what this would cost? Is it worth the extra hassle and the bank fees?

Cheers,

Adam

Date 4 July 2022.

To: AdamAntARB PUB@gmail.com

CC:

Subject: Time to modernise!

Hey Adam,

You definitely should consider EFTPOS and credit card facilities, get out of the dark ages man! No one's using cash these days. Your current 'cash only' system is costing you sales. I have put together some data to help you make up your mind. I would estimate that overall sales could increase by 30%. However, an EFTPOS machine and credit card plan will cost you as follows;

- \$85 establishment fee
- \$95 per month for the plan
- \$10 per month account maintenance fee
- Additional fees for disputed transactions and charge backs

Thanks for the box of paper. I'm going to be sorting this out for days. Do you have any other financial reports or information I can look at?

Cheers,

Barry

Date 5 July 2022

To: BarryGibb@gmail.com

CC:

Subject: re: Time to modernise!

Hi Barry,

Ok, I'll think about the EFTPOS/Credit card thing. Do you really think it will add 30% to sales? Is there any way to compare the results if I stay cash only or take on the extra cost? I'm going to need training and what if it breaks down?

I have attached my Balance sheets for the last two financial years and a summary of financial information that could be good for a cash budget. Hope that helps.

Cheers,

Adam

## Attachment 1.

**ARB PUBLICATIONS**  
**Comparative Balance Sheets 30 June 2022 and 2021**

	2022	2021
<b>ASSETS</b>		
<b>Current assets</b>	\$	\$
Cash at bank	4,600	3,400
Debtors	51,100	47,800
Inventory	66,100	67,800
<b>Non-current assets</b>		
Furniture and fittings	20,000	15,000
<b>Total assets</b>	<b>141,800</b>	<b>134,000</b>
<b>LIABILITIES</b>		
<b>Current Liabilities</b>		
Creditors	19,000	24,000
<b>Non-current liabilities</b>		
Loan	30,000	30,000
<b>Total liabilities</b>	<b>49,000</b>	<b>54,000</b>
<b>EQUITY</b>		
Adam Ant – Capital	92,800	80,000

## Attachment 2.

Monthly sales January 2022 to 30 June 2022. Estimates of sales July 2022 to December 2022

	Cash sales	Credit sales
January	\$8,100	\$11,700
February	8,300	14,000
March	8,400	16,100
April	8,100	21,700
May	14,900	21,650
June	12,100	23,100
July	<i>estimated 10,900</i>	<i>estimated 21,650</i>
August	<i>10,500</i>	<i>20,500</i>
September	<i>10,800</i>	<i>21,600</i>
October	<i>11,100</i>	<i>20,800</i>
November	<i>12,600</i>	<i>23,200</i>
December	<i>13,200</i>	<i>24,000</i>
<b>Total</b>	<b>129,000</b>	<b>240,000</b>

Cash sales and credit sales have been summarised in the table. Credit terms are 30 days.

Credit sales are expected to be collected:

- 60% in the month of the sale
- 25% in the month after the sale
- 10% in the second month after the sale
- Remaining 5% is written off as bad debts.

Monthly expenses incurred by the business are:

- Rent \$7,000
- Depreciation on furniture and fittings \$600
- Sales person's wages \$6,500
- Advertising \$1,780
- Stationary \$40
- Electricity \$180
- Invoicing and mailing costs 0.25% of sales

Date: 14<sup>th</sup> July 2022

To: AdamAntARB PUB @gmail.com

CC: -

Subject: Accounting system

Hi Adam,

I know I agreed to help out but your accounting system is so out of date! It has taken hours but I have put together an aged debtors listing for you from the source documents and my estimate of your current bad debts. It is much higher than you think it is and you had best implement some strategies to collect this money owed to you. You will have some serious problems with cash flow in the future!

The ATO benchmark for debtors' turnover is 30 days for a bookshop with your turnover and you are well beyond that. The potential bad debts may be as high as 10% of your credit sales. Managing your debtors should be your priority.

Have you considered purchasing accounting software and a laptop? There are several good programs available to suit small businesses like yours. I would strongly recommend it as a computerised system will be able to give you much better control over your accounts.

That's as much as I can help you now as you really need the services of small business accounting expert. They can advise you how to best use the accounting information to better manage your business. I would get them to start with a comparative cash budget showing you how good it will be for your liquidity to get that EFTPOS! Maybe they can convince you of all the advantages and give you some strategies to effectively manage those debtors.

BTW I'm sending your box of paper back!

Regards,

Barry

## Attachment 1.

### Aged Debtors analysis as at 30 June 2022. (Prepared by Barry)

Age	Balance	Estimated Bad debts (%)	\$ Bad debts
Current	\$11,500	1.0	\$115
30-60 days overdue	14,000	4.0	560
61-120 days overdue	17,000	50.0	8,500
121 days overdue	4,950	70.0	3,465
Over 6 months overdue	3,650	80.0	2,920
<b>Total</b>	<b>51,100</b>		<b>15,560</b>

## Scenario 3. William Maxwell Farm

### Business background

William Maxwell owns 7,200 hectares of farmland 5km east of Manoora, 120km north of Adelaide. Several years of drought and a drier climate has forced William to reconsider legume farming as a sustainable business. Market prices for legumes have been falling, due to a good growing season in America. A financial loss has been recorded for the last 3 years.

An opportunity available to William is to lease some of his land to a wind farm operator. He has received a letter of offer from a renewable energy operator, **WSE Infrastructure**, who is interested in developing a wind farm on his property. There already exists a successful wind farm nearby, Waterloo Wind Farm owned by Energy Australia. Leasing some of his land to a wind farm operator would be a low stress way to earn guaranteed regular income.

However, part of the farm would need to be given up for exclusive access to operator reducing farm output and income by 20%. If William accepts the offer his available farming land will decrease from 7,200 ha to 5,760 ha. As a result of the smaller scale of operations variable costs per hectare will rise from \$105 ha to \$135 per ha. William needs to weigh up the benefits against possible issues as well as the social and environmental impacts of the wind farm.

### The task

William has sought your analysis of the current state of his business and advice as to whether he should accept the offer of leasing part of his land to the wind farm operator, **WSE Infrastructure**.

Specifically;

- Develop a profitability analysis and forecasted income statement for 2023 to analyse the financial impacts of accepting the offer. Assuming that prices for legumes will not change.
- Discuss what qualitative information William should consider when deciding to accept the offer from *WSE Infrastructure*. For example, an analysis of the trends and risks related to renewable energy production
- Discuss the potential social and environmental impacts if William accepts the offer and explain how government regulations could impact the sustainability of his land.

Use accounting and non-financial information to support your response.

To assist William has provided the following information.

### Maxwell Farm Pty. Ltd.

#### Comparative statements of changes in equity as at 30 June 2022 and 2021

	2022	2021
W. Maxwell, opening capital	\$800,000	\$900,000
Profit/loss	(35,000)	(22,000)
Drawings	(65,000)	(78,000)
W. Maxwell, closing capital	700,000	800,000

**MAXWELL FARM PTY LTD.****Comparative income statements for the period ending 30 June 2022 and 2021**

		<b>2022</b>		<b>2021</b>
<b>INCOME</b>				
Sales	759,900		899,180	
Gains on sale of equipment	16,000	775,900	0	
<b>EXPENSES</b>				
Variable costs		756,000		756,000
Overhead costs				
Council rates	3,600		3,600	
Depreciation	18,220		18,220	
Electricity	4,800		5,100	
Fuel and oil	11,000		12,500	
Insurance	12,000		24,000	
Repairs and maintenance	2,200		8,280	
Telephone	280		480	
Wages	0	26,900	65,000	137,180
Finance costs				
Interest on loan	28,000	28,000	28,000	28,000
<b>PROFIT BEFORE TAX</b>		(35,000)		(22,000)

WSE Infrastructure Pty Ltd.  
225 King Arthur Road  
Adelaide 5000  
8912 6869

7 September, 2022

William Maxwell  
25 John St,  
Manoora SA 5414

Dear William,

Thank you for meeting with our representative from Sales and Services. At WSE Infrastructure, we specialise in unlocking the hidden value in your asset. We currently operate several wind farms in NSW providing clean energy for over 59 000 homes. Our income is earned from selling electricity and large-scale generation certificates (LGCs) to companies and individuals looking to voluntarily offset their CO<sub>2</sub> emissions. It is anticipated that South Australia will be self-reliant on renewable energy by 2030.

Subject to a final contract we would like to outline a preliminary offer for leasing 1440 acres of land which would represent 20% of your available farmland. However, only 3% of this area will be used for the development of actual turbines and supporting infrastructure.

As the operator, WSE Infrastructure would offer a 25 year lease with a monthly rental payment of \$8,000. There is the possibility of extending the contract an additional 5 -10 years. The lease payments will increase each year by 2% to factor in the average inflation rate.

We foresee installation of 25 turbines to produce a target of 75MW which is enough electricity to power around 35,000 households in South Australia. Installation of turbines and other wind farming structures will take 3 months and lease payments will not begin until installation is completed and the wind turbines are turned on 1 January 2023. To compensate for the delay in lease income a sign-on bonus of \$10,000 will be paid 1 November, 2022.

As part of the contract you will still own the land, however, WSE Infrastructure will require the exclusive use of some portions of the land for the following;

- installation of 25 Vestas wind turbines
- 2 substations
- power lines to connect to the electricity network
- a temporary construction compound and access road

In addition to the direct benefits to you and your family, 16 jobs will be created in the local community during construction and installation. We also support the local communities through partnerships, sponsorships and our annual Community Grants Program.

We hope you understand that windfarms have a relatively low environmental impact. WSE Infrastructure must comply with The Commonwealth Environment Protection and Biodiversity Act 1999 (EPBC Act) and the regulations of the South Australian Environment Protection Authority (EPA). We regularly conduct a range of environmental management activities to control any impacts to ensure the surrounding environment is protected.

If these general conditions are acceptable to you, please contact our office for a formal contract.

Sincerely,

General Manager

WSE Infrastructure Pty Ltd.

## Scenario 4. Ahn Ngyuen's Nextra Soft Drinks

### Business background

Ahn Ngyuen owns a small soft drink manufacturing business in Hilton. It has been operating for 28 years with consistent sales and holding a 5% share of the South Australian market. The factory is running at full capacity producing 2,000 bottles a day, 730,000 bottles per year. Variable cost per unit output is 67 cents and all output is sold to retailers for \$2.49. However, plant and equipment are at the end of their useful life leading to frequent production line stoppages and high maintenance costs.

Ahn is exploring options to grow her business and eventually sell her products in Victoria and NSW. She is considering investment in new equipment as current loan rates are low at 3.5%. However, it may be more profitable in the long run to purchase a purpose built automated manufacturing plant. Alternatively, Ahn could change her business model to cease manufacturing in Australia and become an importer of soft drink. This would require leasing a warehouse in Adelaide and only needing a few staff for marketing and distribution.

Preliminary financial information for each option is provided as follows;

Option 1. Stay at the current site and install new equipment.

- New equipment cost: \$400,000. Depreciated at 8% per year straight line
- Output increased by 20%
- Wages savings of \$300,000
- Variable costs per unit \$0.44
- Project time until completion and factory reopened: 6 months

Option 2. Close the old factory and relocate to a purpose built automated manufacturing plant.

- New factory and equipment cost \$1,900,000. Depreciated at 8% per year straight line
- Output increased by 30%
- Wages savings of \$600,000
- Variable costs per unit \$0.29
- Project time until completion and factory reopened: 3 months

Option 3. Cease manufacturing and import.

- New warehouse cost \$440,000. Depreciated at 8% per year straight line
- New equipment cost Nil
- Imported amount 500,000 bottles with option to increase this amount
- Wages savings of \$800,000
- Variable costs per unit \$1.64
- Project time until completion and first batch of inventory available for distribution: 2 months

### The task

Write a report to Ahn which evaluates the three alternatives she is considering; investment in new equipment, purchasing a new automated manufacturing plant, or becoming an importer.

Specifically;

- Develop budgeted financial reports to determine the viability of relocating the factory or becoming an importer.
- Calculate a break-even point for each option and calculate how many units must be produced to achieve a profit of \$100,000. Assume wages, insurance and interest expenses are fixed overhead costs.
- Show the impact on financial stability if she chooses to use a loan to as a source of finance in each of the 3 options.
- Discuss the impacts on stakeholders of each option.

Use accounting and non-financial information to support your response.

To assist Anh has provided the following additional information.

**NEXTRA SOFT DRINKS**  
**Balance Sheet as at 30 June 2022**

	\$	\$
<b>ASSETS</b>		
<b>Current assets</b>		
Cash at bank	14,300	
Debtors	9,500	
Inventory	66,200	90,000
<b>Non-current assets</b>		
Plant and equipment	150,000	
Accumulated depreciation	(132,650)	
Land and buildings	1,200,000	1,217,350
<b>Total assets</b>		<b>1,307,350</b>
<b>LIABILITIES</b>		
<b>Current Liabilities</b>		
Creditors	97,100	
Accrued wages payable	44,400	
Accrued electricity payable	3,500	145,000
<b>Non-current liabilities</b>		
Loan	175,000	
<b>Total liabilities</b>		<b>320,000</b>
<b>EQUITY</b>		
Ahn Ngyuen – Capital		<b>987,350</b>

**NEXTRA SOFT DRINKS**  
**Statement of cash flows for the year ended 30 June 2022**

	\$	\$
<b>Operating activities</b>		
Receipts from customers	1,808,000	
Payments to suppliers, operating expenses and employees	(1,623,700)	
		184,300
<b>Investing activities</b>		
Purchase of new equipment	0	0
<b>Financing activities</b>		
Loan	0	
Drawings	(170,000)	(170,000)
<b>Net increase / decrease in cash</b>	<b>14,300</b>	
<b>Cash at beginning of the year</b>	<b>0</b>	
<b>Cash at end of the year</b>	<b>14,300</b>	

**NEXTRA SOFT DRINKS**  
**Income statement as at 30 June 2022**

<b>INCOME</b>		
Sales	1,817,700	
<b>TOTAL INCOME</b>		<b>1,817,700</b>
<b>EXPENSES</b>		
Cost of sales*	357,700	
Depreciation factory equipment	12,000	
Wages	1,314,875	
Insurance**	27,000	
Interest on loan	6,125	
<b>PROFIT BEFORE TAX</b>		<b>100,000</b>

\*Cost of sales is variable cost per unit multiplied by the total output.

\*\*Insurance is 2% of factory and equipment historic cost

## Scenario 5. Joey Johns' Super Supplement Mart

### Business background

Joey Johns own Super Supplement Mart, a retailer of training supplements, gym apparel and accessories. She has two stores located in metropolitan shopping centres. Both stores are profitable, although one clearly outperforms the other owing to its location near a large gym and swimming centre. Managing the two locations has proved very difficult and tiring for Joey. A permanent sales person is employed at each store and casual sales staff are employed as required.

Recently Joey has performed more of the sales work herself to reduce the need for casual sales staff. She is working harder than ever, however the business was less profitable.

Joey has been considering a change in her business model. She has been investigating whether she should she should close down the less profitable store and sell some inventory through a website. She anticipates that 60% of total sales would be online. Joey has completed some research into the costs of opening an online store. She has provided data as follows;

- Website construction \$4,000
- Website maintenance and support \$500 per annum
- Rent savings annually \$41,500
- Wages savings \$84,000

Alternatively, she would like to investigate whether forming a partnership by inviting a second owner would reduce the workload, add more capital and improve profitability. She is not certain how much a capital contribution from a prospective partner would represent fair value for half the business or whether the business presents an attractive investment opportunity.

### The task

Write to Joey evaluating the two alternative business model changes she is considering; closing one shop and moving into online sales or taking on a new partner and keeping both retail locations. Use accounting and non-financial information to support your response.

To assist Joey has provided the following information.

### SUPER SUPPLEMENT MART Balance Sheet as at 30 June

	\$	\$
<b>ASSETS</b>		
<b>Current assets</b>		
Cash at bank	4,100	
Debtors	2,200	
Inventory	26,800	33,100
<b>Non-current assets</b>		
Furniture and fittings	50,000	
Accumulated depreciation	(12,850)	
Vehicle	65,000	89,150,
Accumulated depreciation	(13,000)	
<b>Total assets</b>		<b>112,250</b>
<b>LIABILITIES</b>		
<b>Current Liabilities</b>		
Creditors	7,100	
Accrued wages payable	4,400	11,500
<b>Non-current liabilities</b>		
Loan	75,000	
<b>Total liabilities</b>		<b>86,500</b>
<b>EQUITY</b>		
Joey Johns – Capital		<b>35,750</b>

**SUPER SUMMPLEMENT MART****Comparative income statements for the period ending 30 June 2021 and 2020**

		<b>Current Year</b>		<b>Prior Year</b>
INCOME				
Net sales revenue		580,000		605,000
<i>Less:</i> Cost of sales		122,600		272,250
GROSS PROFIT		320,000		332,750
EXPENSES				
Selling and distribution				
Advertising	19,000		12,000	
Depreciation expense furniture and fittings	6,425		6,425	
Discount allowed	11,600		12,100	
Freight outwards	2,475		2,675	
Sales staff wages	104,200	143,700	149,150	182,350
Administrative				
Depreciation expense on vehicle	5,200		7,800	
Insurance	18,000		17,000	
Rent	83,000	106,200	46,200	71,000
Finance and other				
Interest	6,300	6,300	6,800	6,800
PROFIT		63,800		72,600

## Scenario 6. The Southern Sharks Football Team

### Background information

The Southern Sharks football team have had a difficult year after finishing in last place. Although the club is a not-for-profit organisation it must be financially sustainable, reinvest into paying members, its junior and women's team, and the club's future. Following its poor performance and a number of off-field incidents; members, supporters, and fans have become frustrated and their loyalty tested. The club has been heavily criticised by sports commentators, the media and internet forums. Key challenges for the upcoming season that the board of directors of the Southern Sharks must consider include;

- Average attendance at matches has fallen by 50% in the last 12 months.
- A \$400,000 upgrade to toilets, seating and facilities at their stadium is urgently required. This would significantly improve spectators experience and potentially attract more families to attend matches.
- Several key players are unable to play for entire next season as a result of injury. These players are ones the fans come to watch. The club has the option of terminating their contracts early at a cost of \$300,000 and sourcing replacements.
- Two other players have been charged with serious offences as a result of their poor behaviour in nightclubs. The board is considering not allowing them to play until their court cases have been heard.
- One player has been charged with the supply of illegal performance enhancing drugs and the board suspects other players may soon be found guilty of using performance enhancing drugs and will be banned from playing for a season.
- The club's headline sponsor, Southern Auto has threatened to leave the club unless changes are made. This would reduce sponsorship income by 50%.
- Keeping prices for memberships, match tickets and merchandise affordable despite rising operating expenses.

Additional data has been provided for your analysis.

### Southern Sharks

#### Statement of cash flows for the Current and Prior years

	Current		Prior	
	\$	\$	\$	\$
<b>Operating activities</b>				
Receipts from memberships, ticket sales and merchandise	432,000		864,000	
Receipts from sponsorship	400,000		400,000	
Payments to players	750,000		750,000	
Payments to suppliers and operating expenses	665,000	(583,000)	600,000	(86,000)
<b>Investing activities</b>				
Sale of equipment	45,000			
Purchase of new equipment				
		45,000		
<b>Financing activities</b>				
Loan			200,000	
<b>Net increase / decrease in cash</b>		(538,000)		114,000
<b>Cash at beginning of the year</b>		152,000		38,000
<b>Cash at end of the year</b>		(386,000)		152,000

### The task

As the club accountant your role is to analyse the financial information available to you to advise the board of directors recommending financial strategies to address the key challenges and improve the club's financial position and profitability within the next 3 years. In your response explain the implications of your recommendations for the club's stakeholders.

Specifically;

- Write a press release in the form of an open letter to members, supporters and fans explaining the impacts of your recommendations and the benefits they can expect to experience.
- Write another letter to Southern Auto explaining the impacts of your recommendations and the benefits they can expect to experience so that remain as key sponsor.

# Solutions

## Chapter 1 – The Balance Sheet Solutions

- CTS Plastics
  - 30 June
  - \$738,844
  - Assets and Liabilities
  - No. Business has \$8,756 more current liability than current assets, which can be used to pay debts
  - \$118,756
  - Debtors of \$110,000, however, will need to wait to receive this money from credit customers before bills can be paid
  - No, it made a loss of-\$407,600
  - More information about the 2019 financial performance and past current performance, such as revenue and expenditure details. Information about the business cash-flows and management of assets such as debtors and inventory.

- The owner would be interested in the Balance Sheet, as it will indicate the businesses liquidity, gearing and return on investment. As the business made a loss of -\$407,600, the owner will be making a negative return on investment. Comparing the current assets of \$110,000 to current liabilities of \$118,756 reveals that the business has poor liquidity. Furthermore, the overdraft of \$48,756 indicates that there is now sufficient cash to manage their working capital requirements. The owner may consider closing down the investment as it has not made a return for him in the current year. Furthermore, the owner may consider to make additional capital injections or take out a loan to attend to the current liquidity needs of the business.

