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Anthony Simmons and Richard Hardy

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Darrell Cruse

Units 1&2

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Author acknowledgements

Although these editions have been updated to reflect the changes to the 2025–2029 VCE Accounting Study Design, much of the material has been developed over a much longer period of time. In spite of the barbs of our students, our experience in VCE Accounting does not reach back to the invention of the double-entry system, but it does stretch back almost 30 years, and we would again like to thank all those who have helped us along the way in developing the materials that appear in these editions.

To the staff and students at Penleigh and Essendon Grammar School (where this series began), Clayfield College, Balcombe Grammar School and Indie School, thank you for your support and guidance. Thank you to the many teachers of Accounting who have assisted us along the way, particularly for this edition Darrell Cruse and Erin McEwan, whose expertise and counsel have been invaluable. Thank you also to the persistent, patient and committed team at Cambridge University Press, especially Nick Melchior, Nicole Jones and the ever-supportive Nick Alexander (without whom these books would never have been done).

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Anthony and Richard

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Introduction

The first editions of this *Cambridge VCE Accounting* series, released in 2007, incorporated a number of features to help students to develop a deep understanding of the principles and practices of VCE Accounting. These design elements included:

- a comprehensive coverage of the key knowledge and key skills identified in the Study Design
- clear language explanations and study tips, drawing attention to the 'how' of learning Accounting
- Review questions and exercises to practise applying the key knowledge and key skills
- the same command terms used in VCE Accounting examinations
- strategic use of colour to make the steps in recording transactions and their effect/s on the reports clearer
- margin definitions and a glossary to support an understanding of key terms
- feedback via a list of Selected Answers and a full set of solutions to the exercises and review questions.

These latest editions continue this tradition but have been updated to reflect the changes to in 2025–2029 VCE Accounting Study Design, ensuring that they continue to equip students to meet the requirements of the VCE Accounting Study Design.

In short, these texts are written for and about the VCE Accounting course, focusing on what it covers and how it is assessed. We hope that you will find them helpful in your study and by using them, you will develop your ability to think like an Accountant.

Understanding command terms used in this resource

In recent years the VCAA has published a glossary of command terms – verbs used to direct students in answering questions in formal assessments, including the VCE examinations. The terms used in this text, taken directly from the VCAA glossary, reflect directly and closely those used in the VCE Accounting examination, so that in a particular question, students 'know what to do'.

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The command terms used in this text include:

Term	Explanation
complete	finalise an Accounting record or report to ensure it contains all necessary information
calculate	determine from given facts, figures or information; obtain a numerical answer showing the relevant stages in the working; determine or find (e.g. a number, answer) by using mathematical processes
define	give the precise meaning and identify essential qualities of a word, phrase, concept or physical quantity
describe	provide characteristics, features and qualities of a given concept, opinion, situation, event, process, effect, argument, narrative, text, experiment, artwork, performance piece or other artefact in an accurate way
discuss	present a clear, considered and balanced argument or prose that identifies issues and shows the strengths and weaknesses of, or points for and against, one or more arguments, concepts, factors, hypotheses, narratives and/or opinions
distinguish	make clear the differences between two or more arguments, concepts, opinions, narratives, artefacts, data points, trends and/or items
explain	give a detailed account of why and/or how with reference to causes, effects, continuity, change, reasons or mechanisms; make the relationships between things evident
identify	recognise and name and/or select an event, feature, ingredient, element, speaker and/or part from a list or extended narrative or argument, or within a diagram, structure, artwork or experiment
justify	show, prove or defend, with reasoning and evidence, an argument, decision and/or point of view using given data and/or other information
list	provide a series of related words, names, numbers or items that are arranged consecutively
model	use Accounting skills to determine the financial effects of a particular decision
name	provide a word or term (something that is known and distinguished from other people or things) used to identify an object, person, thing, place, etc
prepare	create an Accounting document, record or report based on the information provided
record	enter transaction details in an Accounting record
report	prepare an Accounting report according to accepted conventions
show	present an Accounting record or report or a table
state	give a specific name or value or other brief answer without explanation or calculation
suggest	put forward for consideration a solution, hypothesis, idea or other possible answer

Adapted from VCAA 'Glossary of Command Terms'

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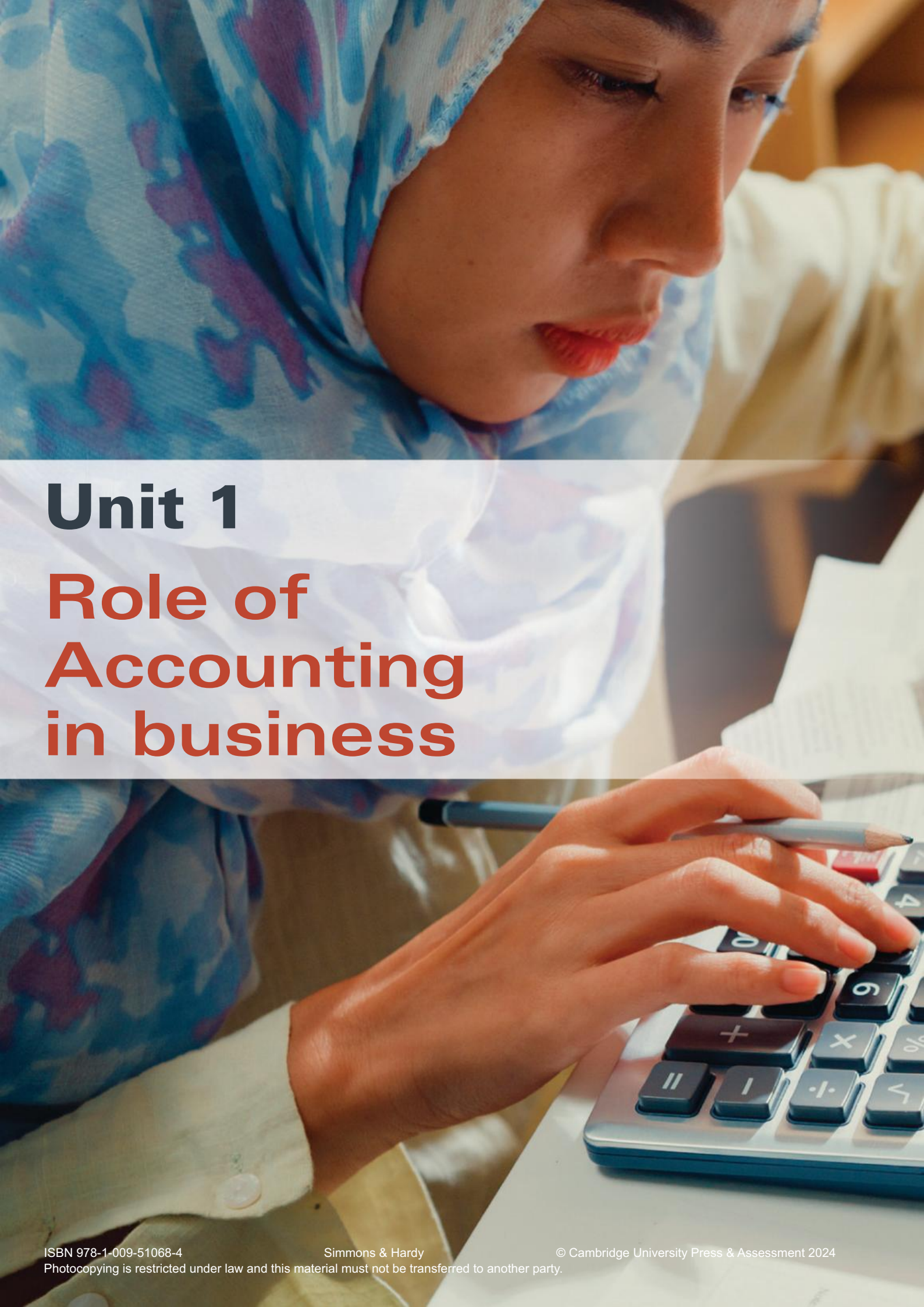

Unit 1

Role of Accounting in business

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Unit overview

This unit explores the establishment of a business and the role of accounting in the determination of business success or failure. It considers the importance of accounting information to stakeholders. Students analyse, interpret and evaluate the performance of the business using financial and non-financial information. They use these evaluations to make recommendations regarding the suitability of a business as an investment.