The staff would be interested in the balance sheet as it will indicate the sustainability of CTS plastics and therefore their job security. The loss made this year and the liquidity issues are concerning and indicates that this business is at risk of failure. This may prompt employee to look for more secure employment opportunities.

Creditors would be interested in the business ability to repay their account on time. The liquidity issues indicate that unless the business arranges alternative forms of finance, that they will experience issues pay their account on time. Creditors may not extend further credit to CTS plastics until their liquidity improves.

- Debtors, Office Equipment and Plant and Equipment and Land. The accumulated depreciation reduces the asset total.
  - Overdraft, Creditors and secured loan.
  - Capital, Profit/ Loss and Drawings.
- OE = \$65,000
  - A = \$115,000
  - L = 45,000

5.

Account Name	Description	Classification
Overdraft	A deficit in a bank account caused by drawing more money than the account holds.	L
Cash on hand	Cash kept on the premise.	A
Accounts payable	Amounts owed to suppliers for unpaid inventory. Also known as Creditors.	L
Plant and Equipment	The fixed assets used to produce goods for the firm.	A
Premise	The property used by the business in their operations.	A
Debtors	Amounts owed to the firm from customers as a result of a past credit sale. Also known as Accounts receivable.	A
Creditors	Amounts that the firm owes its suppliers as a result of past credit purchase.	L

6.

Description	Classification	Description	Classification
Creditors	L	Loan <b>to</b> J Jones	A
Loan <b>from</b> bank (due 1 year)	L	Loan secured by mortgage	L
Owner's interest in the business (Capital)	OE	Motor vehicle	A
Bank overdraft	L	Debtors	A
Furniture	A	Inventories	A
Loan from J Green	L	Premises	A
Cash at Bank	A	Land	A

7. (a) Amounts owed from customers as a result of credit sales.

Debtors	Accounts Receivable	Trade Debtors	Receivables
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(b) Asset held by the business with the intention of being resold

Merchandise	Inventory	Stock
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(c) Money held in the businesses bank account.

Bank	Cash	Cash at Bank
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(d) Amounts the business owes to suppliers as a result of past credit purchases.

Trade Creditors	Accounts payable	Payables	Creditors
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8. (a) It is a resource that the business has control over which can be used in the future to help generate economic returns. E.g used to by inventories to sell at a profit.
- (b) It is a resource that the business has control over which can be used in the future to help generate economic returns. E.g used to make deliveries.
- (c) Creditors need to be repaid in the future and thus represent a future economic sacrifice.
- (d) Loans require regular repayments and thus represent a future economic sacrifice.
- (e) The profit belongs to the owner and thus becomes part of the owner's stake in the business.

9.

**Statement of Changes in Equity**  
**JJ House of Homewares**  
**for the year ending 30 June**

	\$
Opening Capital	80,000
Profit/ loss	65,000
Less drawings	30,000
Closing Capital	<b>115,000</b>

**Balance Sheet**  
**JJ House of Homewares**  
**As at 30 June**

<i>Assets</i>	\$	\$
Bank	9,000	
Debtors	6,000	
Inventory	10,000	
Plant and equipment	56,000	
Furniture	16,000	
Premises	<u>95,000</u>	
<b>Total Assets</b>		192,000
<i>Liability</i>		
Creditors	4,000	
Loan	8,000	
Mortgage	<u>65,000</u>	
<b>Total Liabilities</b>		<u>77,000</u>
<b>Net Assets</b>		<b>115,000</b>

10.

**Statement of Changes in Equity**  
**Ice Cold Tea House**  
**for the year ended 30 June**

	\$
Opening Capital	161,000
Profit	70,000
Less drawings	40,000
Closing Capital	<b>191,000</b>
<i>Total Owners Equity</i>	191,000

**Balance Sheet**  
**Ice Cold Tea House**  
**As at 30 June**

<i>Assets</i>	\$	\$
Bank	5,000	
Debtors	4,000	
Inventory	2,000	
Furniture	20,000	
Kitchen Equipment	30,000	
Premise	200,000	
<b>Total Assets</b>		261,000
<i>Liabilities</i>		
Creditors	5,000	
Mortgage	45,000	
Loan	20,000	
<b>Total Liabilities</b>		70,000
<b>Net Assets</b>		<b>191,000</b>

11.

**Statement of Changes in Equity**  
**Personalised Prints**  
**for the year ended 30 June**

	\$
Opening Capital	80,000
Profit	67,000
Less drawings	20,000
Closing Capital	<b>127,000</b>

**Balance Sheet**  
**Personalised Prints**  
**As at 30 June**

<i>Assets</i>	\$	\$
Bank	40,000	
Debtors	2,000	
Inventory	4,000	
Office Furniture	16,000	
Plant and equipment	<u>100,000</u>	
<b>Total Assets</b>		162,000
<i>Liabilities</i>		
Creditors		35,000
<b>Total Liabilities</b>		<u>35,000</u>
<b>Net Assets</b>		<b>127,000</b>

12.

Description	Classification	Description	Classification
Creditors	<b>CL</b>	Loan <b>to</b> J Jones (due 3 years)	<b>NCA</b>
Loan <b>from</b> bank (due 1 year)	<b>CL</b>	Loan secured by mortgage	<b>NCL</b>
Register Trademark	<b>NCA</b>	Motor vehicle	<b>NCA</b>
Owner's interest in the business (Capital)	<b>OE</b>	Debtors	<b>CA</b>
Bank overdraft	<b>CL</b>	Inventories	<b>CA</b>
Furniture	<b>NCA</b>	Premises	<b>NCA</b>
Loan from J Green (due 2 years)	<b>NCL</b>	Land	<b>NCA</b>
Cash at Bank	<b>CA</b>	Goodwill	<b>NCA</b>

13.

(a) **Wilson Grocery**

Item	Name	CA, NCA, CL, NCL&OE
(a) Amount Wilson invested to begin the business	Capital	OE
(b) Money in the business bank account	Bank	CA
(c) Building from which the store operates	Building	NCA
(d) Grocery items which will be sold to make a profit for the business	Inventory	CA
(e) Amount of money Wilson has taken out of the business for his own use	Drawings	OE
(f) Truck used to deliver goods to customers	Delivery Truck	NCA
(g) Shelves in the shop	Fixtures and Fittings	NCA
(h) Computer and other office machinery	Office Equipment	NCA

(b) **Bencher's Cabinet Making**

Transaction	Name	CA, NCA, CL, NCL&OE
(a) Tools and machines used in the manufacture of benches	Tools and equipment	NCA
(b) Money the owner has invested into the bank account of the business	Capital	OE
(c) Loan made by the bank to this business to purchase premises	Mortgage	NCL
(d) The building purchased with the borrowed funds.	Buildings	NCA
(e) Amounts owing by the business to other firms that have supplied materials to the firm	Creditors	CL
(f) Amounts owing by customers who have purchased benches from the business.	Debtors	CA
(g) Money that the owner has taken out of the business for personal use	Drawings	OE
(h) Unsold benches	Inventory	CA

14. (a)

Overdraft	10,000	CL	Vehicles	68 000	NCA
Inventories	34,200	CA	Office furniture	20,000	NCA
Creditors	14,000	CL	Goodwill	27,000	NCA
Debtors	10,000	CA	Petty cash	180	CA
Capital: J Halbert	377,000	OE	Premises	290,000	NCA
Machinery	210,000	NCA	Mortgage	280,000	NCL
Investments (Maturity 3 years)	35,000	NCA	Drawings	26,000	-OE
Loan from ANP (Due 2 years)	50,000	NCL	Profit/ Loss	<b>-10,620</b>	-OE

(b)

**Statement of Changes in Equity**  
**Halbert Traders**  
**for the year ending 30 June**

Capital: J Halbert	\$ 377,000	
Drawings	-\$ 26,000	\$ 351,000
Loss		\$ 10,620
<b>Closing Capital</b>		<b>\$ 340,380</b>

**Balance Sheet**  
**Halbert Traders**  
**As at 30 June**

	\$	\$
<i>Current Assets</i>		
Petty cash	\$ 180	
Debtors	\$ 10,000	
Inventories	\$ 34,200	
Investments (Maturity 1/10/24)	\$ 35,000	
<i>Total Current Assets</i>		\$ 79,380
<i>Non-current Assets</i>		
Machinery	\$ 210,000	
Vehicles	\$ 68,000	
Office furniture	\$ 20,000	
Goodwill	\$ 27,000	
Premises	\$ 290,000	
<i>Total Non-current Assets</i>		\$ 615,000
<b>Total Assets</b>		<b>\$ 694,380</b>
<i>Current Liabilities</i>		
Overdraft	\$ 10,000	
Creditors	\$ 14,000	
<i>Total Current Liabilities</i>		\$ 24,000
<i>Non-current liabilities</i>		
Loan from ANP (Due 2 years)	\$ 50,000	
Mortgage	\$ 280,000	
<i>Total Non-current Liabilities</i>		\$ 330,000
<b>Total Liabilities</b>		<b>\$ 354,000</b>
<b>Net Assets</b>		<b>\$ 340,380</b>

15.

**Statement of Changes in Equity**  
**Greens Nursery**  
**for the year ending 30 December**

<i>Opening Capital G Thumb</i>	\$ 143,700	
Less Drawings	\$ 32,300	111,400
Add Profit		\$ 119,752.50
Closing Capital		\$ 231,152.50
<i>Opening Capital T Green</i>	\$ 143,700	
Less Drawings	\$ 27,000	116,700
Add Profit		\$ 119,752.50
Closing Capital		\$ 236,452.50
<b>Total Closing Capital</b>		<b>\$ 467,605</b>

**Balance Sheet**  
**Greens Nursery**  
**As at 30 December**

	\$	\$
<i>Current Assets</i>		
Bank	\$ 11,000	
Accounts Receivable	\$ 10,000	
Inventories	\$ 74,020	
<i>Total Current Assets</i>		\$ 95,020
<i>Non-current Assets</i>		
Shares	\$ 5,035	
Machinery	\$ 210,000	
Delivery Vehicle	\$ 52,250	
Office furniture	\$ 500	
Nursery Fixtures and Fittings	\$ 40,350	
Premises	\$ 375,000	
<i>Total Non-current Assets</i>		\$ 683,135
<b>Total Assets</b>		<b>\$ 778,155</b>
<i>Current Liabilities</i>		
Accounts Payable	\$ 13,550	
Loan From NNB (Due 10 months)	\$ 15,000	
<i>Total Current Liabilities</i>		\$ 28,550
Mortgage	\$ 282,000	
<i>Non-current liabilities</i>		\$ 282,000
<b>Total Liabilities</b>		<b>\$ 310,550</b>
<b>Net Assets</b>		<b>\$ 467,605</b>

16.

**Statements of Changes of Equity**  
**Customer Prints**  
**for the year ending 30 June**

Capital- J Dance	143,700	
Less Drawing- J Dance	27,000	116,700
Add Profit		20,590
Closing Capital		137,290

**Balance Sheet**  
**Customer Prints**  
**As at 30 June**

	\$	\$
<i>Current Assets</i>		
Petty Cash	40	
Bank	50,000	
Accounts Receivable	3,000	
Stock	20,000	
Stock of Stationery	300	
Term deposit (Maturity 6 months)	7,000	
<i>Total Current Assets</i>		80,340
<i>Non-current Assets</i>		
Office furniture	1,500	
Office Equipment	1,200	
Delivery Vehicle	52,250	
Machinery	62,000	
<i>Total Non-current Assets</i>		116,950
<b>Total Assets</b>		<b>197,290</b>
<i>Current Liabilities</i>		
Creditors		20,000
<i>Total Current Liabilities</i>		20,000
<i>Non-current liabilities</i>		
Loan From NNB (Due 3 years)		40,000
<i>Total Non-current Liabilities</i>		40,000
<b>Total Liabilities</b>		<b>60,000</b>
<b>Net Assets</b>		<b>137,290</b>

17. (a)  $110,000 - 118,756 = \$-8,756$   
 (b)  $110,000 / 118,756 = 0.93:1$   
 (c)  $110,000 / 118,756 = 0.93:1$   
 (d) The business has a working capital of  $-\$8,756$  and a working capital ratio of 0.93:1. This indicates that they cannot cover their current liabilities with their liquid assets. Furthermore, inspection of the Balance Sheet reveals that the business has no cash assets, and is relying on credit customer to pay their debts before they can cover their bills.  
 (e) The business has a negative bank balance, (an overdraft of  $\$48,756$ ), reflecting poor cash-flow management.  
 (f) Equity financing solutions;
- Increase partners capital injections – however this would increase partners investment in the business. There are questions around the soundness of this investment. (considered internal finance)
  - New equity partner will change the legal structure to a Partnership. Furthermore, the owner will need to find a partner willing to invest and give recent financial results, this may be challenging.
- Debt/ external financing solutions
- Medium to long-term loan. However, the business will need to present finances to the bank as part of the loan application process. Also, this will cause future cash-out flows in the form of loan repayments over a long period of time.
  - Other internal financing solutions
  - Sell off non-current assets- plant and equipment can be sold. The business should determine if any equipment is not being utilised or is returning a low revenue yield.
  - Debtor Factoring- Sell debtors at a discount to another party. This will not improve the Working Capital ratio, however, it will help remedy the immediate liquidity crisis.
- (g) Consumer trends – the decreasing demand for plastics and increasing demand for bio-degradable packaging solutions.
- New competition – buyers may be preferring to source plastic products from competitors
  - Supermarkets and takeaway businesses allowing customers to bring in own containers- reducing the need for plastic
  - Consumer spending – lowered consumer confidence will mean dampen discretionary spending in areas such as takeaway
18. (a)  $\text{Return on assets} = \frac{(50,000 + 5000)}{200,000} \times 100$   
 Return on assets = 27.5%
- (b) The return on asset ratio indicates how efficiently assets have been used to generate profits. A return of 27.5% is 7.5% above the industry average, and therefore indicates that assets have been used effectively to generate economic returns for the business.
19. (a)  $\text{Return on assets} = \frac{(35,000 + 2000)}{400,000} \times 100$   
 Return on assets = 9.25%
- (b) The return on asset ratio indicates how efficiently assets have been utilised to generate profits. An 9.25% return on asset is a poor result as it is 0.75% below the industry average. This indicate that assets have not been used effectively to generate economic returns for the business.
- (c) The business has a very high investment in current assets. It has three times higher investment in these assets compared to non-current assets and liabilities. Current assets typically generate low returns. Investment into income producing non-current assets usually generate higher returns. Furthermore, the business has a working capital ratio of 3:1 and there for ample liquidity to invest further in non-current assets.
20. (a) To assess the firms gearing the firms total equities and total liabilities will be reviewed.  
 (b) (i) 64%  
 (ii) CTS plastics is lowly geared, and has sources the majority of its finance through internal equity sources.  
 (c) To decrease the gearing further, the owners could contribute additional capital. This would assist in improving the firm's liquidity. However, this would increase the owner's investment in the business. This may not be advisable if the financial performance does not improve.

The business could also consider taking out a loan, this would increase gearing, however, as the firm is lowly geared this is a viable option. However, an increase in gearing will increase the firm's risk and increase financing costs. In 2019, the business had trouble managing costs, it may not be advisable to increase costs further.

- (c) The business has a very high investment in current assets. It has three times higher investment in these assets compared to non-current assets and liabilities. Current assets typically generate low returns. Investment into income producing non-current assets usually generate higher returns. Furthermore, the business has a working capital ratio of 3:1 and therefore has ample liquidity to invest further in non-current assets.

21. (a)

	Year 3		Year 2		Year 1
	Monetary Figure	% change	Monetary Figure	% change	Monetary Figure
Assets	\$ 54,000	29%	\$ 42,000	20%	\$ 35,000
Liabilities	\$ 27,000	8%	\$ 25,000	32%	\$ 19,000
Owner's Equity	\$ 27,000	59%	\$ 17,000	6%	\$ 16,000

- (b) Assets, liabilities and owner's equity are all increasing. This indicates that asset purchases were funded by owners' equity and debts. In Year 2, asset purchases were predominately funded through debt, whereas in Year 3, purchases were mainly funded through owners' equity.

(c)

	Current Assets	Non-current Assets	Current Liabilities	Non-current Liabilities	Owners Equity	Working Capital	Working Capital Ratio	Debt to Equity Ratio
Year 3	\$ 20,000	\$ 34,000	\$ 7,000	\$ 20,000	\$ 27,000	\$13,000	2.9:1	100%
Year 2	\$ 8,000	\$ 34,000	\$ 5,000	\$ 20,000	\$ 17,000	\$3,000	1.6:1	147%
Year 1	\$ 5,000	\$ 30,000	\$ 3,500	\$ 15,500	\$ 16,000	\$1,500	1.4:1	119%

- (d) The liquidity of the business has dramatically improved, increasing from 1.4:1 to 2.9:1 over three years. In Year 3, the business has ample current assets to cover current liabilities. As this ratio is now above the recommended ratio of 2:1, it is advisable that the firm use liquid assets to invest in non-current assets which will generate higher returns than bank interest.

The gearing of the business has declined by 19% over the 3 year to 100%. This is a positive trend as the business has lowered its risk as it has less debt servicing requirements.

22. (a)

	Working Capital Ratio	Quick Asset Ratio	Debt to Equity Ratio
Current	1.53:1	0.79:1	330%
Prior	2.15:1	1.4:1	415%
Industry Benchmark	1.8:1	1.3:1	100%

- (b) The working capital ratio indicates the firm has sufficient current assets to meet its short-term obligations. In current year, despite being 0.27 lower than the industry benchmark in current year. However, the quick asset ratio indicates insufficient cash and receivable to cover current liabilities in current year. Furthermore, in the quick asset ratio is .51 below the industry benchmark.

- (c) A debt to equity ratio of 330% indicates that Café Blue is extremely highly geared. Although the business has effectively reduced its gearing by 85% over the last year, it is still at a higher risk of bankruptcy.

- (d) The business has a lack of cash and receivables to cover their short-term liquidity needs. Furthermore, its investment in inventory has doubled. The cafe could focus on converting inventory into cash. This may be achieved through lowering purchases or increasing sales through discounting or advertising.

Furthermore, the business is extremely leveraged and therefore should focus on repaying its debts in order to reduce risk, this can also be achieved through capital contributions.

23. (a) R and M Consultancy is a partnership. This is an unincorporated entity and thus the owners are exposed to unlimited liability. Which means that they are personally responsible for the debts of the business and may be required to use their personal assets to settle business debts.

- (b) (i) Partnership  
(ii) Unincorporated  
(iii) Is the business, R and M Consultancy  
(iv) The owners are subject to unlimited liability, meaning that they are personally responsible for all the debts of the business.

## Extended Activity 1

(a)

**Statement of Changes in Equity for Dog World  
for the year ending 30 June**

Capital Luna Barks	\$230,400	
Drawings	<u>-\$57,000</u>	\$173,400
Loss		\$69,180
Closing Capital		\$104,220

**Balance Sheet for Dog World  
As at 30 June**

	\$	\$
<i>Current Assets</i>		
Debtors	\$10,000	
Inventory	\$74,020	
<i>Total Current Assets</i>		\$84,020
<i>Non-current Assets</i>		
Office Furniture	\$500	
Furniture and Fittings	\$10,000	
Premise	\$375,000	
Motor Vehicle	\$52,250	
<i>Total Non-current Assets</i>		\$437,750
<b>Total Assets</b>		<b>\$521,770</b>
<i>Current Liability</i>		
Overdraft	\$12,000	
Accrued Wages owed	\$5,000	
Creditors	\$70,000	
<i>Total Current Liabilities</i>		\$87,000
<i>Non-current liabilities</i>		
Mortgage	\$300,000	
Loan from M Cat	\$30,550	
<i>Total Non-current Liabilities</i>		\$330,550
<b>Total Liabilities</b>		<b>\$417,550</b>
<b>Net Assets</b>		<b>\$104,220</b>

- (b) The accounting entity concept requires the business to be treated separately from the owner's personal finance. By excluding the owner's personal savings account, the reports adhere to this concept.
- (c) Working capital ratio =  $\frac{84,020}{87,000}$
- Working capital ratio = 0.97:1
- Quick asset ratio =  $\frac{10,000}{87,000}$
- Quick asset ratio = 0.11:1
- (d) Liquidity indicates the firm's ability to pay its debts as they fall due. The working capital ratio (WCR) and quick acid ratio have been used to indicate Dog Worlds liquidity. The WCR indicates the firm's ability to pay its debts with 12 months. A result of 0.97:1, indicates that the business has \$0.97 of current assets for every \$1 of current liabilities. Thus, they are not able to cover their debts over the next year. Furthermore, the quick acid ratio indicates the firm's immediate liquidity. A results of 0.11:1, indicates extreme liquidity issues. The benchmark for the WCR is 1.5:1 and the recommended QAR level is between 1.1-1.5:1. It is recommended that the firm take immediate action to improve liquidity and consider appropriate sources of finance to increase the business' cash assets.
- (e) Dog world is a sole trader and therefore there is no legal distinction between Luna and Dog World. Thus, Luna has unlimited liability and is personally responsible for all the debts of the business.
- (f) No, it cannot. It does not have the cash available to cover immediate bills. Furthermore, it does not have enough liquid assets to pay debt obligations within the next year. This puts the business at high risk of bankruptcy and Luna may need to use her personal assets to repay the debts of the business.
- (g) A change in legal structure may help the business' liquidity position, as it will result in additional equity finance. However, Luna needs to be aware that a change in legal structure will affect her risk, liability, earnings and control over the decisions made within the business. She may consider a partnership. Under this legal structure she will still be exposed to unlimited liability, however this liability will be shared with her partner. She will no longer have the ability to control all the business decisions and will be jointly responsible for all decisions made within the business. The partner will be required to make a capital contribution, which will greatly improve the business liquidity; however, the partner will also be entitled to a share of the business profits.