Students record financial data and prepare reports for service businesses owned by sole proprietors.

Where appropriate, the accounting procedures developed in each area of study should incorporate the application of the IASB's Conceptual Framework and financial indicators to measure business performance. They should also take into account the ethical considerations, including financial, social and environmental considerations, faced by business owners when making business decisions.

Source: VCAA, *VCE Accounting Study Design 2025–2029*, page 17.

Where are we headed?

In Unit 1 of the VCE Accounting course, we will cover the following chapters:

Chapter 1 The nature and role of Accounting in business 4
Chapter 2 The Accounting equation 22
Chapter 3 Business ownership 42
Chapter 4 Sources of finance 76
Chapter 5 Price-setting strategies 90
Chapter 6 Source documents 114
Chapter 7 Cash Accounting for service businesses 140
Chapter 8 Cash control 170
Chapter 9 Credit transactions 180
Chapter 10 Reporting for a service business 204

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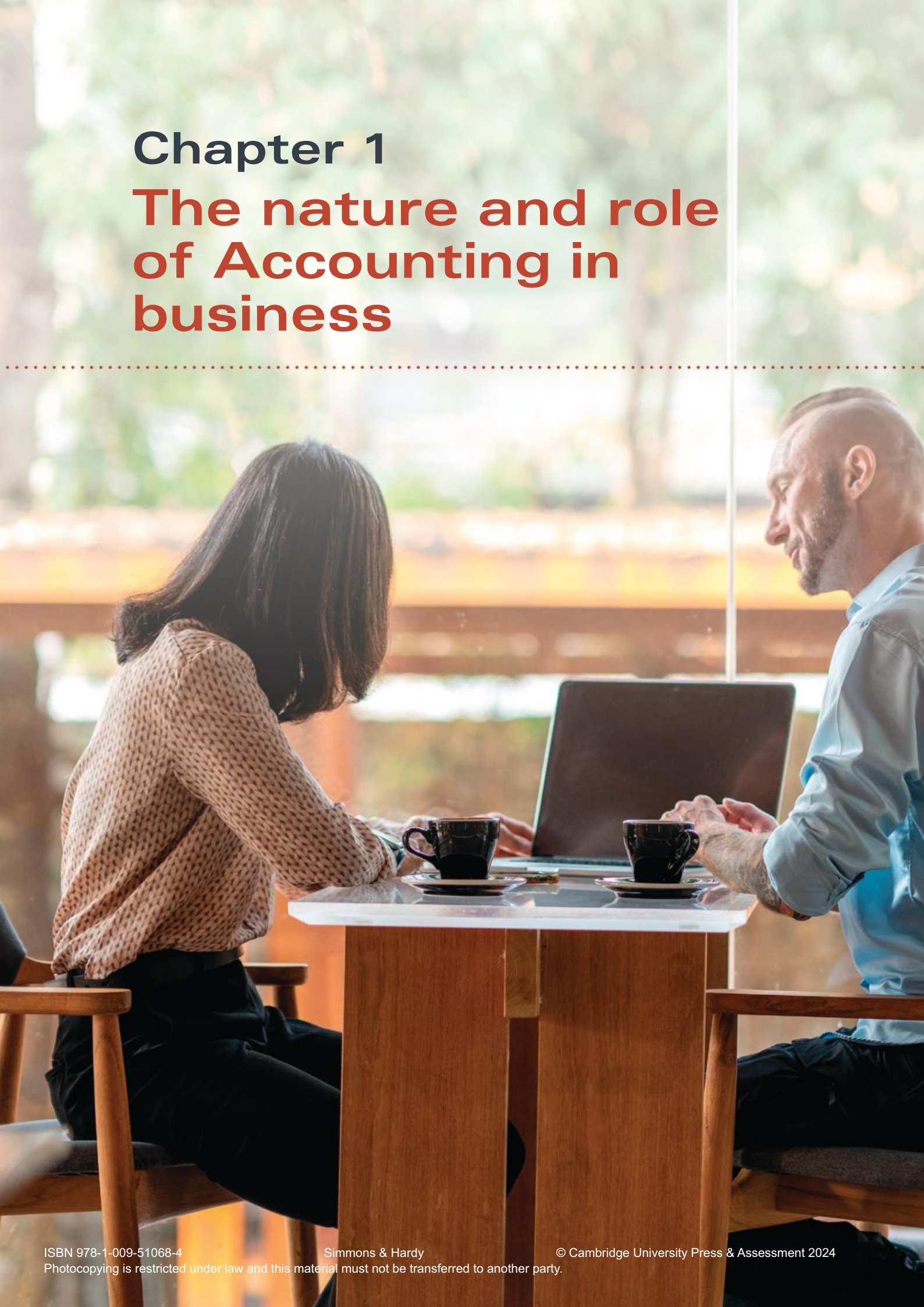
Chapter 1