She could also consider undergoing the process of incorporation to establish the business as a private company. Under this structure, she will be able to sell shares to investors to raise capital and improve the business' liquidity position. She will then have the protection of limited liability, as her liability in the business will be restricted to the amount she invested in the business. However, depending of the proportion of shares released, she may lose her decision-making ability and will need to share a profits in the form of dividends. It is advised that Luna transforms the business to a private company to reserve the benefits of limited liability.

## Chapter 2 – Income Statements

### Activity 2.1 – Income Statement for Service Entity

Fresh Cuts  
Income statement  
For the year ended June 30

	\$	\$
INCOME		
Service fees		110,000
EXPENSES		
Electricity	1,000	
Phone & internet	300	
Rent	20,000	
Salaries	25,000	
Supplies	10,000	
TOTAL EXPENSES		56,300
PROFIT/LOSS		53,700

### Activity 2.2

Account	Classification	Account	Classification
Electricity	AE	Interest on mortgage	FE
Advertising	SE	Delivery inwards	COGS
General expenses	AE	Sales staff vehicle	SE
Insurance	AE	Postage	AE
Sales staff wages	SE	Delivery of sales	SE
Rent of shop	SE	Office salaries	AE
Inventory at beginning	COGS	Repairs to building	AE
Discount expense	SE	Bad debts	FE
Purchases	COGS	Repairs to sales staff cars	SE
Stationery expense	AE	Purchase returns	COGS
Sales staff commission	SE	Buying expenses	COGS

## 2.3 Calculating Gross Profit Activities

1.

	\$	\$
<b>Sales</b>	16,000	58,000
Cash sales	42,000	
Credit sales		
Total sales		
<b>Less: Cost of Goods Sold</b>		
Opening inventory	12,000	49,000
<i>add</i> Purchases	51,000	
<i>less</i> Closing inventory	14,000	
Cost of Goods Sold		
<b>Gross Profit</b>		9,000

2.

	\$	\$
<b>Sales</b>	184,000	172,000
Sales	12,000	
Less Sales returns		
Net Sales		
<b>Less: Cost of Goods Sold</b>		
Inventory: Opening	17,000	135,400
<i>add</i> Purchases	136,000	
<i>add</i> Cartage inwards	5,400	
<i>less</i> Inventory: Closing	23,000	
Cost of Goods Sold		
<b>Gross Profit</b>		36,600

3.

	\$	\$
<b>Sales</b>	390,000	375,800
Sales	14,200	
less Sales returns		
Net Sales		
<b>Less: Cost of Goods Sold</b>		
Inventory – opening	46,000	228,800
<i>add</i> Purchases	221,000	
<i>less</i> Purchase returns	16,100	
<i>add</i> Customs duty	600	
<i>add</i> Buying expenses	2,300	
<i>less</i> Inventory–closing	25,000	
Cost of Goods Sold		
<b>Gross Profit</b>		147,000



4.

	\$	\$
<b>Sales</b>	457,100	432,200
<i>less sales returns</i>	19,900	
<i>less discount allowed</i>	5,000	
Net Sales		
<b>Less: Cost of Goods Sold</b>		
Inventory opening	93,000	276,300
<i>add purchases</i>	274,000	
<i>less purchase returns</i>	16,500	
<i>less discount received</i>	2,000	
<i>add duty and wharfage</i>	7,700	
<i>add cartage inwards</i>	14,400	
<i>less inventory closing</i>	94,300	
<b>Gross Profit</b>		155,900

### Review Questions 2.4

- Provides a measure of financial performance over an accounting period.
- Steve's Surf and Swim
  - Accounting entity is Steve's Surf and Swim, Legal entity is Steve because he is the owner (sole trader) of an unincorporated business.
  - Profit and Loss (P&L) Statement, Revenue Statement
  - 1 July – 30 June (1 year)
  - \$900,235
  - The costs of acquiring inventory to be sold
  - Profit is what remains from income after all expenses have been paid. If income increases and expenses remain the same, profit will increase. Similarly if income remains the same and expenses decrease, profit will increase.
  - Key industry benchmarks, previous year's results, competitors (if possible). The accountant will also need to consider external factors such as market share of competitors and economic growth.
- 

Account Name	Classification
Purchases of inventory	Expense
Depreciation on delivery vehicle	Expense
Loss on sale of delivery vehicle	Income
Received fees for services	Income
Office rent	Expense
Council rates	Expense
Sales	Income
Staff wages	Expense
Managers salary	Expense
Gave a customer a refund	Income
Bought office stationery	Expense

4. (a) Selling expense because the sales assistant job is to generate revenue for the business.  
 (b) Other income because interest earned is not directly related to the main activity of the business.  
 (c) Administration expense because the cost is linked to general operating activities of the business and not linked to a specific activity.  
 (d) Cost of Goods Sold expense because it is associated with the cost of purchasing inventory although the amount is deducted from purchases costs.

5.

Expense	Selling	Administration	Financial
Sales staff wages	✓		
Interest on loan			✓
Petrol for manager's car		✓	
Advertising	✓		
Electricity		✓	
Sales staff mobile plan	✓		
Internet and data use		✓	
Software upgrades and anti-virus software for office computers		✓	
Commission paid to sales staff	✓		
Bank fees and charges			✓

6. (a) Because the discount has been given by the supplier and reduces the cost of goods sold.  
 (b) Because the discount has been provided by the business to its customers to encourage sales and payment of invoices. Discount allowed reduces the income from earned from sales.

7.

INCOME STATEMENT  
Business Enterprises  
For the period ending 31 March

	\$	\$
<b>Revenue</b>		
Sales	65,000	
Less sales returns	500	
Less discount allowed	50	64,450
<b>Cost of Goods Sold</b>		26,675
Opening stock	8,000	
+ Purchases	22,000	
- Purchase return	900	
- Discount received	125	
+ Freight inwards	120	
+ Buying expenses	230	
+ Customs duty	350	
- Closing stock	3000	
<b>Gross Profit</b>		37,775
<b>Other Revenue</b>		
Interest received	550	550
		38,325
<b>Selling Expenses</b>		
Advertising	1,300	
Delivery outwards	800	
Promotions	300	
Salespersons salaries	9,500	11,900
<b>Administrative Expenses</b>		
Insurance	280	
Office salaries	12,000	
Rates and taxes	670	
Stationary	40	
Telephone	340	13,330
<b>Financial Expenses</b>		
Bad and doubtful debts	140	
Interest	900	1040
<b>Net Profit</b>		<b>12,055</b>

## Review Questions 2.5

- (a) Lenders, creditors, government b) owners, shareholders, c) managers, d) managers
- 

Stakeholder	Stakeholder information needs	Relevant information from the Income statement
<b>Members</b>	<i>Is the club financially healthy enough to continue operating into the future?</i>	<i>Income, expenses, and profit</i>
<b>Friends and other non-members guests</b>	<i>Is the club charging a fair price for accommodation?</i>	<i>Profit</i>
<b>Directors of the lodge</b>	<i>Will increases in annual levy and accommodation rates be necessary?</i>	<i>Income, expenses, and profit</i>
<b>Lodge manager</b>	<i>Is the club able to provide job security and pay increases in the future?</i>	<i>Income</i>
<b>Traditional owners of the park</b>	<i>Is the club financially viable and able to pay for operating and managing the land in a culturally sensitive and ecologically appropriate way?</i>	<i>Profit</i>
<b>Parks Victoria</b>	<i>Is the club able to pay its lease and fees on time?</i>	<i>Income and profit</i>
<b>Building committee</b>	<i>Is the club able to make finance available to pay for regular maintenance and future renovation requirements?</i>	<i>Income and expenses</i>
<b>Accountant</b>	<i>Is the club compliant in record keeping and able to lodge accurate reports for tax purposes?</i>	<i>All aspects of the income statement</i>

- Government will be interested in responsible financial recording and management of income from park entry and other fees. The Anangu board of management interested in income from operating the park entry to pay the costs associated with maintaining Anangu culture and heritage, environmental protection, and provide for visitor enjoyment and learning opportunities in the park. Tourists will be interested in the costs of places to stay, park entry and amenities provided as well as educational programs. Commercial tour group operators will be interested in permit costs.
- Marketing managers would analyse sales trends and the efficiency of advertising and promotional costs in generating sales.
  - Operations managers will be use information about inventory costs, Costs of Goods Sold, and the Gross Profit Ratio.
  - Human resources managers will use wage and salaries expenses to analyse the efficiency of employees generating income for the business.
- Answers could include;
  - Trends and patterns are useful for forecasting income and expenses
  - Information for different aspects of the business can help managers of different business functions make decisions about marketing, operations, human resources and finance
  - Data can be compared to industry averages and benchmarks, to identify if changes are needed to the business to improve performance
  - Data can be compared to past periods, similar sized businesses and competitors to identify if changes are needed to improve performance
  - Ratio analysis can help managers make more informed planning decisions about future spending and strategic business decisions such as expansion.

## Activity 2.6

1. (a) \$35,000  
(b) \$78,000
2. \$84,700
3. (a) \$88,710  
(b) increased by \$30,780
4. \$77,000
5. \$35,880

## Activity 2.7

1.

	\$
<b>INCOME</b>	
Sales revenue	242,000
<i>Less: sales returns</i>	1,560
Total Income	240,440
<i>Less: Cost of Goods Sold</i>	72,600
<b>GROSS PROFIT</b>	167,840
<b>EXPENSES</b>	
Selling and distribution expenses	69,100
Administration expenses	15,500
Finance expense	940
Total expenses	85,540
<b>PROFIT</b>	82,300

2. An increase in expenses greater than the increase in revenue will cause profit to decrease.
3. Because profit will increase the value of equity and assets equally.
- 4.

### E Span, Cleaning

Income statement

For the year ended 30 June

	\$	\$
<b>INCOME</b>		
Fees for services		4,800
<b>EXPENSES</b>		
Selling and distribution	80	
Administration	840	
Finance	0	920
<b>PROFIT</b>		3,880

5.

**A. Win's Tax and Investment Service**

Income statement

For the year ended 30 June

	\$	\$
INCOME		
Fees for services		17,410
EXPENSES		
Selling and distribution		
Advertising	3,240	3,240
Administration		
Mobile and internet	1,890	
Insurance	1,700	
Stationery and printing	2,830	
Rent	15,000	21,420
PROFIT		<u>(7,250)</u>

**Statement of Changes in Equity****A. Win's Tax and Investment Service**

For the year ended 30 June

Opening Capital		20,000
<i>plus</i> profit		(7,250)
<i>less</i> drawings		4,000
Closing Capital		8,750
<b>Balance Sheet</b>		
	\$	\$
<i>Current Assets</i>		
Bank	3,600	
Debtors	2,350	
<i>Total Current Assets</i>		5,950
<i>Non-current Assets</i>		
Office equipment	4,000	
<i>Total Non-current Assets</i>		<u>4,000</u>
<b>Total Assets</b>		9,950
<i>Current Liabilities</i>		
Creditors	1,200	
<i>Total Current Liabilities</i>		1,200
<i>Non-current liabilities</i>		
	0	
<i>Total Non-current Liabilities</i>		0
<b>Total Liabilities</b>		<u>1200</u>
<b>Net Assets</b>		<b>8,750</b>

6.

**Halbert Traders**  
**Income Statement**  
**For the period ending 30 June**

	\$	\$	\$
<b>Income</b>			
Sales revenue			618,430
Less: Sales returns			17,270
Discount allowed			8,550
Net sales revenue			592,610
Cost of Sales			
Inventory opening		7,900	
Add: Purchases	397,600		
Less: Purchase returns	8,430		
Less: Discount received	7,950		
Cost of goods available for sale		389,120	
Less: Inventory closing		19,300	
Cost of sales			369,820
<b>Gross profit</b>		<b>,</b>	<b>222,790</b>
<b>Other income</b>			
Gain on sale of equipment	2,500		225,290
<b>Expenses</b>			
Selling and distribution expenses			
Advertising	6,240		
Freight outwards	3,300		
Sales salaries	51,600	61,140	
Administration expenses			
Depreciation equipment	4,200		
Insurance expense	12,000		
Office salaries	89,500		
Rent expense	15,000	120,700	
Financial expenses			
Interest expense	2,000	2,000	
Total expenses			183,840
<b>Profit before tax</b>			
			<b>\$41,450</b>

## Activity 2.8

1. (a)

(i) Gross Profit margin	54%
(ii) Profit ratio	20%
(iii) Expense ratio	
Selling	22%
Admin	8%
Finance	4%

(b) Using the Gross Profit ratio Duran's Boat Sales is making 54 cents for every \$1 of sales and using the Net Profit ratio the business is making 20 cents for every dollar of sales. The largest expense is Selling expenses, for every \$1 of sales the business is spending 22 cents on selling and marketing.

2. (a)

(i) Gross Profit margin	33%
(ii) Profit ratio	17%
(iii)	
Selling	12%
Admin	5%
Finance	0.25%

(b) Using the Gross Profit ratio Bloomingdales Flower Shop is making 33 cents for every \$1 of sales and using the Net Profit ratio the business is making 17 cents for every dollar of sales. The largest expense is Selling expenses, for every \$1 of sales the business is spending 12 cents on selling and marketing.

3. (a) Increase

(b) Decrease

(c) Decrease

(d) Increase

(e) Increase

4. (a) Cost of sales ratio 32%, Selling expense ratio 25.54%, Administration expense ratio 7.66%, Financial expense ratio 1.7%, Expense ratio 34.9%, Profit ratio 32.85%

(b) To improve the profitability of the business reducing cost of sales and selling and distribution expenses would be most effective. The owners could negotiate discounts from its supplier to reduce the cost of purchasing inventory. The marketing manager should review advertising expense and explore ways to get a better return on this spending using less expensive and more effective advertising.

5. (a)  $\$450,000 \times 12\% = \$54,000$

(b)  $61\% - 9\% = \text{Operating expense ratio} = 52\%$

(c) Profit \$ =  $240,000 \times 8\%$

Profit \$ = \$19,200

COG =  $240,000 - 96,000 - 19,200$

COG = \$124,800

6. Change in competitive environment, new competitors may have entered the market, existing competitors may have innovated new products.

The economic environment will influence the level of spending in the economy, and therefore, sales.

7.

Sales	\$227,330	
Less Sales returns	3,540	
Less Discount allowed	12,490	\$211,300
Inventory on hand 1 July	68,290	
Purchases	218,000	
Less Purchase returns	14,500	
Freight inwards	3,500	\$275,290
Less Closing Stock	Total COG-COG Calc	\$135,832
Total COGS	I-GP	\$139,458
Gross Profit	IX 34%	\$71,842

(b) Faithful representation, consistency and prudence would be appropriate accounting concepts.

## Activity 2.9

1. (a) 20 cents (b) 8% (c) 18 cents (d) 7.2% (e) was 9% fallen to 7.2% so a fall in 1.8% owing to the market price of the shares rising.
2. (a) Profit has increased significantly by 33.3%.

$$(b) \text{ 2021 EPS} = 1,200,000 / 750,000 \\ = \$1.6$$

$$\text{EY} = 1.6 / 6.8$$

$$\text{EY} = 23.5\%$$

$$\text{2020 EPS} = 900,000 / 500,000$$

$$\text{EPS} = \$1.8$$

$$\text{EY} = 1.8 / 7.4$$

$$\text{EY} = 24.3\%$$

The earnings per share have remained consistent. The profit has risen, but so to has the number of shares, the earning is divided over more shareholders.

$$(c) \text{ 2021 DPS} = 800,000 / 750,000$$

$$\text{DPS} = \$1.06$$

$$\text{DY} = 1.06 / 6.8$$

$$\text{DY} = 15.6\%$$

$$\text{2020 DPS} = 900,000 / 500,000$$

$$= 1.8$$

$$\text{DY} = 1.8 / 7.4$$

$$\text{DY} = 24.3\%$$

The dividend yield has gone down due to a lower dividend being distributed in the 2021.

3. Earnings yield describes the earnings profit made per share. It indicates how efficiently the capital invested has been used to generate profits. The dividend yield reflects the profits which have been paid to shareholders in proportion to their investment.

4. (a) Earnings per ordinary share  
 $2,200,000 / 4,000,000$   
 $= \$0.55$
- (b) Earnings yield  
 $EY = 0.55 / 18.4$   
 $EY = 3\%$
- (c) Dividend per ordinary share  
 $2,200,000 / 4,000,000$   
 $\$0.55$
- (d) Dividend yield  
 $EY = 0.55 / 18.4$   
 $EY = 3\%$
- Advice is that overall Kennerds Ltd. is performing below industry averages. However, capital growth in these shares is 8.2%. The business represents an opportunity for investment if earnings can be improved.
5. Recommend Company A because of the higher dividend yield 50% compared to 48%. In addition investor may consider that there is very little profit reinvested for growth for company B.
6. (a) \$0.50  
 (b) Dividend per share \$0.3125  
 (c) Dividend yield 18%  
 (d) Earnings yield 29%  
 (e) The data is not very useful to a potential shareholder as there is no prior year's data, or industry benchmark to compare to. Although, the earnings yield is much higher than a standard savings account.
7. Firstly, high earnings (profit) is being reinvested back into the business and therefore the dividend distributed to shareholders will be low. Secondly, a rising market share price, a result of strong financial performance will reduce the dividend yield percentage.

### Accounting advice activity

1. Answer:

	Year 3	Year 2	Year 1
Gross profit margin	62.5%	70%	70%
Profit margin	36%	43%	45%

The ratio for gross profit has been on target for Year 1 and Year 2. The net profit ratio was above the industry average in Year 1 and Year 2. However, both ratios have fallen below the industry average indicating that profitability has fallen and the business is not as efficient.

2. (a) Increase in cost of sales from Year 2 to Year 3  
 (b) Season, rising price of flowers owing to poor growing season, new competitors, changing tastes, online purchasing
3.  $64,500 / (60,000 + 124,500) / 2 = 64,500 / 92,250 = 70\%$
4. Return on assets
5. Reduce the cost of goods sold by renegotiating prices with the supplier and asking for a discount for inventory purchases. Increase spending on advertising to generate more sales.



## Chapter 3 – Recording and Processing Accounting Transactions

### Activity 3.1

1.

	Identify the 2 accounts affected	Classification	Change
(a)	Cash	Asset	Increase
	Capital	Equity	Increase
(b)	Car	Asset	Increase
	Capital	Equity	Increase
(c)	Equipment (Pizza oven)	Asset	Increase
	Cash	Asset	Decrease
(d)	Purchases expense	Expense	Increase
	Cash	Asset	Decrease
(e)	Rent expense	Expense	Increase
	Cash	Asset	Decrease
(f)	Wages expense	Expense	Increase
	Cash	Asset	Decrease
(g)	Cash	Asset	Increase
	Sales	Revenue	Increase
(h)	Purchases expense	Expense	Increase
	Creditors	Liability	Increase

2.

	Identify the 2 accounts affected	Classification	Change
(a)	Boat	Asset	Increase
	Cash	Asset	Decrease
(b)	Cash	Asset	Increase
	Fees	Revenue	Increase
(c)	Repairs expense	Expense	Increase
	Cash	Asset	Decrease
(d)	Storage expense	Expense	Increase
	Cash	Asset	Decrease
(e)	Drawings	Equity	Decrease
	Cash	Asset	Decrease
(f)	Cash	Asset	Increase
	Loan	Liability	Increase
(g)	Purchases expense	Expense	Increase
	Creditors	Liability	Increase
h)	Cash	Asset	Increase
	Debtors	Asset	Decrease

3.

Date	Two accounts affected	Type	Debit OR Credit	Amount \$
1/7	Cash Capital	Asset Equity	Debit Credit	20,000 20,000
2/7	Furniture & Fittings Cash	Asset Asset	Debit Credit	6,000 6,000
4/7	Cash Loan - ANZ	Asset Liability	Debit Credit	15,000 15,000
5/7	Purchases Cash	Expense Asset	Debit Credit	2,000 2,000
14/7	Cash Sales	Asset Revenue	Debit Credit	1,450 1,450
15/7	Wages Cash	Expense Asset	Debit Credit	300 300
15/7	Drawings Cash	Equity Asset	Debit Credit	200 200
17/7	Equipment Cash	Asset Asset	Debit Credit	2,200 2,200
19/7	Purchases Creditors	Expense Liability	Debit Credit	1,500 1,500
20/7	Debtor – PWC Sales	Asset Revenue	Debit Credit	280 280
21/7	Interest Cash	Expense Asset	Debit Credit	150 150
29/7	Creditor Cash	Liability Asset	Debit Credit	1,350 1,350
29/7	Creditor Discount received	Liability Revenue	Debit Credit	150 150
30/7	Cash Debtor - PWC	Asset Asset	Debit Credit	250 250
30/7	Discount allowed Debtor - PWC	Expense Asset	Debit Credit	30 30
30/7	Electricity Cash	Expense Asset	Debit Credit	300 300
31/7	Sales returns Cash	Revenue Asset	Debit Credit	10 10
31/7	Cash Sales	Asset Revenue	Debit Credit	4,800 4,800

## Activity 3.2

1.

Account	Normal Balance	Account	Normal Balance
Creditors	Credit	Debtors	Debit
Advertising expense	Debit	Cash at Bank	Debit
Drawings	Debit	Electricity expense	Debit
Furniture and Fittings	Debit	Interest expense	Debit
Interest income	Credit	Loan	Credit
Mortgage	Credit	Accounts payable	Credit
Rent	Debit	Sales	Credit
Wages expense	Debit	Sales returns	Debit

2. (a) True (b) True (c) True (d) True (e) False (f) True (g) True (h) True

3. (a) The owner, C Change, contributed \$15,000 in cash as capital to the business.

(b) A loan of \$6,000 was used to purchase a vehicle.

(c) \$400 for vehicle insurance expense was paid using cash.

(d) Bought stock for \$1,200 from a supplier using cash.

(e) Bought stock for \$700 from a supplier on credit.

(f) \$140 for advertising expense was paid using cash.

(g) Received revenue of \$1,450 in cash from sales

(h) Paid wages of casual staff of \$180.

(i) The owner withdrew \$1,000 from the business bank account for personal use.

(j) Paid the supplier from e) and received a 10% discount.

4. (a)

Date	Particulars	Debit	Credit
2/7	Bank	12,000	
	Capital		12,000

(b)

Date	Particulars	Debit	Credit
9/7	Debtors – R. Pearlman	360	
	Sales		360

(c)

Date	Particulars	Debit	Credit
14/7	Rent expense	600	
	Bank		600

(d)

Date	Particulars	Debit	Credit
15/7	Purchases expense	4,000	
	Bank		4,000

(e)

Date	Particulars	Debit	Credit
19/7	Drawings	500	
	Bank		500

(f)

Date	Particulars	Debit	Credit
21/7	Wages expense	820	
	Bank		820

(g)

Date	Particulars	Debit	Credit
22/7	Purchases	1,500	
	Creditor – M. Arvel Comics		1,500

(h)

Date	Particulars	Debit	Credit
25/7	Fittings and Fixtures	700	
	Bank		700

(i)

Date	Particulars	Debit	Credit
26/7	Debtor – S. Man	85	
	Sales		85

(j)

Date	Particulars	Debit	Credit
28/7	Bank	170	
	Debtor – R. Pearlman		170

## 5. Amelia's Horse Riding Lessons

Cash			
1/5	Capital	5,000	
13/5	Lesson fees	550	
30/5	Lesson fees	<u>850</u>	
		6,400	
3/5	Horse feed expense		150
7/5	Advertising		600
14/5	Rent		300
22/5	Equipment		<u>1,250</u>
31/5	Balance		4,100
1/6	Closing balance	4,100	
Capital			
	1/5	Cash	5,000
	31/5	Closing balance	5,000
Equipment			
22/5	Cash	1,250	
31/5	Closing balance	1,250	
Rent expense			
14/5	Cash	300	
31/5	Closing balance	300	
Advertising expense			
7/5	Cash	600	
31/5	Closing balance	600	

Lesson fees			
	13/5	Cash	550
	20/5	Cash	850
			1,400
	31/5	Closing balance	1,400
Horse feed expense			
	3/5	Cash	150
			150
	31/5	Closing balance	150

## 6. KM Recruitment and Business Consulting

Capital - K Town					
	1/7	Vehicle	19,990		
		Cash	5,000		
			24,990		
	31/7	Closing balance	24,990		
Capital – C Van					
	28/7	Cash	25,000		
			25,000		
	31/7	Closing balance	25,000		
Cash					
1/7	Capital – K Town	5,000	4/7	Furniture	500
12/7	Fees	995	10/7	Rent expense	1,500
28/7	Capital – C. Van	25,000	13/7	Drawings	3 000
29/7	Debtor – Corner Cafe	<u>2,985</u>	22/7	Electricity expense	<u>321</u>
		33,980		Balance	28,659
			28,659		
	31/7	Closing balance	28,659		
Vehicles					
	1/7	Capital – K Town	19,990		
	18/7	Loan – Elbans Subaru	41,888		
			61,878		
	31/7	Closing balance	61,878		
Furniture					
	4/7	Cash	500		
	24/7	Creditor – Kesic Furniture	4,500		
			5,000		
	31/7	Closing balance	5,000		
Debtor – The Corner Cafe					
21/7	Fees	3,980	29/7	Cash	2,985
			995		
	31/7	Closing balance	995		
Creditors – Kesic Furniture					
	4/7	Furniture	4,500		
			4,500		
	31/7	Closing balance	4,500		

Creditor – OEG Supplies			
15/7	Office supplies expense	44	Office supplies expense 355
			31/7 Closing balance 311
Credit card			
	9/7	Insurance	793
	24/7	Entertainment	370
	31/7	Closing balance	1,163
Loan			
	18/7	Vehicle	41,888
	31/7	Closing balance	41,888
Rent expense			
10/7	Cash	1,500	
31/7	Closing balance	1,500	
Electricity expense			
22/7	Cash	321	
31/7	Closing balance	321	
Entertainment expense			
24/7	Credit card	370	
31/7	Closing balance	370	
Insurance expense			
9/7	Cash	793	
31/7	Closing balance	793	
Fees			
	12/7	Cash	995
	21/7	Debtor – Corner Cafe	3,980
	31/7	Closing balance	4,975
Drawings			
13/7	Cash	3,000	
31/7	Closing balance	3,000	
Office Supplies expense			
15/7	Creditor - OEG	355	15/7 Creditor - OEG 44
31/7	Closing balance	311	

### Activity 3.3

1. Answers could include
  - Real time information
  - Analytics to analyse trends and make forecasts
  - Easy to read comparisons and summaries
  - Colour coding for alerts
  - Data available for a range of performance measures
2. Answers could include
  - Risks of lost, corrupted data or theft of data
  - Incorrect inputting of information will result in inaccurate reports and other information on which decisions are made
  - Some small businesses rely on a key employee to manage the accounting software so there is a risk from no separation of duties so a skilled user disguising fraud. The absence or departure of the key employee can significantly disrupt accounting processes and production of information and reports.
3. Completing each part of the accounting process is essential to ensuring that accounting reports and information contain reliable and accurate information. If an error is suspected it is possible to identify the source of the error by working backwards through the accounting process using the references for each entry.
4. Debits and credits are simply the principals followed when processing accounting transactions. Debit entries indicate an increase in the value of assets which is why they are sometimes thought of as being 'good' and credit entries for a liability indicates increases in future obligations for the business, and hence 'bad'. However, following the principals and ensuring that every debit entry has a credit ensure that transactions are processed correctly and the duality concept holds true.
5. Overall the advantages for owners and managers in decision making from using accounting software easily outweighs the cost and risk created. There will be a period of transition as a business converts from a manual system to a software based system which can be disruptive and result in some incorrect information being produced. However, the advantages for timeliness and accuracy of information will result in better control and decision making.

### Chapter 3 – Accounting advice activity

Answers could include:

The business has an issue with its cash position and cash flow. The balance on the Business Bank Account is \$9,081.58 in overdraft and has been in a negative balance for month of July. This can be explained by using the information for Total cash in and out the business has experience more cash flowing out than in for the months of June and July. This cash position is not expected to improve by reviewing the invoices owed from debtors and the bills requiring payment to creditors. Even though the value of debtors is \$16,006.55, nearly half of the debtors totalling \$7,087.50 are overdue and could become bad and doubtful debts. The business may not receive enough cash in August to cover payments pay its creditors \$8,507.78. Also, the business has exceeded the credit terms as 4 bills are overdue. This information confirms that the business's cash position may not improve in the future.

A strategy to improve the business's cash position and cash flow is to increase sales revenue through marketing. This will increase the cash coming into the business and hopefully restore the bank account to a positive balance. The business can encourage prompt payment by its debtors by offering a discount. A discount may also be offered to the overdue debtors to motivate them to pay their overdue invoices.

## Chapter 4 – Managing Assets; Debtors; Inventory and non-current Assets

### 4.1 – Managing Assets

#### Activity 1 – Recording transactions for periodic inventory systems

(a)

Date	Particulars	Debit	Credit
9/2	Purchases	3,200	
	Creditors/ Wood Landscaping		3,200
<i>To record cash sales</i>			
11/2	Bank	300	
	Sales		300
<i>To record credit purchases</i>			
15/2	Debtors/ Better Solutions	5,200	
	Sales		5,200
<i>To record credit sales</i>			
21/2	Creditors/ Wood Landscaping	50	
	Purchase returns		50
<i>To records purchase returns</i>			
26/2	Sales returns	100	
	Debtors/ Better Solutions		100
<i>To record credit sales</i>			
28/2	Debtors/ J Jones	4,700	
	Sales		4,700
Credit Sales			
28/2	Stock	12,000	
	Trading		12,000
<i>To record closing stock</i>			

(b)

<b>Income</b>			
Sales		10,200	
Less Sales returns		100	10,100
<b>Cost of Goods Sold</b>			
Opening inventory		15,000	
Add purchases	3,200		
Less purchase returns	50	3,150	
Less closing inventory		<u>12,000</u>	6,150
<b>Gross Profit</b>			3,950



- (c) The periodic system is simple to maintain for businesses which hold low levels of inventory. However, a trading business such as Visual Landscaping would benefit from using the perpetual system because it will assist in monitoring stock levels, reduces inaccuracies and allows interim reports to be generated without the need of a stocktake.

Disadvantages of the Periodic System:

- Minimal control over stock as business cannot determine what stock should be on hand
- Cannot tell the value of any stock losses
- Cannot prepare Income Statement until stock take is undertaken
- Doing a stock take can be costly and time consuming

Advantages of the Periodic system:

- Simplicity – no additional time and cost in recording all items of stock

## Activity 2 – Recording transactions for perpetual inventory systems

(a)

Date	Particulars	Debit	Credit
12/9	Bank	5,000	
	Sales		5,000
	COGS	4,300	
	Inventory		4,300
<i>To record cash sales</i>			
17/9	Sales returns	1,000	
	Bank		1,000
	Inventory	800	
	COGS		800
<i>To record sales return</i>			
19/9	Debtors- V Mad	1,700	
	Sales		1,700
	COGS	600	
	Inventory		600
<i>To record credit sales</i>			
22/9	Bank	300	
	Inventory		300
<i>To records purchase returns</i>			
24/9	Inventory	40,000	
	Creditor Control/ Bargain Supplies		40,000
<i>To record credit purchase</i>			
30/9	Stock Loss	600	
	Inventory		600
<i>To record stock loss</i>			

Inventory Control					
1-Sep	Balance	6,000	12-Sep	COGS	4,300
17-Sep	COGS	800	19-Sep	COGS	600
29-Sep	Creditors Control/ Bargain Supplies	40,000	22-Sep	Bank	300
			30-Sep	Stock loss	600
			30-Sep	Balance	41,000
		<b>46,800</b>			<b>46,800</b>
1-Oct	Balance	41,000			

Sales				
		12-Sep	Bank	5,000
		19-Sep	Debtors/V Mad	1,700
				<b>6,700</b>

COGS					
12-Sep	Inventory	4,300	19-Sep	Inventory	800
19-Sep	Inventory	600	30-Sep	Balance	4,100
		<b>4,900</b>			<b>4,900</b>
1-Oct	Balance	4,100			

Stock loss		
30-Sep	Inventory Control	600

(b)

<b>Income</b>		
Sales	6,700	
Sales returns	-1,000	5,700
<b>Cost of Goods Sold</b>		
COGS	4,100	
Stock loss	600	4,700
<b>Gross Profit</b>		1,000

(c) This is a risky decision given for a number of reasons. He now has invested \$40,000 in inventory and will not receive cash inflows from this investment until he sells the inventory. Given that net sales for September were 5,700, it will more than likely take many months to liquidate (sell) this inventory.

Secondly, the value of phones can drop rapidly, as this technology can quickly become out-of-date and surpassed by new releases. Thus, there is the risk of holding obsolete stock which cannot be sold.

(d) Interim reports can be prepared based on the information from the inventory account. Sometimes the inventory ledger can be inaccurate because it has not been updated for stock loss. The stock take will identify any stock shrinkage and therefore assist in producing up-to-date accurate inventory records. Regular stock takes can reduce risks of stock loss.



## Activity 3 – Recording transactions for perpetual inventory systems

(a)

Inventory Control					
1-Jun	Balance	5,000	12-Jun	COGS	3,200
16-Jun	Creditors/ M Jordan	6,400	19-Jun	COGS	1,800
			30-Jun	Creditors/ M Jordan	300
			30-Jun	COGS	2,000
			30-Jun	Stock loss	200
			30-Jun	Balance	3,900
		<b>11,400</b>			<b>11,400</b>
1-Jul	Balance	3,900			

Sales				
		12-Jun	Bank	4,000
		19-Jun	Debtors/T Woods	2,600
		30-Jun	Debtors/ C Freeman	3,500
				10,100

COGS			
12-Jun	Inventory	3,200	
19-Jun	Inventory	1,800	
30-Jun	Inventory	2,000	
		7,000	

(b)

<b>Income</b>		
Sales		10,100
<b>Cost of Goods Sold</b>		
COGS	7,000	
Stock loss	<u>200</u>	7,200
<b>Gross Profit</b>		2,900

(c) Gross Profit Margin at 29%, the business is achieving well below the benchmark of 50%. This indicates that the business may struggle to cover operating expenses. Management should examine pricing or supplier of cheaper inventory.

## Activity 4 Inventory Cards FIFO

(a)

Date	Ref	In		Out		Balance		
		Qty	Cost	Qty	Cost	Qty	Cost	Total
1-Jan	Balance					15	180	2,700
3-Jan	Sales			10	180	5	180	900
4-Jan	Credit	40	190			5	180	900
	Purchases					40	190	7,600
9-Jan	Credit			5	180			
	Sales			17	190	23	190	4,370
15-Jan	Credit	50	200			23	190	4,370
	Purchases					50	200	10,000
17-Jan	Credit			23	190			
	Sales			5	200	45	200	9,000
27-Jan	Credit	40	205			45	200	9,000
	Purchases					40	205	8,200
29-Jan	Credit			24	200	21	200	4,200
	Sales					40	205	8,200
30-Jan	Stock Loss			2	200	19	200	3,800
						40	205	8,200

## Inventory Control

1-Jan	balance	2,700	3-Jan	COGS	1,800
4-Jan	Creditors	7,600	9-Jan	COGS	4,130
15-Jan	Creditors	10,000	17-Jan	COGS	5,370
27-Jan	Creditors	8,200	29-Jan	COGS	4,800
			31-Jan	Stock Loss	400
			31-Jan	Balance	12,000
		<b>28,500</b>			<b>28,500</b>
1-Feb	balance	12,000			

## COGS

3-Jan	Inventory	1,800			
9-Jan	Inventory	4,130			
17-Jan	Inventory	5,370			
29-Jan	Inventory	4,800			
		<b>16,100</b>	30-Apr	Balance	16,100
		<b>16,100</b>			<b>16,100</b>
1-Feb	Balance	16,100			



(b)

Income Statement  
Slumber City

Sales		21,780
COST OF GOODS SOLD		
COGS	16,100	
Stock loss	400	16,500
<b>Gross Profit</b>		<b>5,280</b>

### Activity 5 Inventory Cards

(a)

Inventory Card: Lawn mowers – **Identified Cost**

Date	Ref	In		Out		Balance		
		Qty	Cost	Qty	Cost	Qty	Cost	Total
May-01	Balance					5	140	700
May 1	Purchases	3	150			5	140	700
						3	150	450
5-May	Credit Sales			1	140	4	140	560
				2	150	1	150	150
9-May	Credit Sales Returns			-1	140	5	140	700
						1	150	150
10-May	Credit Purchases	2	160			5	140	700
						1	150	150
						2	160	320
15-May	Cash Sales			2	140	3	140	420
				1	150	0		0
				1	160	1	160	160

Inventory Card: Hose – **FIFO**

Date	Ref	In		Out		Balance		
		Qty	Cost	Qty	Cost	Qty	Cost	Total
May-01	Balance					15	14	210
2-May	Credit Sales			10	14	5	14	70
7-May	Credit Purchases	10	15			5	14	70
						10	15	150
9-May	Cash Sales			5	14			0
				2	15	8	15	120
12-May	Credit Purchases	5	16			8	15	120
						5	16	80
16-May	Cash sales			7	15	1	15	15
						5	16	80
20-May	Stock Loss			1	15			0
				1	16	4	16	64

(b)

## GENERAL JOURNAL

DATE	PARTICULARS	DEBIT	CREDIT
31/5	Stock Loss	31	
	Inventory Control		31
	<i>To record stock loss</i>		

(c)

## Inventory Control

1-May	Balance	910	2-May	COGS	140
1-May	Bank	450	5-May	COGS	440
	Creditors/Irrigation solutions				
7-May	Manufacturing	150	9-May	COGS	100
9-May	COGS	140	15-May	COGS	590
10-May	Creditors/ CT Wholesalers	320	16-May	COGS	105
12-May	Debtors/ JT traders	80	20-May	Stock loss	31
			30-May	Balance	644
		<b>2,050</b>			<b>2,050</b>

Note - Entries can be summarised further 1-June Balance 644.

- (d) It would be difficult and impractical to track the movement flows of water hoses, given that these items have a high turnover, are low in value and do not normally have unique identifying codes. The lawnmowers, however, are higher in value and like many electrical products may have unique identification codes, enabling the identified cost method to be used.

### Activity 6 – Applying lower of cost rule

$$\begin{aligned} \text{(a) Historical Cost} &= (50 \times 300) + 50 \\ &= \$15,050 \\ \text{NRV} &= (400 \times 50) - 1,000 \\ &= \$19,000 \end{aligned}$$

Value recorded Historical Cost \$15,050

$$\begin{aligned} \text{(b) Historical Cost} &= 40 \times 20 \\ &= \$800 \\ \text{NRV} &= (40 \times 25) - 150 \\ &= \$850 \end{aligned}$$

Value recorded Historical Cost \$800

### Activity 7 – Applying lower of cost rule

(a) \$80

$$\begin{aligned} \text{(b) Historical Cost} &= 40 \times 35 \\ &= \$1,400 \\ \text{(c) NRV} &= (40 \times 40) - 250 \\ &= \$1,350 \end{aligned}$$

(d) Lower of Cost or Net Realisable Value is NRV

Thus Cost of Inventory = \$1,350

$$\begin{aligned} \text{(e) Total Sales} &= \text{Full Price} + \text{Discounted Price} \\ &= (40 \times \$80) + (40 \times \$40) \\ &= 3,200 + 1,600 \\ &= \$4,800 \end{aligned}$$

$$\begin{aligned} \text{COGS} &= 40 \times 35 = 1,400 \\ &= (40 \times 40) - 250 = 1,350 \\ &= \text{Total COGS} = \$2,750 \end{aligned}$$

$$\begin{aligned} \text{Gross Profit} &= 4,800 - 2,750 \\ &= \$2,050 \end{aligned}$$

### Activity 8 – Calculating Inventory turnover

$$\text{(a) Inventory turnover} = \frac{\text{COGS}}{\text{Average inventory}}$$

$$\text{Inventory turnover} = \frac{7,000}{((2,000 + 1,000) / 2)}$$

Inventory turnover = 4.6 times per month

(b) The inventory turnover indicates how quickly stock is sold and replaced in a period. It is important that Daisy maintain a high turnover because she sells perishable goods and therefore the value of stock will quickly decline. A turnover of 4.60 times per month indicates that her business replaces stock every 6.7 days (3.1 – 4.6). This is 2.2 days greater than the industry benchmark. This indicates inefficient management of stock. Furthermore, as many flowers only last about 5 days, this result indicates that the business may frequently dispose of unsold goods.

## Activity 9 – Calculating Inventory turnover

$$(a) \text{ Inventory turnover} = \frac{\text{COGS}}{\text{Average inventory}}$$

$$\text{Inventory turnover} = \frac{1,000,000}{((500,000+400,000)/2)}$$

$$\text{Inventory turnover} = 2.2 \text{ times per year}$$

- (b) The inventory turnover indicates how many times stock has been sold over the period (a year) and replaced. Car dealerships tend to hold a significant investment in stock because of the high value items being sold. The inventory turnover of 2.2 is a poor result. This indicates the dealership takes 166 on average to sell each car ( $365 \div 2.2$ ). This is much lower than the industry average of 73 days.
- (c) To improve the turnover the business could reduce stock held. This would mean that they would only buy additional stock when the stock numbers are low. Furthermore, they should invest in models which are in high demand.