The nature and role of Accounting in business



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Learning intentions

After completing this chapter, you should be able to:

- **explain** the role of Accounting
- **identify** the users of Accounting information and the financial information they require
- **distinguish** between financial data and financial information
- **identify** and **explain** the stages in the Accounting process
- **state** the various forms of source documents
- **identify** and **explain** the four Accounting assumptions, the six Qualitative characteristics and **explain** their relationship to each other
- **identify** ethical considerations.

Key terms

After completing this chapter, you should be familiar with the following terms:

- Accounting
- stakeholder
- financial data
- financial information
- non-financial information
- ethical considerations
- transaction
- source documents
- recording
- reporting
- advice
- Accounting assumptions
  - Accounting entity
  - Going concern
  - Period
  - Accrual basis
- Qualitative characteristics
  - Relevance
  - Faithful representation
  - Comparability
  - Verifiability
  - Timeliness
  - Understandability.

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1.1 The need for Accounting

The next time you visit a shopping centre, take a look at the types of businesses operating there. Chances are, you'll see a variety of shops: some with names you know and some that are unfamiliar; some selling clothes, food or household goods; and some providing services such as building or hairdressing. Behind each of these businesses is a small business owner who has detailed knowledge of the product or service they are selling. But unfortunately, this product knowledge on its own is not enough to guarantee the success of their business. Business is not just about making and selling; it is about *managing* – managing people, managing inventory, managing customers and suppliers and, last but not least, managing cash. And if a business owner is to manage their business *effectively*, then they will need accurate information that can be relied upon to assist them in the decisions they make.

This is why Accounting is important; it is essentially an information service. **Accounting** is the collecting and recording of financial data to produce and report financial information to assist business owners in decision-making. It is a process that turns the day-to-day operations of a small business (such as sales over the counter or payment of bills) into a form that the owner can study to determine which areas of their business need improvement.

Accounting
the collecting and recording of financial data to produce and report financial information to assist business owners in decision-making

stakeholders
a person or organisation that has an interest in the performance of the business and can affect operations or be affected by them

The purpose of Accounting then is to provide business owners with financial information that will assist them in making decisions about the activities of their firms. This does not mean that Accounting will ensure owners make the right decision, but it should help them to make a *more informed* decision, one that will hopefully improve the performance of the firm and its chance of success.

Users of Accounting information

Accounting in this course concentrates on small businesses where the person managing the business is also the owner of that business. Thus, any Accounting information will be generated primarily for the benefit of the owner/manager. However, it is important to note that in businesses of all types and sizes there will be a number of different parties besides owners, directors or managers who will also be interested in the firm's financial information. All of these parties are known as **stakeholders**, and they include:

- *Accounts Receivable and other customers*, who may wish to know about the firm's continuing ability to provide them with inventory
- *Accounts Payable and other suppliers*, who may wish to know about the firm's ability to repay what it owes them
- *banks and other financial institutions*, which will certainly want to know about the firm's current levels of debt and their ability to repay before providing them with any additional finance
- *employees*, who may wish to know about the firm's long-term viability, and their own long-term employment prospects, or its ability to afford improvements in wages and conditions
- *prospective owners*, who may wish to know about the firm's financial structure and earnings performance, and its assets and liabilities to determine the firm's worth
- *the Australian Taxation Office (ATO)*, which will require financial information for taxation purposes.