## Extended Activity Solutions

### Extended Activity 1 – Inventory Management

Date	Description	In		Out		Balance		
		Qty	Cost	Qty	Cost	Qty	Cost	Total
1-Mar	Balance					10	2	20
5-Mar	Purchases	8	2.2			10	2	20
						8	2.2	17.6
10-Mar	Sales			10	2			0
				1	2.2	7	2.2	15.4
22-Mar	Purchases	8	2.3			7	2.2	15.4
						8	2.3	18.4
28-Mar	Stock disposal			2	2.2	5	2.2	11
						8	2.3	18.4
30-Mar	Stock loss			1	2.2	4	2.2	8.8
						8	2.3	18.4

- (a) Stock had to be thrown out as it had expired and therefore could not be sold. He could order less stock reducing the chance of stock expiring. He could also make sure oldest stock is sold first, by stocking the oldest tubs at the front of the fridge.
- (b) No, it would be difficult and time consuming to label each product with a unique identifier. Furthermore, because the stock is of low value it would not be worthwhile tracking the movement of individual stock items.
- (c)

Inventory Control					
1-Mar	Balance	20	30-Mar	COGS	22.2
30-Mar	Bank	36	30-Mar	Stock loss	6.6
			30-Mar	Balance	27
		<u>56</u>			<u>56</u>
1-Apr	Balance	27			

(d)

Sales		55
Less COGS		
COGS	22	
stock loss	<u>7</u>	<u>29</u>
Gross Profit		<u>26</u>

(e) Inventory turnover =  $\frac{\text{COGS}}{\text{Average inventory}}$

Inventory turnover =  $\frac{22.2}{(20 + 27) / 2}$

Inventory turnover = 0.9 times per month

Days Turnover = 31 days / 0.94

= 33 days

(f) The inventory turnover indicates how quickly stock sells. A turnover of 33 days for yogurt is very poor, leading to spoilt stock. The industry average is 10.3 days, dramatically less than the businesses turnover. The business needs to address how frequently it is buying stock and also any other considerations impacting sales such as pricing, stock levels (consider “just-in-time”), advertising and customer service

**Guideline solutions for Statement of Advice – Managing Assets**

*Note: The following is not a written statement of advice, rather a list of factors that you can consider in your response. Responses can be varied, but should always focus on identifying the accounting information needs of stakeholders, which in this example to the owner, Katherine. You should also focus on evaluating the accounting information to develop and propose authentic accounting advice to inform stakeholder decision-making.*

**Assess the financial position of Scandinavian Designs.**

Responses could include some of the following:

Liquidity and Gearing Ratios

	Current	Prior	Notes
Working Capital	\$9,000	\$48,500	Note, that this includes a bank overdraft
Working Capital ratio	1.5:1	98:1	Sharp decrease in liquidity, due to rising current liabilities. Although the ratio is within the recommended range.
Quick Asset Ratio	0:16	58:1	Very concerning as there is no cash to cover the immediate bills. The business will need to arrange some short-term finance solutions such as an overdraft extension or another short-term loan.
Debt to Equity	91%	48%	Large increase in gearing, however, as the ratio is still under 100% there is still some room to use debt financing.

Overall, Scandinavian Designs has shown concern deterioration in financial position.

Your advice for improving competitiveness could include:

#### Marketing strategies

- Lower prices to increase sale volume
  - However, this strategy will result in lower margins. The current GPM is 48%, 12% below the industry average. This indicates that prices are lower than industry, or cost of goods sold is higher than industry average. The slow moving stock and declining sales would indicate that cost of goods sold is high and thus management should seek to reduce these costs. They may do this by reviewing suppliers list and seeking alternative suppliers. Low cost of good sold will allow the business to reduce prices without further lower the gross profit margin.
- Examine the product mix to suit changes in the external environment. Base inventory decisions on sales analytics.
  - Focus on high turn-over stock
  - Delete low moving, low profit lines
- Offer credit terms
  - This may result in increased sales
  - Could also earn extra revenue through late fees
  - However, this lead to the risk of debtors not paying or not paying on time. This will increase financial costs and worsen, already strained cash-flow. The business should for seek to improve the cash position before pursuing this option.

When discuss the inventory management and the impact it has on cash-inflows you could consider:

- Increased warehouse costs in the current year, 35% rise. Insurance on inventory and warehousing costs equate to 10% of total costs. This is excessively high and is one of the factors contributing to the high cost of goods sold and reducing gross profit margins. Moving to a just-in-time inventory management system, or reducing stock levels should decrease both costs. It will also allow the business to purchase stock which is on-trend and in customer demand. However, this system only works if the business is able to establish a strong supply chain with short lead times.
- Heavy discounting could generate some cash inflow from stock that is no longer fashionable.
- Turnover ratio in the current year was 7.4 times per year, which is 49 days. In the prior year, it was 14 times per year, which is every 26 days. This shows a declining control over stock.
- The low inventory turnover will have large impacts on cash. A low turnover indicates the business's liquidity is tied up in inventory. This can lead to problems paying short-term obligations such as creditors and wages, it also leads to increased chance of declining demand, prompting discounting.

#### Recommendations

- Discount old stock
- Purchase low margin, fashionable, high-selling items
- Implement competitive pricing whilst seeking new suppliers
- Reduce the level of stock held.

## 4.2 – Managing Debtors

### Activity 1 – Posting to Debtor Control Account and Subsidiary Accounts

#### General Ledger

Debtor Control			
1-Jul	Balance	4,300	
15-Jul	Sales	1,700	
15-Jul	Late fees	20	
		<u>6,020</u>	
16-Jul	Balance	2,370	
15-Jul	Sales returns		200
15-Jul	Bad debts		450
15-Jul	Bank		3,000
15-Jul	Balance		<u>2,370</u>
			<u>6,020</u>

#### Debtors Subsidiary Ledger

J Nile			
1-Jul	Balance	<u>450</u>	
11-Jul	Bad debts		<u>450</u>

C Mount			
1-Jul	Balance	1,100	
5-Jul	Sales	1,000	
15-Jul	Late fees	20	
		<u>2,120</u>	
16-Jul	Balance	2,120	
15-Jul	Balance		2,120
			<u>2,120</u>

K Kats			
1-Jul	Balance	<u>750</u>	
10-Jul	Bank		500
		750	
16-Jul	Balance	250	
15-Jul	Balance		<u>250</u>
			750

ABC Enterprise			
1-Jul	Balance	2,000	
1-Jul	Sales	<u>700</u>	
3-Jul	Sales returns		200
15-Jul	Bank		<u>2,500</u>

#### Schedule of Debtors

C Mount	2,120
K Kats	250
	<u>2,370</u>

## Activity 2 – Posting to Debtor Control Account and Subsidiary Accounts

**General Ledger**

## Debtor Control

1-Aug Balance	20,000	30-Aug Bank	6,490
30-Aug Sales	8,500	30-Aug Discount	10
30-Aug Late fees	50	Balance	22,050
	<u>28,550</u>		<u>28,550</u>
1-Sep Balance	22,050		

**Debtors Subsidiary Ledger**

## Entertaining and Co

1-Aug Balance	500	4-Aug Bank	490
		Discount	10

## Professional events

1-Aug Balance	10,000	30-Aug Bank	6,000
		30-Aug Balance	4,000
	<u>10,000</u>		<u>10,000</u>
1-Sep Balance	4,000		

## M &amp; D Harold

1-Aug Balance	4,500	30-Aug Balance	4,550
10-Aug Late fees	50		
	<u>4,550</u>		<u>4,550</u>
1-Sep Balance	4,550		

## D Love

1-Aug Balance	5,000	30-Aug Balance	7,000
17/8 Sales	2,000		
	<u>7,000</u>		<u>7,000</u>
1-Sep Balance	7,000		

## Mr &amp; Mrs Carlos

2-Aug Sales	<u>6,500</u>		
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## Schedule of Debtors

Professional events	4,000
M & D Harold	4,550
D Love	7,000
Mr & Mrs Carlos	<u>6,500</u>
	22,050

### Activity 3 – Posting to Debtor Control Account and Subsidiary Accounts from Single Entry Journals

**General Ledger**

		Debtor Control			
1-Jan	Balance	7,500	31-Jan	Sales returns	650
31-Jan	Sales	8,500	31-Jan	Discount	150
			31-Jan	Bank	9,900
			31-Jan	Balance	<u>5,300</u>
		<u>16,000</u>			16,000
1-Feb	Balance	5,300			
Sales					
			31-Jan	Bank	2,800
			31-Jan	Debtors	8,500
					<u>11,300</u>
Discount					
31-Jan	Debtor Control	<u>150</u>			
Sales returns					
31-Jan	Debtor control	<u>650</u>			
Interest revenue					
			31-Jan	Bank	<u>200</u>
Bank					
1-Jan	Balance	5,500	31-Jan	Cash Payments Journal	12,000
31-Jan	Sales	2,800			
31-Jan	Debtors	9,900			
31-Jan	Interest revenue	<u>200</u>	31-Jan	Balance	<u>6,400</u>
		18,400			18,400
1-Feb	Balance	6,400			

## Debtors Subsidiary Ledger

S Violet			
1-Jan Balance	2,000	24-Jan Bank	2,000
14-Jan Sales	1,000	31-Jan Balance	1,000
	<u>3,000</u>		<u>3,000</u>
1-Feb Balance	1,000		
R Rose			
1-Jan Balance	3,500	9-Jan Sales returns	250
6-Jan Sales	1,500	12-Jan Discount	50
		Bank	3,200
		Balance	1,500
	<u>5,000</u>		<u>5,000</u>
1-Feb Balance	1,500		
T Lily			
1-Jan Balance	800		
	<u>800</u>		
S Jasmine			
1-Jul Balance	1,200	1-Jan Discount	100
16-Jul Sales	2,000	Bank	1,100
		31-Jan Balance	2,000
	<u>3,200</u>		<u>3,200</u>
1-Feb Balance	2,000		
D Daisy			
12-Jan Sales	4,000	15-Jan Sales returns	400
		28-Jan Bank	3,600
	<u>4,000</u>		<u>4,000</u>

## Schedule of Debtors

S Violet	1,000
R Rose	1,500
T Lily	800
S Jasmine	<u>2,000</u>
	5,300

### Activity 4 – Managing Collections from debtors

- Luna barks has \$3,000 in long outstanding debt. Furthermore, \$1,000 of this debt is over 90 days old.
- Reduces cash inflow, which can cause problems meeting debt obligations. Management needs to allocate resources to chasing and managing overdue debtors. Can complicate customer relationships, as debts need to be recovered; however, at the same time, the business may still wish to seek ongoing business.
- Management have not been effective in collecting debts according to the trade terms. \$4,100 of the \$6,900, debtor balance is outstanding, which is almost 60% of all accounts.
- Two of the clients with long outstanding debt, bought more stock on credit, even though previous accounts had not been settle. Harris and Co should revise their credit policy so that customers can only buy on credit if all outstanding accounts have been settled. Harris and Co could take a more aggressive strategy when collect managing long overdue accounts. For instance, hire a debt collector or charge fees for late payment.

### Activity 5 – Calculating the Debtor Turnover

$$(a) \text{ Debtor turnover} = \frac{17,000}{((20,000 + 22,000) / 2)}$$

0.81 times per month

$$(b) \text{ Average collection in days} = \frac{31}{0.81}$$

38 days > round to 39 days

- The debtor turnover result and average collection days indicate that debtors have not been paying their accounts with-in trade terms. On average, debtor bills are 9 days outstanding.
- Harry's approach may foster a good relationship with loyal customers. However, his approach is not encouraging customer to pay on time and therefore may lead to problems with cash flow and liquidity.  
Could improve collection strategies. Strategies may include:
  - Reminder letters/ emails.
  - Early payment discount.
  - Fees for late payment. – May not use this strategy if he wishes to continue a positive approach.

### Activity 6 – Calculating the Debtor Turnover

$$(a) \text{ Debtor turnover} = \frac{170,000}{((19,000 + 23,000) / 2)}$$

Debtor turnover= 8.1 times per year

$$(b) \text{ Average collection days} = \frac{365}{8.1}$$

Average collection days = 45.1 days > round to 46 days

- Results indicate poor debtor management as on average debtors pay 15 days after accounts are due.
- Upfront cash payments will improve her cash flow and free up time spent managing debtors. However, the policy change may result in reduced demand as customers may prefer businesses which offer credit.

## Activity 7 – Writing off bad debts

(a)

Date	Particulars	Debit	Credit
1/3/20	Bad debts Debtor Control/ D Love	5,000	5,000
<i>To write off bad debts</i>			

(b) An Allowance for Doubtful Debts will present a more prudent valuation of assets in the balance sheet, as it will recognise that not all Debtors will pay their accounts. The financial costs (bad and doubtful debts) associated with the credit sales are matched to the periods in which the revenues were raised. Furthermore, as her sales are 100% on credit and therefore establishing an allowance would be appropriate.

## Activity 8 – Writing off bad debts and establishing an allowances

(a)

Date	Particulars	Debit	Credit
31/7	Bad and doubtful debts expense Allowance for doubtful debts	600	600
<i>To establish allowance for doubtful debts</i>			

(b)

Date	Particulars	Debit	Credit
10/8	Allowance for doubtful debts Debtor control/ P Evans	1,000	1,000
<i>To write off debts</i>			

### Allowance for Doubtful debts

10/8	Debtor Control / P Evans	1,000	31/7	Bad and Doubtful Debts	600
------	--------------------------	-------	------	------------------------	-----

(c)

Date	Particulars	Debit	Credit
31/8	Bad and Doubtful Debts expense Allowance for doubtful debts -CA	1,150	1,150
<i>To adjust allowance to 5% of debtors</i>			

### Allowance for Doubtful debts

10/8	Debtor Control / P Evans	1,000	1/7	Bad and Doubtful Debts	600
31/8	Balance	750	31/8	Bad and Doubtful Debts	1,150
		1,750			1,750
			1/9	Balance	750

## Activity 9 – Writing off bad debts and adjusting allowances

(a)

Date	Particulars	Debit	Credit
17/12	Allowance for doubtful debts	200	
	Debtor control		200
<i>To write off bad debts</i>			

(b)

Date	Particulars	Debit	Credit
31/12	Bad and Doubtful Debts	40	
	Allowance for doubtful debts		40
<i>To adjust allowance to 2% of debtors</i>			

## Extended Activity Solutions

### Extended Activity – Debtor and Inventory Management

(a)

		Debtor Control		
19-Sep	Balance	4,000	30-Sep Sales returns	50
30-Sep	Sales	900	30-Sep Bad debts	400
	Delivery	30	30-Sep Bank	260
			30-Sep Discount	20
			30-Sep Balance	4,200
		4,930		4,930
1-Oct	Balance	4,200		

(b) The debtor control should balance with the schedule of debtors. Robin can check that the sum of the individual subsidiary ledger agrees to the debtor control balance.

$$\begin{aligned}
 \text{(c) Debtor turnover} &= \frac{\text{Net Sales}}{\text{Average Debtors}} \\
 &= \frac{900 - 50}{((4000 + 4200) / 2)}
 \end{aligned}$$

$$\text{Debtor turnover} = 0.2 \text{ times per week}$$

$$\text{Average day outstanding} = 7 \text{ days} / 0.2$$

$$= 35 \text{ days}$$

The average debtor collection period is 35, 4 days over credit terms, indicating ineffective debtor control. It is recommended that Robin incorporate strategies that encourage debtor to pay their accounts within 30 days. She may consider tightening up her debtor screening, charging late payments or sending out more frequent reminders to outstanding debtors. Robin should not extend further credit to Debtors with outstanding balances.

(d)

		Inventory Control			
19-Sep	Balance	2,000	30-Sep	COGS	580
30-Sep	Creditors/ Deluxe	1,000	30-Sep	Creditors/ Deluxe	100
30-Sep	COGS	20	30-Sep	Stock loss	115
30-Sep	Bank	200			
			30-Sep	Balance	2,425
		<u>3,220</u>			<u>3,220</u>
1-Oct	Balance	2,425			

$$(e) \text{ Inventory turnover} = \frac{580 - 20}{((2,000 + 2425) / 2)}$$

Inventory turnover = 0.25 times per month

$$\text{Inventory turnover in days} = \frac{30}{0.25}$$

Inventory turnover in days = 118.5 days

The trend in inventory turnover is showing slower movement of stock. The turnover in days has increased significantly from 70 days in July this year to 118.5 day in September. This is a negative trend and will have significant impacts, reducing the business liquidity and increasing inventory holding costs. Furthermore, holding inventory for long periods can lead to deterioration of stock value, leading to discounting and difficulties in liquidating stock. A declining inventory turnover is caused by either reduced cost of goods sold, reflecting lower sales, or increased inventory on hand. Thus, the business has either been less effective in selling goods or may be holding excess stock.

(f)

Transaction	Balance Sheet			Income Statement				
	Assets	Liabilities	Owners' Equity	Revenue	Cost of goods sold	Selling expenses	Administrative expenses	Financial expenses
21 <sup>st</sup> Sept	-100		+100		-100			
23 <sup>st</sup> Sept	+600		+600	+600	+200			
	-200		-200					
30 <sup>th</sup> Sept	-400		-400					-400

(g)

**Income Statement (abstract) for Lux Walls Pty Ltd  
As at 30 September**

	\$	\$
REVENUE		
Sales	1,695	
less sales returns	50	
less discount allowed	20	1,625
		<hr/>
COST OF GOODS SOLD		
COGS	560	
Stock Loss	115	675
GROSS PROFIT		<hr/> <hr/>
		950

(h)

Date	Description	In		Out		Balance		
		Qty	Cost	Qty	Cost	Qty	Cost	Total
1-Oct	Balance					9	10	90
	COGS			4	10	5	10	50
10-Oct	Creditors	5	11			5	10	50
						5	11	55
15-Oct	COGS			5	10			
				3	11	2	11	22
16-Oct	Sales returns	3	11			5	11	55
20-Oct	Purchase returns			2	11	3	11	33
31-Oct	stock loss			1	11	2	11	22

(i) Holding less stock results in lower holding costs, reduced chance of stock devaluing, and stock loss. However, Robyn will be unable to access bulk discounts and may run the risk of stock outs.

(j) Cost of Inventory = \$9 (cost price) × 20  
= \$180

Net Realisable Value = \$6 (sale price) × 20  
= \$48

Using the Prudence concept, stock should be valued at NRV of \$48, according to the lower of cost rule

### 4.3 – Managing Inventory and non-current Assets

#### Activity 1 – Straight line depreciation

(a) Depreciation expenses =  $\frac{(30,000 - 5,000)}{7}$

Depreciation expenses = \$3,571

(b)

Date	Particulars	Debit	Credit
30 June	Depreciation expenses- delivery vehicle	3,571	
	Accumulated Depreciation on delivery vehicle		3,571
To record depreciation on delivery vehicle for the period			

(c)

Selling expenses		
Store rent	15,000	
Salespersons wages	25,000	
Depreciation on delivery vehicle	3,571	43,571

(d) The vehicle is used for selling activities and therefore any expenses related to the delivery vehicle, such as depreciation, is classified as a selling expense.

(e)

	Year 1		Year 2		Year 3	
Non-current assets						
Delivery Vehicle	30,000		30,000		30,000	
Less Accumulated Depreciation	<u>3,571</u>	26,429	<u>7,142</u>	22,858	<u>10,713</u>	19,287

### Activity 2 – Straight line depreciation

(a) Depreciation expenses =  $\frac{2,500}{3}$

Depreciation expenses = \$833

(b)

Date	Particulars	Debit	Credit
30 June	Depreciation expenses- computer	833	
	Accumulated Depreciation- computer		833
To record depreciation on computer for the period			

(c) It is classified as an administrative expenses because the asset will be used in the office for administrative duties.

(d) Accumulated depreciation =  $\$833 \times 2$

Accumulated depreciation = 1,666

Book value =  $2,500 - 1,666$

Book value = 834

### Activity 3 – Diminishing Balance

(a) Depreciation expense 2022 =  $15,000 \times 20\%$

= 3,000

Depreciation expense 2023 =  $(15,000 - 3,000) \times 20\%$

= 2,400

Depreciation expense 2024 =  $(15,000 - 5,400) \times 20\%$

= 1,920

(b)

	Year 1		Year 2		Year 3	
Non-current assets						
Delivery Vehicle	15,000		15,000		15,000	
Less Accumulated Depreciation	<u>3,000</u>	12,000	<u>5,400</u>	9,600	<u>7,320</u>	7,680

## Activity 4 – Partial Year Depreciation

(a) New computers

$$\text{Depreciation} = (2,000 \times 30\%) \times \frac{8}{12}$$

$$\text{Depreciation} = 400$$

$$\text{Old Computers} = 5,000 - 2,000$$

$$\text{Old Computers} = 3,000$$

$$\text{Depreciation} = (3,000 - 2,000) \times 30\%$$

$$\text{Depreciation} = 300$$

$$\text{Total depreciation} = 400 + 300$$

$$\text{Total depreciation} = 700$$

(b) New machinery

$$\text{Depreciation} = (5,000 \times 15\%) \times \frac{5}{12}$$

$$\text{Depreciation} = 312.5$$

$$\text{Old Machinery} = 20,000 - 5,000$$

$$\text{Old Computers} = 15,000$$

$$\text{Depreciation} = (15,000 \times 15\%)$$

$$\text{Depreciation} = 2,250$$

$$\text{Total depreciation} = 312.5 + 2,250$$

$$\text{Total depreciation} = 2,562.50$$

(c)

Date	Particulars	Debit	Credit
30 June	Depreciation expenses- Computer	700	
	Accumulated Depreciation Computer		700
To record depreciation on computer for the periods.			
30 June	Depreciation expenses- Machinery	2,562.50	
	Accumulated Depreciation Machinery		2,562.50
To record depreciation on Machinery for the periods.			