There is a wide variety of users of Accounting information, and each of them may require different information. The Accounting system must ensure that it can generate the information necessary to satisfy the users' needs. This means that it is the intended user, not the Accounting system, who decides what information needs to be prepared.

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Financial data versus financial information

Accounting is about providing information; however, that information has to come from a source and actually begins its life as raw facts (source documents) before being transformed into a form that is useful for decision-making (financial reports). Therefore, we need to distinguish between financial *data* and financial *information*. **Financial data** refers to the raw facts and figures on which financial information will be based. For most businesses this data is contained in their source documents such as receipts, EFT payment receipts, invoices, memorandums (memos) and Bank Statements. This data then becomes **financial information** once it has been sorted and processed into a more usable and understandable form. For instance, a pile of source documents (data) may provide specific details of the firm's transactions over the past week or so, but a pile of documents conveys no useful information. The data has not been sorted, or classified into groups, or summarised in any way. Once this data is sorted, classified and summarised, it becomes financial information that can be used as the basis for business decisions. This is the role of the Accounting system.

financial data
raw facts and figures upon which financial information is based

financial information
financial data that has been sorted, classified and summarised into a more usable and understandable form

non-financial information
any information that cannot be found in the financial statements, and is not expressed in dollars and cents, or reliant on dollars and cents for its calculation

Non-financial information

Most information used in Accounting is financial in nature. Important information like sales revenue, monthly wages, cash in the bank and even Net Profit are all measured in dollars and cents (or another currency) and reported in the financial statements. This information is critical but does not present the whole picture as to how a business is performing. A business may present well on paper financially; however, there may be events occurring that will not be identified by the financial statements that could be cause for concern, for example a high staff turnover.

Non-financial information is a very broad term that includes any information that cannot be found in the financial statements, and is not expressed in dollars and cents, or reliant on dollars and cents for its calculation. Examples include employee absentee rates (sick days), website hits, the amount of wastage in production, market share and adoption rates of new products. It is seen as an indicator of a business's future financial performance. For example, an increasing number of customer complaints about a particular product or service and declining customer satisfaction will eventually lead to deterioration in financial performance. It can also include other information such as strike rates – the percentage of inquiries that turn into sales.

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Taken together with the financial information, this non-financial information presents a more complete and accurate picture of the firm's circumstances, allowing the owner to make more informed and thus more effective decisions.

Ethical considerations

Ethical considerations

Stakeholders also want to look beyond the financial statements of a business and examine its corporate social responsibility or the ethics it displays. The financial decisions that a business makes often have non-financial consequences. For this reason, Accounting is increasingly concerned not just with the financial parameters of decision-making, but also with its ethical ramifications. These **ethical considerations** include the social and environmental consequences of a decision: the effects on people, communities and society, and the local and wider environment. Some ethical considerations a business needs to consider include:

ethical considerations the social and environmental consequences of a financial decision

- the way a business looks after its employees in terms of pay, opportunities and work environment
- its choices regarding suppliers and products and whether those choices are sustainable
- whether a business is representing itself, regarding its products and practices, fairly and accurately, for example product safety and warranties.

Study tip

There is no set list of 'ethical considerations' in this course, but examples will be presented as issues arise.

A business needs to be very aware of its ethical decisions as they relate directly to its reputation. This can have serious corporate ramifications in terms of negative publicity, reduced sales, and fines and penalties.

Users of Accounting information need to think about how a decision will affect not only the business, but also the people and community with whom it is connected, and its local and global environment. After all, the long-term success of a business is inextricably linked to the health of the society and environment in which it operates.