## Activity 5 – Units of Use

(a) Year 1

$$\text{Depreciation expenses} = (30,000 - 5,000) \times \frac{70,000}{250,000}$$

$$\text{Depreciation expenses} = \$7,000$$

Year 2

$$\text{Depreciation expenses} = (30,000 - 5,000) \times \frac{80,000}{250,000}$$

$$\text{Depreciation expenses} = \$8,000$$

Year 3

$$\text{Depreciation expenses} = (30,000 - 5,000) \times \frac{92,000}{250,000}$$

$$\text{Depreciation expenses} = \$9,200$$

(b) The delivery vehicle will be used to deliver sales to customers and therefore will be classified as a selling expense.

(c) The life of a vehicle is mainly determined by how much is used. The more a vehicle is used, the greater the consumption of its economic benefits. Therefore, it is appropriate to allocate the cost of the asset according to kilometres travelled.

## Extended Activity – Adjusting trial balance for depreciation

### (a) Delivery Vehicle

$$\text{Depreciation on Delivery Vehicles} = 38,000 \times \frac{30,000}{250,000}$$

$$\text{Depreciation on Delivery Vehicles} = 4,560$$

### Fixtures and Fittings

$$6,000 - 2,000 = 4,000 \text{ fixtures and fittings held for full year}$$

$$\text{Depreciation on Fixtures and Fittings held for the full year} = 4,000 \times 15\%$$

$$\text{Depreciation on Fixtures and Fittings held for the full year} = 600$$

$$\text{Depreciation on new Fixtures and Fittings} = 2,000 \times 15\% \left( \frac{4}{12} \right)$$

$$\text{Depreciation on new Fixtures and Fittings} = 100$$

$$\text{Total Depreciation on Fixture and Fittings} = 100 + 600$$

$$\text{Total Depreciation on Fixture and Fittings} = 700$$

### Office Equipment

$$\text{Depreciation on Office Equipment} = (5,000 - 1,200) \times 20\%$$

$$\text{Depreciation on Office Equipment} = 760$$

### (b)

	Debit	Credit	Adjustment	Balance
Building	\$ 900,000			
Sales		\$ 80,000		
Sales returns	\$ 8,000			
Drawings	\$ 29,000			
Inventories	\$ 30,000			
COGS	\$ 20,000			
Delivery Vehicle	\$ 38,000			
Accumulated depreciation – Delivery Vehicles		\$ 8,000	\$ 4,560	\$ 12,560
Land	\$ 150,000			
Advertising	\$ 2,400			
Insurance on building	\$ 1,600			
Internet and Telephone	\$ 1,200			
Compliance expenses	\$ 1,000			
Debtors	\$ 10,000			
Creditors		\$ 13,000		
Cash at bank	\$ 5,650			
Store fixture and fittings	\$ 6,000			
Accumulated depreciation – store fixtures and fittings		\$ 1,000	\$ 700	\$ 1,700
Interest received		\$ 2,000		
Office equipment	\$ 5,000			
Accumulated depreciation – Office Equipment		\$ 1,200	\$ 760	\$ 1,960
Mortgage on land and buildings		\$ 700,000		
Capital		\$ 462,650		
Salesperson Salaries	\$ 60,000			
Depreciation- Delivery Vehicles			\$ 4,560	\$ 4,560
Depreciation- Fixtures and Fittings			\$ 700	\$ 700
Depreciation- Office Equipment			\$ 760	\$ 760

(c)

**Income Statement for Trinity's Trinkets  
for the year ended June 30**

	\$	\$
<b>REVENUE</b>		
Sales	80,000	
Less sales returns	<u>8,000</u>	72,000
 COST OF GOODS SOLD		 20,000
 <b>GROSS PROFIT</b>		 52,000
 <b>OTHER REVENUE</b>		
<b>Interest received</b>		<u>2,000</u>
		54,000
 EXPENSES		
<b>Selling Expenses</b>		
Advertising	2,400	
Salesperson Salaries	60,000	
Depreciation expense – Store Fixtures and Fittings	700	
Depreciation expense – Delivery Vehicle	<u>4,560</u>	67,660
 <b>Administrative Expenses</b>		
Insurance on building	1,600	
Compliance expenses	1,000	
Depreciation expense- Office Equipment	760	
Internet and Telephone	<u>1,200</u>	4,560
		<u>72,220</u>
 <b>LOSS</b>		 <u>18,220</u>

**Statement of Changes in Owners' Equity**  
**Trinity's Trinkets -for the period ending June 30**

	\$	\$	\$
Capital	462,650		
Less Drawings	29,000	433,650	
Loss		-\$ 18,220	415,430

**Balance Sheet**  
**Trinity's Trinkets -as at June 30**

ASSETS			
<i>Current Assets</i>			
Cash at bank		5,650	
Debtors		10,000	
Inventory		30,000	45,650
<i>Non-Current</i>			
Building		900,000	
Land		150,000	
Delivery Vehicle	38,000		
Accumulated depreciation – Delivery Vehicles	(12,560)	25,440	
Store fixture and fittings	6,000		
Accumulated depreciation – store fixtures and fittings	(1,700)	4,300	
Office equipment	5,000		
Accumulated depreciation – Office Equipment	1,960	3,040	1,082,780
<b>TOTAL ASSETS</b>			<b>1,128,430</b>
LIABILITIES			
<i>Current</i>			
Creditors			13,000
<i>Non-current</i>			
Mortgage on land and buildings			700,000
<b>Total Liabilities</b>			<b>713,000</b>
<b>Net Assets</b>			<b>415,430</b>

## Chapter 5 – Balance Day Adjustment

### Review Question 1

The accounting period convention requires expenses to be matched to corresponding revenues into the period that the revenue was earned. This requires adjustments at balance day to adjust the value of an expense, which did not neatly fit into one time period.

### Activity 1

(a)  $(9600/10) \times 3 = \$2,880$

(b)

Date	Particulars	Debit	Credit
30/6	Wages expense	2,880	
	Wages Payable		2,880
To record the wages balance day adjustment			

(c)

Dr	Wages Payable	Cr	Dr	Wages Expense	Cr
	30 Wages June Expense	2,880	30 Wages June payable	2,880	

### Activity 2

(a)

Date	Particulars	Debit	Credit
June 30	Landscaping fees receivable	\$5,000	
	Landscaping fees		\$5,000
To record landscaping fees receivable			

### Review Question 2

The accrual accounting requires expenses to be recognised when they have been incurred not paid. This requires apportioning the item to an expense as the insurance is consumed or expired. Any unexpired insurance is treated as an asset until it is used up.

### Review Question 3

The realisation principle is the accounting concept that requires revenue to be recognised once the services have been performed. Thus, only earned revenue can be recognised as revenue. Payments received for services not yet provided is treated as a liability.

## Activity 3

Number	Event	BDA
Example	Annual insurance is paid on the 30 <sup>th</sup> of March.	Prepaid expense
(a)	\$1,000 is owed to employees, on balance day, for worked performed.	Wages payable
(b)	Services worth \$1,000 have been performed for a client, who has not yet been billed	Service revenue receivable
(c)	A client transferred service fee of \$5,000 for work not yet performed.	Unearned revenue
(d)	A radio advertising package was bought for \$2,000. The advertisements have not yet aired.	Prepaid advertising

## Activity 4

(a)

Date	Particulars	Debit	Credit
30 June	Internet expenses	1,500	
	Internet expenses payable		1,500
<i>To record internet expense payable</i>			
30 June	Fees revenue receivable	17,000	
	Fees revenue		17,000
<i>To record the fee revenue earned</i>			

Internet Expense			Internet expense payable		
30/6	Internet expense payable	1,500		30/6	Internet expense 1,500
Service revenue receivable			Service revenue		
30/6	Service revenue	17,000		30/6	Service revenue receivable 17,000

## Activity 5

(a)

Date	Particulars	Debit	Credit
May 1	Insurance expense	600	
	Cash at bank		600
<i>To record the payment of the annual insurance account</i>			

Insurance Expense			Cash at Bank		
1 May	Cash at bank	600		1 May	Insurance Expense 600



(b)

10 months unexpired

Prepaid insurance =  $(600/12) \times 10$

Prepaid insurance = \$500

(c)

Date	Particulars	Debit	Credit
June 30	Prepaid Insurance	500	
	Insurance expense		500
<i>To record the prepaid insurance</i>			

Insurance Expense (AE)			Prepaid Insurance (CA)		
1 May	Cash at bank	600		30 June	Insurance expense 500
		600			500
1 July	Balance	100			
		100			

(d)

Date	Particulars	Debit	Credit
May 1	Prepaid insurance expense	600	
	Cash at bank		600
<i>To record the payment of the annual insurance account</i>			

Prepaid Insurance Expense			Cash at Bank		
1 May	Cash at bank	600		1 May	Prepaid Insurance Expense 600

Record the balance day adjustment required on the 30th of June.

Date	Particulars	Debit	Credit
June 30	Insurance expense	100	
	Prepaid insurance		100
<i>To record the insurance expense</i>			

Insurance Expense (E)			Prepaid Insurance (CA)					
30 June	Prepaid Insurance	100	1 May	Cash at bank	600	30 June	Insurance Expense	100
						30 June	Balance	<u>500</u>
			1 July	Balance	500			600

(e)

The final balance are the same. The choice of approach will only effect interim reports prepared prior to the balance day adjustments being made.

## Activity 6

General Journal

Date	Particulars	Debit	Credit
1 March	Accounting software expenses Cash	1,000	1,000
<i>To record the Accounting software expenses paid</i>			
30-June	Prepaid Accounting software Accounting software expense	667	667
<i>To recognise Prepaid Accounting software</i>			

Accounting Software Expense (AE)			Cash at bank					
1/3	Cash	1,000	30/6	Prepaid Accounting software	667	1/3	Accounting Software expense	1,000
Prepaid Accounting Software								
			30/6	Accounting Software expenses	667			

### Activity 7

General Journal

Date	Particulars	Debit	Credit
1-April	Prepaid advertising Cash	12,000	12,000
<i>To record the Accounting software expenses paid</i>			
30-June	Advertising expense Prepaid advertising	6,000	6,000
<i>To recognise Prepaid Accounting software</i>			

Prepaid Advertising				Cash at bank				
1/4	Cash	12,000	30/6	Advertising expense	6,000	1/4	Prepaid advertising	12,000
				Advertising Expense				
				30/6	Prepaid advertising	6,000		

### Activity 8

Date	Particulars	Debit	Credit
May 1	Cash at Bank (CA) Construction Fees (R)	30,000	30,000
<i>To record the receipts from customers</i>			

Cash at Bank (CA)				Construction Fees (R)			
1	Construction May Fees	30,000		1	Cash at May Bank	30,000	

(a) Prepare and post the BDA entry for the necessary adjustment on the 30th of June.

Date	Particulars	Debit	Credit
June 30	Construction fees (R) Unearned construction fees (CL)	22,500	22,500
<i>To record the unearned revenue</i>			

	Dr		CR		Dr		Cr	
30	Unearned June revenue	22,500	1	Cash at May bank	30,000	30	Construction June fees	22,500
30	Balance	7,500						
		30,000						30,000
			1	July Balance	7,500			

## Activity 9

General Journal

Date	Particulars	Debit	Credit
25-June	Cash Unearned revenue	10,000	10,000
<i>To record the cash received for sales orders</i>			
30-June	Unearned revenue Sales revenue	8,000	8,000
<i>To recognise the unearned sales revenue</i>			

Cash at Bank (CA)				Unearned Sales Revenue (CL)			
25/6	Unearned revenue	10,000		30/6	Sales Revenue	8,000	
				25/6	Cash	10,000	
Sales Revenue (R)							
				30/6	Unearned sales revenue	8,000	

## Activity 10

General Journal

Date	Particulars	Debit	Credit
1-May	Cash Service revenue	9,000	9,000
<i>To record receipts from customers</i>			
30-June	Service revenue Unearned service revenue	2,700	2,700
<i>To recognise earned revenue</i>			

Cash at Bank (CA)				Services revenue (R)			
1/5	Service revenue	9,000		30/6	Unearned service revenue	2,700	
				1/5	Cash	9,000	
Unearned Revenue (CL)							
				20/6	Service revenue	2,700	

### Activity 11

Prepare the appropriate general journal entries to record the additional information:

Date	Account	Debit	Credit
30 June	Stock of Stationery	450	
	Stationery expense		450

State the balances in the final accounts:

**Balance Sheet – Current Assets**

Stock of Stationery \$450

**Income Statement – Expenses**

Stationery \$3,550

### Activity 12

Complete the BDA general journal entries for Fuel:

Date	Account	Debit	Credit
30 June	Fuel Expense	900	
	Stock of Fuel		900

(a) State the balances in the final accounts:

**Balance Sheet – Current Assets**

Stock of Fuel \$1,100

**Income Statement – Expenses**

Fuel \$14,320

### Activity 13

	Balance Sheet			Income Statement		
	Name	Classification	Amount	Name	Classification	Amount
(a) (example)	Unearned sales revenue	Current Liability	\$2,000	Sales revenue	Revenue	\$108,000
(b)	Interest receivable	Current Asset	1,800	Interest revenue	Other Revenue	1,800
(c)	Prepaid advertising	Current Asset	6,000	Advertising expense	Selling Expense	6,000
(d)	Prepaid rent	Current Asset	2,500	Rent expense	Admin expense	27,500
(e)	Wages payable	Current Liability	1,500	Wages	Selling expense	130,000
(f)	Prepaid insurance on inventory	Current Asset	583	Insurance on Inventory	COGS	417
(g)	Prepaid magazine subscription	Current Asset	17.5	Magazine subscription expense	Admin Expense	17.5
(h)	Unearned service revenue	Current Liability	120	Service Revenue	Other revenue	29,880

Complete balance day adjustments for transactions (a) – (f).

Date	Particulars	Debit	Credit
30 June	Sales (R decreasing) Unearned sales revenue (CL increasing)	2,000	2,000
<i>To record prepaid sales</i>			
30 June	Interest receivable (CA increasing) Interest revenue (R Increasing)	1,800	1,800
<i>To record interest receivable</i>			
30 June	Prepaid advertising (CA increasing) Advertising expense (SE decreasing)	6,000	6,000
<i>To record prepaid advertising</i>			
30 June	Prepaid rent expense (CA increasing) Rent expense (AE decreasing)	2,500	2,500
<i>To record prepaid rent</i>			
30 June	Wages expense (SE increasing) Wages payable (current liability increasing)	1,500	1,500
<i>To record wages owing</i>			
30 June	Insurance expense Inventory (COGS increasing) Prepaid insurance expense (CA decreasing)	417	417
<i>To record Insurance expense</i>			
30 June	Prepaid magazine subscription (CA Increasing) Magazine subscription expense (AE decreasing)	17.50	17.50
<i>To record prepaid subscriptions</i>			
30 June	Service revenue (R decreasing) Unearned service revenue (CL increasing)	120	120
<i>To record revenue received in advance</i>			

### Review Question 4

- The bank account is in overdraft for \$720 and should be classified as an Overdraft
- The amount for debtors should be on the Debit side
- The amounts for the loan from ANZ used to buy the motor vehicle and the motor vehicle have been incorrectly debited and credited
- It is likely that the amount for Staff wages is incorrect given the size of the other amounts. A decimal point has been missed.

## Activity 14 – Reversal of errors

Date	Particulars	Debit	Credit
30/6	Selling expenses Administration expenses	40	40
<i>Reversal of an incorrect posting to the wrong account</i>			
30/6	Wages expense Cash at bank	1,200	1,200
<i>Reversal of an incorrect posting to wrong side</i>			

## Extension Activity 1

General Journal – D Hound

Date	Particulars	Debit	Credit
30 June	Inventory Trading	9,588	9,588
<i>To record closing inventory</i>			
30 June	Insurance Expense (Admin Exp, Inc) Prepaid Insurance (CA Dec)	450	450
<i>To record insurance expense</i>			
30 June	Rent revenue (R Dec) Unearned rent revenue (CL Dec)	1,500	1,500
<i>To record prepaid rent revenue</i>			
30 June	Wages (AE Inc) Wages payable (CL inc)	250	250
<i>To record wages owing</i>			
30 June	Interest receivable (CA inc) Interest on government bonds (OR Inc)	300	300
<i>To record interest earned</i>			

**Statement of Changes in Owners' Equity****D. Hound-for the period ending June 30th**

Capital		34,578	
Less Drawings		1,000	33,578
Add profit			20,348
			<u>53,926</u>

**Balance Sheet****D. Hound-as at June 30th**

<b>Current Asset</b>			
Bank	2,234		
Debtors	2,420		
Inventory	9,588		
Prepaid Insurance	200		
Interest receivable	\$ 300	\$14,742	
<b>Non-Current</b>			
5 year Government Bonds	1,200		
Fixtures and fittings	20,000		
Motor vehicles	25,000	46,200	
<b>TOTAL ASSETS</b>			<u>60,942</u>
<b>LIABILITIES</b>			
<b>Current</b>			
Wages payable	250		
Unearned Rent revenue	1,500		
Creditors	5,266		7,016
<b>NET ASSETS</b>			<u>53,926</u>

**Income Statement of D. Hound  
for the year ended June 30**

**REVENUE**

Sales		30,188
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**COST OF GOODS SOLD**

Inventories –opening	7,500	
Purchases	6,432	
Less Discount received	- 300	
Less Inventory- Closing	- 9,588	
	4,044	

**GROSS PROFIT**

		26,144
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**OTHER REVENUE**

Interest on government bonds	700	
Rent Revenue	1,500	
	2,200	
		28,344

**EXPENSES****Selling Expenses**

Delivery charges on sales	372	
Sales salaries	4,200	
	4,572	

**Administrative Expenses**

Stationery expense	2,224	
Wages	750	
Insurance	450	
	3,424	

**PROFIT**

		7,996
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		20,348
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## Extension Activity 2

Date	Particulars	Debit	Credit
30 June	Inventory Trading	43,000	43,000
<i>To record closing inventory</i>			
30 June	Prepaid Insurance (CA Dec) Insurance Expense (AE, Inc)	3,600	3,600
<i>To record prepaid insurance</i>			
30 June	Wages (AE Inc) Wages payable (CL Inc)	760	760
<i>To record wages owing</i>			
30 June	Prepaid rates (CA Inc) Rates (AE Dec)	2,400	2,400
<i>To record prepaid rates</i>			
30 June	Interest (FE Inc) Interest Payable (CL Inc)	400	400
<i>To record accrued interest payable</i>			
30 June	Office expenses (AE) Rates (AE)	700	700
<i>To reverse classification error</i>			

**Statement of Changes in Owners' Equity**  
**V. B Sporting for the period ending June 30th**

<b>Capital</b>	36,200	
<b>Add profit</b>	149,740	
	149,740	185,940

**Balance Sheet**  
**V.B Sporting Supplies as at June 30th**

<b>ASSETS</b>		
Current Assets		
Bank	40,000	
Debtors	56,700	
Prepaid insurance	3,600	
Prepaid Rates	2,400	
Inventory	43,000	145,700
	43,000	
Non-Current		
Equipment	106,400	
Display shelving	42,000	
Government bonds	8,000	156,400
<b>TOTAL ASSETS</b>		302,100
<b>LIABILITIES</b>		
Current		
Interest Payable	400	
Wages Payable	760	
Creditors	70,000	71,160
	70,000	
Non-current		
Loan from XYZ (due in 5 years)		45,000
		116,160
<b>NET ASSETS</b>		185,940

**Income Statement V.B Sporting Supplies  
for the year ended June 30**

**REVENUE**

Sales		648,900
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**COST OF GOODS SOLD**

Inventories – opening	94,000	
Purchases	372,000	
Less Purchase returns	<u>5,000</u>	367,000
Freight inwards	9,000	
Less Inventory- Closing	43,000	427,000

**GROSS PROFIT**

221,900

**EXPENSES****Selling Expenses**

Advertising		23,500
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**Administrative Expenses**

Wages	33,760	
Insurance	3,600	
Offices expenses	9,200	
Rates	<u>1,700</u>	48,260

**Financial Expenses**

Interest on loan	<u>400</u>	72,160
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**PROFIT**

		<u>149,740</u>
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## Extension Activity 3

**Statement of Changes in Owners' Equity**  
**Shoe Barn for the period ending December 31**

Capital	49,800		
Less Drawings	2,000	47,800	
Profit		14,950	62,750

**Balance Sheet**  
**Shoe Barn as at December 31**

## ASSETS

## Current Assets

Cash on hand	1,000		
Debtors	8,000		
Inventory	1,000		
Prepaid expenses	750		
Inventory of wrapping paper	600		
Interest receivable on government bonds	400	11,750	

## Non-Current

Office furniture	4,000		
Investments	10,000		
Building	23,000		
Fixtures and fittings	3,000		
Government bonds	5,000		
Land	33,000	78,000	89,750
<b>TOTAL ASSETS</b>			

## LIABILITIES

## Current

Creditors	10,000		
Bank overdraft	6,000		
Interest Payable	1,000		
Loan (January next year)	10,000	27,000	

## NET ASSETS

27,000

62,750

**Income Statement Shoe Barn  
for the year ended December 31**

**REVENUE**

Sales	45,000	
Less sales returns	1,000	
Less Discount allowed	1,000	43,000

**COST OF GOODS SOLD**

Inventories –opening	6,000	
Purchases	20,000	
Less Purchase returns	5,000	15,000
Freight inwards	500	
Customs duty	700	
Less Discount received	1,300	
Less Inventory- Closing	1,000	19,900

**GROSS PROFIT**

23,100

**OTHER INCOME**

Interest on government bonds	600	
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23,700

**EXPENSES****Selling Expenses**

Display expenses	700	
Delivery of sales	900	
Traveller's expenses	2,800	
Wrapping paper expense	200	4,600

**Administrative Expenses**

Cleaning	2,000	
General expenses	500	2,500

**Financial Expenses**

Interest on overdraft	1,200	
Bad debts	200	
Bank charges	250	1,650

8,750

**PROFIT**

14,950

## Extension Activity 4

(a)

**Statement of Changes in Owners' Equity**  
**Nemo's Aquariums for the period ending June 30**

Capital	242,557		
Less Drawings	3,000	239,557	
Loss		-23,137	216,420

**Balance Sheet**  
**Nemo's Aquariums - as at June 30**

## ASSETS

## Current Assets

Cash at bank	5,650		
Debtors	10,000		
Prepaid building insurance	300		
Stock of fuel	1,200		
Interest receivable	250		
Inventory	17,000	34,400	

## Non-Current

Building	550,000		
Motor Vehicle	8,000		
Land	15,000		
Goodwill	12,000	585,000	

## TOTAL ASSETS

619,400

## LIABILITIES

## Current

Creditors	2,000		
Insurance Payable	200		
Unearned rent revenue	100		
Salesperson Salaries payable	640		
Telephone expense payable	40	2,980	

## Non-current

Mortgage on land and buildings		400,000	
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## Total Liabilities

402,980

## Net Assets

216,420

(b)

**Income Statement Nemo's Aquariums  
for the year ended June 30**

**REVENUE**

Sales	60,000	
Less sales returns	1,746	
Less Discount allowed	2,000	56,254

**COST OF GOODS SOLD**

Inventories –opening		15,240
Purchases	20,000	
Less Purchase returns	4,000	16,000
Freight inwards		246
Less Discount received		1,560
Less Inventory- Closing		17,000
		12,926

**GROSS PROFIT**

43,328

**OTHER INCOME**

Rent from shops		4,500
Interest		450
		4,950
		48,278

## EXPENSES

**Selling Expenses**

Advertising	2,400	
Salesperson Salaries	60,640	
Fuel expense	4,800	
Insurance on motor vehicle	800	68,640

**Administrative Expenses**

Insurance on building	1,300	
Telephone	275	
Rates	1,200	2,775

71,415

**LOSS**

-23,137

- (c) The BDA posted to record rent received in advance, had a number of impacts. It reduced rent revenue, in recognition that 100 of the revenue had not yet been earned, subsequently reducing profit by 100. The entry also established the liability to the tenants of 100, also reducing net assets.
- (d) Accountants record and report only those items that are material or important enough to affect the decisions of statement users. The telephone adjustment of \$40 increased telephone expenses to \$275, decreasing profit from \$18,627 to \$18,587. \$40 is only 0.06% to total expenses, and thus this transaction had an immaterial and insignificant impact on the accounts and therefore would not be required.



## Extension Activity 5

- (a) Violet will have an increased need for accurate, up-to-date financial information to make decisions. Furthermore, timeliness and accuracy of accounts may be improved with an on-line real time accounting system
- It suits businesses that do not get paid upfront from customers or do not pay for supplies in cash. For example, if Violet buy flowers on credit, she may have a significant amount outstanding payments, the accrual system will recognise these liabilities.
    - It is likely that she will start to trade on this level if she opens a retail operation
- (b) Open question. Students could explore a number of factors such as:
- Market demand/ competition
  - Locations
  - Costs of setting up a retail store
  - Additional compliance and administrative requirements e.g. BAS
  - Sources of finance to cover
    - Working capital
    - Set-up costs
  - Upskilling
    - E.g. learn accounting systems and retail software

## Chapter 6 – Difference between cash and profit

### Activity 1

Account	Has an impact on the Cash Account	Does not impact on the Cash Account	Impacts profit	Does not impact profit
Cash Sales	✓		✓	
Receipts from debtors	✓			✓
Cash purchases	✓		✓	
Capital contributions	✓			✓
Loan repayments	✓			✓
Wages and Salary expense	✓		✓	
Depreciation expense		✓	✓	
Drawings	✓			✓
Purchase of equipment	✓			✓

### Adjustments to expenses

#### Payables

##### Activity 1

Cash outflow = 25,000 – 800 + 900

Cash outflow = 25,100

##### Activity 2

outflow = 2,500 – 400 + 100

Cash outflow = 2,200

#### Revenue Receivable

##### Activity 1

Cash inflow = 2,000 – 500 + 600

Cash inflow = 2,100

##### Activity 2

Cash inflow = 4,000 – 400 + 250

Cash inflow = 3,850

#### Prepaid Expenses

##### Activity 1

Cash outflow = 25,000 + 800 – 900

Cash outflow = 24,900

##### Activity 2

Cash outflow = 2,500 – 100 + 400

Cash outflow = 2,800

## Unearned Revenue

### Activity 1

Cash inflow = 2,000 – 600 + 500

Cash inflow = 1,900

### Activity 2

Cash inflow = 4,000 – 250 + 400

Cash inflow = 4,150

## Statement of Cash-Flows

### Activity 1

(a) (i) **Cash Received from debtors:**

		Debtors			
1-Jul	Balance	40,000	Bad debts	6,000	
	Sales	220,000	Bank	<b>218,000</b>	
			30-Jun	Balance	36,000
		<u>260,000</u>			<u>260,000</u>

(ii) **Payments to suppliers & employees:**

		Creditors			
	<b>Bank</b>	<b>534,000</b>	30-Jun	Balance	20,000
				Purchases	562,000
		48,000			
		<u>582,000</u>			<u>582,000</u>

(iii) **Other calculations**

Operating expenses

Insurance	3,000
Add current year Prepaid	5,000
Less prior year Prepaid	<u>3,000</u>
	5,000

Sales wages	72,000
Less current year Accruals	2,000
Add prior year Accruals	<u>3,000</u>
	73,000

Operating expenses	
Insurance	5,000
Sales Wages	73,000
Cartage	8,000
Advertising	<u>16,000</u>
	102,000

(b)

**Mad Fit Products**  
**Statement of Cash Flows for the year ended 30 June**

CASH FLOWS FROM OPERATING ACTIVITIES		
Inflows		
Receipts from Debtors	218,000	
Cash Sales	480,000	698,000
Outflows		
Payments to suppliers	534,000	
Payments for operating expenses	102,000	
Interest paid	19,000	(655,000)
<i>Net cash flows from operating activities</i>		<b>43,000</b>
CASH FLOWS FROM INVESTING ACTIVITIES		
Inflows		
Sale of shares		50,000
Outflows		
Acquisition of furniture and fittings	15,000	
Acquisition of Premises	130,000	(145,000)
<i>Net cash flows from investing activities</i>		(95,000)
CASH FLOWS FROM FINANCING ACTIVITIES		
Outflows		
Drawings	7,000	
Mortgage repayments	10,000	
<i>Net cash flows from financing activities</i>		(17,000)
NET INCREASE/DECREASE IN CASH HELD		(69,000)
CASH AT BEGINNING OF PERIOD		9,000
CASH AT END OF PERIOD		(60,000)

(c) To determine if the business is able to:

- Generate a positive cash flow and determine which activities contribute to cash movements
- Pay interest on loans
- Fund future expansion
- Pay drawings for unincorporated businesses and dividends for companies

A

**(d) Operating Activities**

Madfit made a small cash surplus of \$43,000 from its Operating Activities. Cash sales generated the largest cash inflow. Payments to suppliers was the largest component of cash outflows. Generating positive cashflows from operating activities is important as it shows the business can generate sufficient cash to cover operating activities.

**Investing Activities**

The purchase of the non-current assets; furniture and fittings and premises resulted in a negative cash outflow of \$145,000 which was only partly offset by the sale of shares for \$50,000. The investing activities significantly contributed to the bank overdraft. Funding the purchase of furniture and fittings and premise through a bank overdraft is an inappropriate form of finance as it will need to be repaid in the short term and will incur a high interest rate.

- (e) The premises and some of the furniture and fittings could have been leased. This would have resulted in a smaller cash outflow. Alternatively, these acquisitions could have been funded from a loan (furniture and fittings)/ mortgage (premise). However, interest and principle repayments on these loans will result in future additional cash outflows.

## Statement of Cash Flows

### Activity 2

(a) (i)

		Debtors		
1-Jul	Balance	700	Discount	70
	Sales	35,000	Bad debts	60
			Bank	35,170
			30-Jun Balance	400
		<u>35,700</u>		<u>35,700</u>

(ii)

		Creditors		
<b>Bank</b>	9,325	30-Jun	Balance	3,180
Discount	60		Purchases	10,900
	<u>4,695</u>			
	14,080			<u>14,080</u>

(iii)

Operating expenses

Insurance	100
Add current year Prepaid	<u>240</u>
	<b>340</b>

Wages	12,000
Less current year Accruals	<u>1,235</u>
	<b>10,765</b>

(iv)

Operating expenses	
Insurance	340
Wages	10,765
Rent	730
Telephone	340
	<b>12,175</b>

(b)

CASH FLOWS FROM OPERATING ACTIVITIES		
Inflows		
Receipts from Debtors	35,170	
Interest on loan	125	35,295
Outflows		
Payments to suppliers	9,325	
Payments for operating expenses	12,175	
Interest paid	445	(21,945)
<i>Net cash flows from operating activities</i>		<b>13,350</b>
CASH FLOWS FROM INVESTING ACTIVITIES		
Inflows		
Sale of shares		600
Outflows		
Acquisition of shop fittings	3,150	
Acquisition of Display equipment	4,000	(7,150)
<i>Net cash flows from investing activities</i>		<b>(6,550)</b>
CASH FLOWS FROM FINANCING ACTIVITIES		
Outflows		
Loan to N. Smart	2,000	
Drawings	2,000	
<i>Net cash flows from financing activities</i>		<b>(4,000)</b>
NET INCREASE/DECREASE IN CASH HELD		2,800
CASH AT BEGINNING OF PERIOD		800
CASH AT END OF PERIOD		3,600

- (c) (i) The operating activities had a positive impact on the cash position by contributing an additional \$13,350. This demonstrates the business can generate cash internally. However, it was not enough cash to comfortably cover investments and leave sufficient working capital.
- (ii) The investing activities resulted in a negative outflow of \$8,550 because of non-current asset purchases. Although this had a detrimental impact on the current cash position, these assets may contribute to generating future cash inflows. Appropriate financing for these assets needs to be considered to improve the cash position.

## Statement of Cash Flows

### Activity 3

(a) (i)

Debtors			
1-Jul	Balance	9,000	
	Sales	45,000	
		<u>54,000</u>	
30-Jun	Balance		<u>10,000</u>
	Bad debts		500
	Bank		<b>43,500</b>
			<u>54,000</u>

(ii)

Creditors				
	<b>Bank</b>	45,900	30-Jun Balance	5,000
	Discount	600	Purchases	46,000
		<u>4,500</u>		
		51,000		<u>51,000</u>

(iii)

Wages	50,000
Less current year Accruals	400
Add prior year Accruals	<u>500</u>
	50,100
Operating expenses	
Rent	11,000
Administration expenses	4,000
Wages	50,100
	<u>65,100</u>

(b)

**Clean Kitchen Statement of Cash Flows for year ending 30 June**

CASH FLOWS FROM OPERATING ACTIVITIES		
Inflows		
Cash sales	70,000	
Receipts from Debtors	43,500	113,500
Outflows		
Payments to suppliers	45,900	
Payments for operating expenses	65,100	
Interest paid	1,200	(112,200)
<i>Net cash flows from operating activities</i>		<b>1,300</b>
CASH FLOWS FROM INVESTING ACTIVITIES		
Inflows		
Sales of Vehicles		8,000
Outflows		
Acquisition of Restaurant fittings		(2,000)
<i>Net cash flows from investing activities</i>		<b>6,000</b>
CASH FLOWS FROM FINANCING ACTIVITIES		
Outflows		
Drawings		(10,000)
<i>Net cash flows from financing activities</i>		<b>(10,000)</b>
NET INCREASE/DECREASE IN CASH HELD		(2,700)
CASH AT BEGINNING OF PERIOD		800
CASH AT ENDING OF PERIOD		(1,900)

(c) The investing activities contributed \$6,000 cash inflows, reducing the cash deficit. The sale of the vehicle improved the cash position. Investing activities cannot be used as a continuous source of finance as non-current assets must be sold to create inflows. Furthermore, the business requires non-current assets to produce future income and generate cash inflows.

## Preparing Bank Reconciliation

### Activity 1

Cash at Bank			
	30-June	Balance	5,675
	30-June	Bank interest	25
			5,700
	30-June	Balance	5,700
			5,700
	1-July	Balance	5,700

RC Accountants Bank reconciliation statement  
as at 30 June

Balance as per the Bank Statement	5,000 Cr
Add deposits not yet presented	1,500
Less unrepresented cheques	<u>(800)</u>
Balance as per the bank statement	5,700 Dr

## Preparing Bank Reconciliation

### Activity 2

Cash at Bank			
		30-June	Balance
			1,700
		30-June	Bank Fee
			100
	30-June	Balance	1,800
			1,800
	1-July	Balance	1,800

**The T-Shirt Company Bank reconciliation statement  
as at 30 June**

Balance as per the Bank Statement	2,000 Dr
Add deposits not yet presented	500
Less unrepresented cheques	<u>(300)</u>
Balance as per the bank statement	1,800 Cr

## Preparing Cash Budgets

### Activity 1

(a)

Collection from Debtors			
	Jan	Feb	March
November	\$ 1,000		
December	\$ 3,825	\$ 1,020	
January		\$ 3,900	\$ 1,040
February			\$ 3,900
March			
<b>Total</b>	<b>\$ 4,825</b>	<b>\$ 4,920</b>	<b>\$ 4,940</b>

(b) Cash Budget for the months of January, February and March

<b>Estimated Cash Receipts</b>	January	February	March
Cash sales	4,500	4,000	3,300
Receipts from debtors	4,825	4,920	4,940
<b>Total Estimated Cash Receipts</b>	<b>9,325</b>	<b>8,920</b>	<b>8,240</b>
<b>Estimated Cash Payments</b>			
Purchases	2,850	2,755	2,375
Wages	3,000	3,000	3,090
Interest on loan	1,000	1,000	1,000
Advertising	400	400	400
Website maintenance	400	400	400
Administrative expenses	500	500	500
Rent	1,500	1,650	1,650
Social Media Consultant			7,000
<b>Total Estimated Cash Payments</b>	<b>9,650</b>	<b>9,705</b>	<b>16,415</b>
Balance at bank – opening	3,000	2,675	1,890
Receipts – Payments	(325)	(785)	(8,175)
Balance at bank – closing	2,675	1,890	(6,285)

- (c) The projected cash position is \$12,285 in overdraft. If the business is to sustain its operations into the future, it needs to improve its cash position to ensure that the business can continue to meet its financial obligations.
- (d) The owners could contribute additional capital contributions. This source of finance does not require repayment, however, the owners may not have the personal funds available. Furthermore, the owners may not want to place further investment into the business given its financial position.

Apply for a medium term loan. This will require regular repayment with interest. However, the further repayments may put future strain on the business cash flows.

- (e)
- Although sales have reduced overall, the credit sales from commercial clients are projected to continue to increase, indicating that it may be a profitable market segment. The business could redirect their marketing strategies to target the commercial market.
  - Reducing prices may result in increased sales revenue.
  - Analyse sales trends by product to identify and focus on the products that generate the most revenue.
  - Changing the product range or diversifying the product the garden centre sells such as hardware items or firewood.
  - Engage in targeted marketing techniques which will focus on attracting the target market.
  - Negotiate an alternative contract to paying \$7,000 in advance for the social media campaign.

## Preparing Cash Budgets

### Activity 2

(a)

Collection from Debtors	April	May	June
January (10% 8000)	\$800		
February (60% 9000, 10%9000)	\$5,400	\$900	
March (30% 10000) (60% 10000) (10%10000)	\$3,000	\$6,000	\$1,000
April (9000x 30%) (9000 x60%)		\$2,700	\$5,400
May (10000 30%)			\$3,000
June			
	\$9,200	\$9,600	\$9,400

Cash Budget for the months of January, February and March

Estimated Cash Receipts	April	May	June
Cash receipts from debtors	\$9,200	\$9,600	\$9,400
Total Estimated Cash Receipts	\$9,200	\$9,600	\$9,400
Estimated Cash Payments			
Wages	\$6,000	\$6,000	\$5,000
Administrative Expenses	\$2,000	\$2,200	\$2,500
Sundry Expenses	\$1,100	\$1,400	\$1,500
IT fees for App creation	\$6,000		\$24,000
Total Estimated Cash Payments	\$15,100	\$9,600	\$33,000
Balance at bank – opening	-\$1,000	-\$6,900	-\$6,900
Receipts – Payments	-\$5,900	\$0	-\$23,600
Balance at bank – closing	-\$6,900	-\$6,900	-\$30,500

- (b) The business's projected cash budget presents concerns for management. Under this budget the business will not have the liquidity to meet its debt obligations. The projected overdraft will be over the current limit.
- (c) Management will need to either rework the budget to ensure the projected balance is safely within the overdraft limit. The App project should be delayed and sundry expenditure reduced. Alternatively management could seek additional finance to fund the deficit and fund the development of the App.

## Preparing Cash Budgets

### Activity 3

(a)

	July	August	Sep
Cash payment	\$26,000	\$ 28,000	\$ 30,000

#### Credit payment Schedule

July	29,400
August	25,480
Sept	27,440

(b)

	May	June	July	August	Sep
Cash			\$ 91,000	\$ 98,000	\$105,000
Credit	\$45,000	\$ 42,000	\$39,000	\$ 42,000	\$ 45,000

Collection from Debtors	July	August	September
May (10% May credit)	\$4,500		
June (20% & 10% June credit)	\$8,400	\$4,200	
July (70%, 20%, 10% July credit)	\$27,300	\$7,800	\$3,900
August (70% & 20% credit)		\$29,400	\$8,400
September (70% credit)			\$31,500
Total	\$40,200	\$41,400	\$43,800

Fresh Choice Supermarkets

<b>Estimated Cash Receipts</b>	July	August	September
Cash Sales	\$ 91,000	\$ 98,000	\$ 105,000
Receipts from debtors	\$ 40,200	\$ 41,400	\$ 43,800
Online Sales			\$ 15,000
Total Estimated Cash Receipts	\$ 131,200	\$ 139,400	\$ 163,800
<b>Estimated Cash Payments</b>			
Credit Purchases	\$ 29,400	\$ 25,480	\$ 27,440
Cash Purchases	\$ 26,000	\$ 28,000	\$ 30,000
Sales staff salaries	\$ 16,000	\$ 15,000	\$ 20,500
Advertising	\$ 3,000	\$ 5,000	\$ 5,000
Office expenses	417	417	417
Finance expenses	\$ 1,250	\$ 1,250	\$ 1,250
Drawings	\$ 8,500	\$ 8,500	\$ 8,500
Truck		\$ 200,000	
Website and app design	\$ 100,000		
Total Estimated Cash Payments	\$ 184,567	\$ 283,647	\$ 93,107
Balance at bank – opening	\$ 149,652	\$ 96,285	-\$ 47,962
Receipts – Payments	-\$ 53,367	-\$ 144,247	\$ 70,693
Balance at bank – closing	\$ 96,285	\$ 47,962	\$ 22,731

(d) Drawings reduces the owner's investment in the business and increases gearing. The business generated a large profit in 2019, and had a healthy cash balance, thus the drawings taken by the owner in 2019 were reasonable. Retained earnings is a very good source of finance and would be an ideal source of finance for the new project. In August, the business projected to have a cash deficit. If the owner, reduces their drawings and retains more investment in the business, this cash-deficit in August can be reduced.