Review questions 1.1

1 **Define** the term 'Accounting'.
2 **Explain** the purpose of Accounting.
3 **Identify** the 'stakeholders' of a business. **Determine** if they are internal or external to the business and **describe** their interest in the Accounting reports of a business.
4 **Explain** the relationship between financial data and financial information.
5 **Distinguish** between financial and non-financial information, providing examples. **Explain** how they support each other.
6 Referring to the three dot points under ethical considerations, **choose** an area and **outline** an actual example where a business has **not** been ethical in its decision-making. **Discuss** what may have led to that decision being made and its consequences.

Ethical considerations

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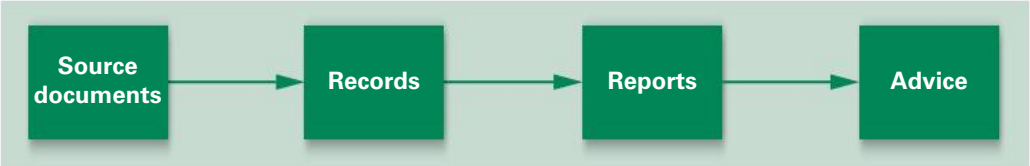
1.2 The Accounting process

The process of turning financial data into financial information is facilitated by what is known as the *Accounting process*.

Figure 1.1 The Accounting process



Video 1.1
The Accounting process

Stage 1: source documents

This is where the business collects the source documents relating to its **transactions**.

Source documents are documents (paper or electronic) that provide both the evidence that a transaction has occurred and the details of the transaction itself. Thus, source documents provide the data on which the Accounting information will be based.

Common source documents include:

- *receipts (including EFT, EFTPOS and BPAY) and Bank Statements* – provide evidence of cash received by the business
- *EFT payment receipts, EFTPOS receipts (issued by the seller) and Bank Statements* – provide evidence of cash paid by the business
- *invoices* – provide evidence of credit transactions
- *credit notes* – provide evidence of a decrease in an amount owed as a result of returning goods due to incorrect type or damage
- *memos* – provide evidence of transactions within the firm itself.

EFT stands for Electronic Funds Transfer and occurs whenever you receive cash (EFT receipt) or make a payment (EFT payment) online. EFTPOS is an acronym for Electronic Funds Transfer Point of Sale – which means that when a customer uses a card (either a physical tap or electronically via their phone) to make a payment, cash is transferred from their account to the business as soon as the transaction has been processed. The Point of Sale (POS) indicates that the transaction occurs **in store or at the place of business**, while EFT transactions can be made anywhere.

Despite the nature of transactions changing, the need for documentary evidence has not. An advantage of EFT is that all transactions are directly recorded (with a transaction record) straight into the business's bank account. Bank Statements not only verify the cash transactions of the business but also provide evidence of transactions that the business may have been unaware of, such as the receipt of interest or the charging of a service fee.

A business will enter into many transactions every day, and each one of these transactions must be detailed on a source document. As far as the Accounting process is concerned, if it isn't on a source document, it didn't happen.

transaction
an exchange of goods or services with another party

source documents
documents that provide both the evidence that a transaction has occurred and the details of the transaction itself

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Stage 2: recording

Once the source documents have been collected, the information they contain must be written down or 'recorded'. **Recording** involves sorting, classifying and summarising the information contained in the source documents so that it is more usable.

Common Accounting records include:

- *journals*, which record daily transactions of a common type (such as all cash paid, all cash received, or all inventory purchased or sold on credit)
- *inventory cards*, which record all the movements of inventory in and out of the business.

recording
sorting, classifying and summarising the information contained in the source documents so that it is more usable

reporting
the preparation of financial statements that communicate financial information to the owner

advice
the provision to the owner of a range of options appropriate to their aims/objectives, and recommendations as to their suitability

Stage 3: reporting

This involves taking the information that has been generated by the Accounting records (the journals) and 'reporting' that financial information to the owner of the business in a form that they can understand. **Reporting** involves the preparation of financial statements that communicate financial information to the owner so that decisions can be made.