- (e)
- There is a predicted negative cash balance in August and thus finance will need to be arranged. Could fund the temporary cash shortfall with an overdraft.
  - The predicted cash balance in September is low, and the business have not left enough cash balance to cover working capital needs, thus could lead to problems paying bills as they fall due.
  - The online project is predicted to increase sales in the future, therefore it will aid in generated future cash in-flows. It is recommended that the business delay this project by two months to allow the business to retain more earnings.
  - Drawings should be suspended so that retained earnings can be used to finance the project.
  - The business could fund the project through external finance, through a medium term loan. This will ensure that the business stays solvent. Under this approach, the project will not need to be delayed and drawing will not need to be suspended. However, it will result in future cash outlays, as the business will need to make loan repayments.

## Preparing Cash Budgets

### Activity 4

(a)

Collection from Debtors	April	May	June
February	\$500		
March	\$1,400	\$600	
April		\$1,400	\$600
May			\$1,750
Total	\$1,900	\$2,000	\$2,350

(b)

Estimated Cash Receipts	April	May	June
Park entrance fees	\$14,000	\$8,000	\$7,000
Café sales	\$7,000	\$4,000	\$3,500
Public donations	\$1,250	\$1,250	\$1,250
Government Grants	\$10,000		
Merchandise sales	\$500	\$500	\$500
Receipts from debtors	\$1,900	\$2,000	\$2,350
Total Estimated Cash Receipts	\$34,650	\$15,750	\$14,600
Estimated Cash Payments			
Payments to suppliers	\$12,400	\$12,800	\$11,600
Park maintenance	\$10,000	\$10,000	\$10,000
Mortgage Payments	\$2,000	\$2,000	\$2,000
Wages	\$6,000	\$6,000	\$6,000
Tractor		\$5,000	
Total Estimated Cash outflows	\$30,400	\$35,800	\$29,600
Balance at bank–opening	\$10,000	\$14,250	(\$5,800)
Receipts–Payments	\$4,250	(\$20,050)	(\$15,000)
Balance at bank–closing	\$14,250	(\$5,800)	(\$20,800)

(c) The purchase of the tractor has significantly contributed to the cash deficit in June. This purchase should be delayed if possible.

## Variance Analysis

### Activity

(a)

	January			Favourable/ Unfavourable	February			Favourable/ Unfavourable
	Budget	Actual	Variance		Budget	Actual	Variance	
<b>ESTIMATED RECEIPTS</b>								
Receipts from debtors	56,000	40,000	- 16,000	UF	50,000	53,000	3,000	F
Sales	100,100	90,000	- 10,100	UF	97,000	100,000	3,000	F
<b>Total estimated receipts</b>	<b>156,100</b>	<b>130,000</b>	<b>- 26,100</b>	UF	<b>147,000</b>	<b>153,000</b>	<b>6,000</b>	F
<b>ESTIMATED PAYMENTS</b>								
Payments to creditors	40,000	40,000	–		41,000	43,000	2,000	UF
Purchases	43,000	37,000	- 6,000	F	42,000	44,000	2,000	UF
Utilities	2,000	2,500	500	UF	21,000	24,000	3,000	UF
Wages	50,000	50,000	–		49,000	50,000	1,000	UF
Advertising	800	400	- 400	F	800	900	100	UF
Rent	10,000	10,000	–		10,000	10,000	–	
<b>Total estimated payments</b>	<b>145,800</b>	<b>139,900</b>	<b>- 5,900</b>	<b>F</b>	<b>163,800</b>	<b>171,900</b>	<b>8,100</b>	UF
Cash at beginning	55,500	55,500			65,800	45,600		
Receipts-payments	10,300	- 9,900			- 16,800	- 18,900		
Cash at end	65,800	45,600			49,000	26,700		

- (b) Receipts from debtors in January variance is proportionately large. Budgeted is 40% higher than actual. Suggests that the firm may be experiencing issues collect receipts from debtors. Stronger debtors' management is suggested such as offering discount for early payment. Cash sales is also \$10,100 below what was expected. This may be explained by changes in the external environment such as more competition or slowing economy. If this is case the advertising strategies will need review.

## Chapter 7 – Providing Accounting Advice

### Scenario 1. Calvin's Electronics.

#### Answers could include:

Analysis of the external factors affecting the business:

- Economic influences are reducing sales. Rising inflation and interest rates is reducing available income for spending on discretionary goods such as electronics
- Technological innovation will lead to new products that the business could sell. However, the disadvantage is that existing products quickly become obsolete
- Competitors strategies and tactics to gain market share and sales.

The current financial performance of the business:

- Analysis reveals very low profitability and poor margins on goods sold:
  - Gross Profit Ratio: Current year, 37.5%. Previous year, 41.3%
  - Net Profit Ratio: Current year, 7%. Previous year, 7%
  - Return on equity current year, 3.0%
- 80% of revenue comes from 20% of inventory indicates an inefficient mix of products. The business is carrying a lot of dead stock

The current liquidity position and suggested strategies to improve inventory turnover:

- Cash available in the previous year was \$85,400, falling to \$84,100. However, this is not enough to cover Creditors which has increased from \$140,000 to \$220,000
- Debtors has risen significantly, over 7 times to \$28,200. Risk that a higher than anticipated number of debtors could become Bad Debts
- Inventory Turnover current year is 5.67 times a year or 64 days. This will lead to slow cash inflow
- There is slow moving stock and the discounting has not been successful at clearing excess inventory which is at risk of becoming obsolete:
  - Sales Variance Report shows that forecasted sales were too optimistic and the business's actual sales was below budgeted for every product line; Televisions, Home Appliances and Entertainment DVD's and Blue ray actual sales were well below forecasted. Car Gear, Cameras and Music contribute very little to overall sales. Analysis of this report indicates changes to product lines are required such as deleting some products and changing to products that are increasing in demand.
- Current year ratios; Quick ratio, 0.49:1 means the business only has \$0.49 in highly liquid assets to cover \$1 in current liabilities which indicates the high risk. Although Current Ratio, 1.04:1 indicates that the business can meet its obligations it is still in a risky situation because the stock must be converted to cash to pay current liabilities and this is becoming more difficult for the business to achieve in the trading environment
- The Net Realisable Value of this stock would be a more prudent valuation.
- Strategies to improved inventory turnover:
  - Improved forecasting to identify popular products that the business could sell
  - Increase sales through more effective and efficient marketing such as social media
  - Better inventory management (JIT) to reduce stock on hand
  - Eliminate old stock that is obsolete and taking up shelf space
  - Delete slow moving stock and focus on fast moving stock items.

Changes that the owner could make to the business to improve its financial sustainability:

- Change pricing policies
- Consideration of local and global influences when ordering stock; business cycle, consumer confidence
- Identify the individual products that have the highest margin and sell the fastest. Focus on promotion of these
- Introduce instalment payment method such as AFTER Pay to increase sales from budget conscious shoppers
- Delete poor performing products
- Increase the prices to increase mark-up and therefore Gross Profit.

## Scenario 2. Adam Ant's ARB PUBLICATIONS

### Answers could include:

Analysis of the external factors affecting the business:

- Social influences include customers moving away from cash as form of payment. This requires the business to implement technology to process electronic payments.
- Technological influences include the low cost and user-friendly electronic payments systems. Secondly, the availability of inexpensive cloud-based accounting software packages that small businesses can use eliminates the need to manually process accounting information.
- Competition from online book sellers and publishing companies who are offering digital versions of their text books will mean less demand for physical books.

The current financial position of the business:

- Cash available in the previous year was \$3,400, rising to \$4,600 at the end of the most recent accounting period. However, this is not enough to cover Creditors even though this figure has fallen from \$24,000 to \$19,000.
- Debtors has risen by a small amount. The Aged Debtors analysis indicates that the value of net debtors will be far lower owing to higher than anticipated debtors that could become Bad Debts.
- Current year Quick ratio; 2.93:1 improved on the previous year; 2.13:1, means the business has \$2.93 in highly liquid assets to cover \$1 in current liabilities which indicates the low risk.
- Current Ratio also indicates very low risk in the short term; current year; 6.4:1, and previous year; 4.96:1. Even if Debtors and Inventory are over valued the business is considered financially stable in the short term, able to pay its liabilities as they fall due. However, very low cash reserves indicates that this is not really the case if creditors need to be paid within a short period of time (30 days)
- Solvency ratio results indicate relatively low risk when has decreased since the previous year.
  - Debt ratio; current year; 35.4%, previous year; 40%.
  - Debt to equity ratio; current year; 49.6% previous year; 67.5%

The current debtors' management system and suggested strategies to improve debtors' turnover.:

- Current ratio analysis shows a slow accounts receivable turnover ratio, 62 days. This indicates poor debtor's control. Poor credit policies and debtors control means that bad debts are rising. Bad debts, according to Barry's estimate are about 6.5% of \$195,500 credit sales. This impacts on cash flow and increases potential for higher bad debts expense. He could hand the current outstanding debts over to a professional debt collecting agency or bank to obtain cash.
- The owner has been too generous and manual accounting system means that he is not able to access information to better monitor and control debtors. There is a need for more information about specific debtors and therefore being able to produce internal management reports is necessary. A monthly debtors' aging analysis will be valuable.
- Strategies to improve debtors' turnover appropriate to a retailer;
  - Reminder emails
  - Discounts for early payment and late fees
  - Refuse sales to customers who neglect credit terms
  - Use a rating system for customers to identify unreliable, high-risk customers and impose stricter credit terms
  - Encourage customers to pay with debit card/credit card rather than invoicing

Changes that the owner could make to the business to improve its operations:

- The introduction of credit card payment system has advantages;
  - Clients can order and pay over the phone with a credit card this will help cash inflow and reduce bad debts significantly.
  - The bank will immediately credit the business
  - Debt collection is effectively passed over to the bank and their factoring services.



- Updating the accounting system will improve operations through;
  - More monitoring and control possible such as having the KPI's summarised on a 'dashboard' accessible from his mobile, iPad.
  - Solve problems of bank reconciliation and improve cash management
  - Computerised accounting system can identify slow moving accounts and this will help predict cash inflows for planning purposes.
  - Automatically generated invoices and reminders.
- Students may create a cash budget for the months July, August and September factoring in the implementation of a Point of Sale and credit card payments system to demonstrate the financial impacts and advantages of installing an integrated payments systems software, enabling credit card payments, and tighter credit policies.

### Scenario 3. William Maxwell Farm

The current performance of the business:

- Profitability trend is that the business is experiencing small, but increasing losses. The loss recorded for the current financial year was reduced by earning income of \$16,000 from selling equipment, however, this strategy is not sustainable in the long term.
- Ratio analysis indicates:
  - Return on Equity previous year, -2.75%. Current Year, -4.6%\* (\*average equity used)
  - Profit margin previous year -2.4%. Current year -4.5%
- Additional information is required to determine financial stability measures.

Analysis of the external factors affecting the business.

- Environmental factors can impact revenue. Weather and climate change directly influence farm output and what types of crops can be grown. Growing conditions in other countries impacts global supply of legumes causing the global price on commodity markets to fluctuate.
- Government policy to encourage renewable energy generation.
- Social attitudes towards fossil fuels indicate rising demand from consumers for renewable energy.

Analysis of the offer of leasing part of his land to the wind farm operator, WSE Infrastructure with respect to the financial sustainability of the business:

- A forecasted income statement will reveal;
  - Impact on variable costs of legume farming will increase
  - 7200 ha @ \$105 per ha = \$756,000 will increase to 5760 ha @ \$135 per ha = \$777,600
  - Using current year's expenses and revenue as a guide. Annual farm income will fall by 20%. 80% of \$759 900 – Variable costs \$777,600 = Gross profit of (\$169 680) less overheads \$26 900. Variable costs have risen owing to decreased efficiency.
  - Even with additional payment of \$10,000 plus 6 months of lease payments (\$48,000) the business will still record a financial loss.
- Factoring in 2.5% per annum increase in lease payments will not have a significant impact with inflation in Australia above 2.5% in recent years.
- Advice is that accepting the offer with additional income from the sign-on bonus and lease payments will not lead to higher overall income for Will. Better to reject the offer and investigate farming alternative higher value crops.

The social and environmental impacts if Will accepts the offer from WSE Infrastructure:

- WSE Infrastructure is subject to a full an Environmental Impact Assessment to ensure that negative environment impacts on the immediate surroundings are minimised through erosion prevention, weed and pest control, bird monitoring, remnant vegetation protection and the protection of on-site water sources.
- There is no conclusive evidence that wind turbine noise affecting health.
- The employment opportunities will benefit the local community socially and economically.
- Renewable energy will potentially reduce the impact of climate change in the long term.

## Scenario 4. Ahn Ngyuen's Nextra Soft Drinks

### Answers could include

Financial performance:

- Gross Profit Ratio; 95.2%. This appears to be a very good result. An industry average and data for similar sized drink manufacturing businesses would be useful for analysis.
- Profit Ratio; 8.5%. This appears to be a satisfactory result. For every \$1 of sales the business is earning 8.5 cents before tax.
- Expense ratio; Wages is the highest expense at 61.2%. This result appears very high. With technology and automation, the need for labour can be significantly reduced.
- Return on Assets\*; 9.6%. However, it is evident from the balance sheet that a lot of land is owned but the equipment is essentially worthless based on accumulated depreciation.
  - \*Limited data provided means that averages were not used for ratio calculations
- Return on Equity\*; 11.6%. A good result considering the alternative investments (bank accounts, shares) offer lower returns.
  - \*Limited data provided means that averages were not used for ratio calculations
- Analysis is limited because previous years financial data has not been provided.

Financial position:

- Quick ratio; 0.53:1 indicating a high level of risk in the short term and inability to pay current liabilities as they fall due from the liquid assets.
- Working capital ratio is 2:1 indicating strong working capital. This margin of safety is created by the high level of stock on hand. Soft drink should maintain its value because it does not perish or become obsolete
- Debt ratio; 16.9% which is a very low level indicating a safe financial position in the long term. However, much of the value of assets is the land and buildings valued at \$1.2 million.
- Debt to equity is 20.3% so very low gearing can take on more debt.

A comparison of the costs and benefits of each option with a recommendation to improve the financial sustainability of the business.

Students may:

- Calculate a break-even point for each option (Figure 1)
- Develop a forecasted income statement to determine the viability of investing in new equipment or becoming an importer. Forecasted income statement will need to factor in;
  - Changes to revenue, costs of sales and profitability
  - Changes to wages and maintenance expenses
  - Any gain/loss on sale of equipment
- Show the impact on financial stability if a loan to finance Options 1, compared to Option 2.

Students will need to provide a case for or against each option with a final recommendation. Option 2 appears more financially sustainable than Option 1 owing to significant reductions in wages and maintenance expenses, additional debt is not required, and lower break-even point.

Qualitative factors that that owner should consider when deciding whether or not to invest in new equipment or cease manufacturing and import soft drink:

- Economic performance including changes to inflation and interest rates. Consumer attitudes towards soft drinks and the healthier alternatives offered by competitors. Changes to laws that can affect operating and compliance costs.
- The length of time for closure at the site while changes are made could take longer than planned. Customer loyalty could be lost.
- Potential to increase market share and expand in the long term.
- The impact on stakeholders; employees, local community, loyal customers may impact brand value and business's reputation.
- Importing risks such as delayed delivery, quality issues, and the supplier increasing the price in the future.
- Changing to an importer after being a long standing, South Australian brand could also impact brand value and consumer loyalty.

Figure 1. Breakeven modelling



	Currently	Option 1	Option 2
Overhead fixed costs	\$1,350,000	\$1,200,000 + 400,000 \$1,600,000	\$1,200,000
Variable cost per unit	\$0.10	\$0.08	\$0.40
Selling price	\$2.10	\$2.10	\$2.10
Contribution margin	\$2.00	\$2.02	\$1.70
<b>Breakeven point</b>	<b>675,000</b>	<b>792,080</b>	<b>705,883</b>
Output; number of bottles a year	700,000	840,000	800,000

## Scenario 5. Super Supplement Mart

### Answers could include:

An analysis of the legal entity of the business and the information needs of the stakeholders:

- Legal entity is an unincorporated business regardless of whether it is a sole trader or partnership. There is no so separation of the business from the owners in terms of the law, therefore the owner(s) have unlimited liability and personally responsible for the debts of the business. The owners as stakeholders will need information on the potential return on investment, the level of debt the business carries and financial risk
- Other stakeholders will be the creditors and the lender who provided the loan. The information need will be whether the business can make interest repayments and the value of assets used as collateral for the loan.

The current performance and position of the business (by referring to relevant ratios and reports):

Financial Performance:

- Profit Ratio current year, 11% which is consistent with the previous year; 11%. However, in nominal terms this figure has fallen by \$8,800 to only \$63,800. This is not an appropriate reward for the risk and hard work of the small business owner. Comparison to industry average would be beneficial
- Gross Profit Ratio current year is 55.2 % which is consistent with the previous year; 55%. Joey could switch to a cheaper supplier to improve margins
- Expense ratio. Advertising spend previous year was 2% of sales, in the current year it was 3.2%. This indicates a very low spending on advertising and this could be increased to boost sales
- Rent has increased 50% so closing one store would be significant saving in both rent and wages.

Financial Position:

- Quick ratio 0.55:1 indicates difficulty paying short term liabilities as they fall due. Creditors and employees will expect to receive payment within a month further indicating poor short term position
- Working capital is 2.89:1 which indicates a safe level of short-term financial risk once inventory is included.
- Poor solvency is indicated by the Debt ratio; 77%, and Debt to Equity ratio; 242%
- Financial stability in terms of the Times Interest

Earned ratio is 11 times indicating that interest payments are easily covered from profit.

A comparison of the costs and benefits of each option with a recommendation to improve the financial sustainability of the business: (10 marks)

- Closing one store and adding online sales:
  - There needs to be an assessment of Joey's skills in online sales and digital media
  - A forecasted income statement based on the online sales and cost reductions will be useful to calculate forecasted sales and expenses and the change in profit
  - Strategies to reduce variable expenses in the short term and fixed costs in the long term for the remaining store should be implemented
  - A consideration would be the personal impact on employees who lost their jobs and the potential to lose customers who do not transfer to buying online from Joey.
- Taking on a new partner:
  - Although profitable, the actual profit in nominal terms not very attractive, in particular when split between two partners. This will make it difficult to attract another partner

- Discussion of the impacts on the business and the implications for Joey of forming a partnership with reference to both advantages and disadvantages
- Based on analysis of financial position the business will need the capital contribution from the second partner. This is poor solvency, therefore enticing a new partner may prove difficult. Perhaps an additional capital injection from Joey or using proceeds from the sale of furniture and fittings from the store that is closed to pay off debt will improve solvency. Both strategies could improve solvency and reduce risk to a new owner/investor making it more appealing to invest
- A new partner would be a source of capital to improve solvency and expertise to improve profitability.

## Scenario 6. The Southern Sharks Football Team

### Answers could include:

Analysis of the cash flow:

- The business has moved from a positive cash position; \$152,000, to a negative cash position; (\$386,000). This is likely to result in a bank overdraft which has very high rates of interest
- The biggest change is in the negative cash outflow for operating activities indicating the business cannot generate cash from its core activities. Receipts from memberships, ticket sales and merchandise halved in the current year, falling from \$864,000 to \$432,000
- A small cash inflow was generated in the current year from selling equipment. This equipment will need to be replaced in future years. Without this equipment it will be more difficult to maintain facilities and fields
- The previous year's positive cash position only occurred due to a \$200,000 loan. The business will have to repay this principal and interest causing additional cash outflows in future years.

Strategies to improve the short-term cash position of the business:

- Higher ticket prices and parking fees for games
- Player fees for amateur divisions could be decreased
- Additional sponsorship could be sold. For example, naming rights for the stadium
- Payments to players could be cut until their on-field performance improves
- Leasing or selling of land that is not used
- A large cash inflow from an investor will provide cash inflow to financing activities. This may come from selling part ownership of the club or an Angel Investor.

Strategies to improve long-term financial sustainability

- Students may provide a source of finance recommendation for how the upgrade of toilet facilities and seating. This is will attract families and improve ticket sales
- Students may use Break-even calculations that justify ticket price and membership fee increases
- Students may recommend termination of contracts of existing players unable to play and recruiting new less expensive talent which may lead to winning more games in the longer term. There is a clear link between winning more games leads to more cash inflow from more memberships, weekly ticket and merchandise sales
- Students may create a forecasted Cash Flow Statement that incorporates strategies to increase cash inflow and reduce cash outflow for the next accounting periods
- Recommend investing more in junior and women's league. The women's league could attract new fans and lead to increased ticket sales.

Impacts on stakeholders that the board of directors needs to consider when implementing changes to improve the business:

- Members, supporters and fans. Higher prices for gate entry, increased membership fees will impact supporters and fans making attendance less affordable
- Existing players. Terminating contracts will impact existing players. The ethical considerations of terminating the contracts of injured players. Reserve grade players and other emerging talent will be interested in the opportunity for promotion. The injured player with the highest fan base could be kept on for promotional activities and media work
- Fans and their families. Terminating the contracts of players who have breached the clubs code of conduct may help attract fans back to attending matches. Upgrading facilities will make attending games more pleasant
- Junior and women who are part of the club deserve investment in their playing future
- Existing sponsors. Deserve to be represented by the club in accordance with their brand as this will impact their own sales and reputation.