There are three general-purpose reports that all businesses should prepare:

- *Cash Flow Statement* – a statement of the cash inflows and outflows of the firm, and the change in its cash balance over a period
- *Income Statement* – a statement of the firm's revenue and expenses over a period
- *Balance Sheet* – a statement of the firm's assets and liabilities at a particular point in time.

Essentially, the Accounting process is about collecting data from source documents; sorting it, classifying it and recording it in journals; and then communicating the information to the owner via financial reports.

Stage 4: advice

Armed with the information presented in the reports, an accountant should be able to make some suggestions on an appropriate course of action. This is where the real skill of an accountant comes into play. Without proper **advice**, the information in the reports is as good as useless, but if the reports are explained carefully and the accountant provides the owner with a range of options, a more informed decision – and a better outcome for the business – should occur.

Review questions 1.2

1. **Explain** the four stages of the Accounting process.
2. **State** and **describe** five types of source documents and **identify** the type of transaction evidenced by each. **Discuss** the changing nature of transactions and source documents.
3. **State** and **describe** two types of Accounting records.
4. **State** and **describe** three types of Accounting reports.

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1.3 Accounting assumptions

As they generate financial information, accountants must follow a number of guidelines and in some cases strict rules governing the way Accounting is done. Some of these guidelines are generally agreed to by all accountants as they have been followed for a long period of time. Others are enforced by law, and they have to be followed or legal sanctions may follow. Together, these guidelines dictate the way records and reports are prepared.

The main guidelines of importance to this course are:

- *Accounting assumptions*, which govern the way Accounting information is recorded
- *Qualitative characteristics*, which inform the way Accounting reports are prepared.

Accounting assumptions are the 'generally accepted rules' that govern the way Accounting information is recorded. In our course, the four assumptions that govern the way Accounting information is recorded are the:

- Accounting entity assumption
- Accrual basis assumption
- Going concern assumption
- Period assumption

Accounting entity assumption

The **Accounting entity assumption** states that from an Accounting perspective, the business is separate from the owner and other entities, and its records should be kept on this basis.

For a small business, this concept may appear strange, as it is the person behind the counter or the one actually performing the service who owns the business. Surely any money the business earns belongs to the owner and any assets or debts the owner has would be part of the business since they would be one and the same. In the eyes of the law this is true, but in terms of Accounting we assume that the business and the owner are separate entities/beings. If we are to assess the performance of the business itself, we must only include information that is relevant to that business. The owner may have a home and a large loan (mortgage), but if neither of these items is being used by the business, it must not be included as a business asset or liability. If the owner brings these items into the business for business use, then we should treat that as a transaction between the owner and the firm as if they are separate Accounting entities.

Accrual basis assumption

Because it recognises elements of the reports when they meet their respective definitions, the **Accrual basis assumption** will calculate profit by subtracting *expenses incurred from revenue earned* in a particular reporting period. Revenue is recognised as earned when the expected inflow of economic benefit can be measured in a faithful and verified way. This is in effect when the good or service is provided. Expenses are incurred when the consumption of a good or service can be measured or when the item is 'used up'.

Study tip

Accounting assumptions and Qualitative characteristics are linked but different: be careful to provide exactly what is asked for in each question.

Accounting assumptions
the generally accepted rules that govern the way Accounting information is recorded

Accounting entity assumption
the assumption that the records of assets, liabilities and business activities of the entity are kept completely separate from those of the owner of the entity as well as from those of other entities

Accrual basis assumption
the assumption that the elements of the reports are recognised when they satisfy the definitions and recognition criteria, meaning profit is calculated as revenue earned in a particular period less expenses incurred in that same period

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Importantly, the Accrual basis assumption does not require cash to be received or paid for revenue and expenses to be recognised. Even where a business has made a credit sale and is waiting to receive cash or has not yet paid for some of its expenses, the Accrual basis assumption says these amounts should still be included in the calculation of profit as the revenue has been earned (when the goods were sold) and the expense incurred (when the item was consumed) during the current period.

Going concern assumption

Going concern assumption
the assumption that the business will continue to operate in the future, and its records are kept on that basis

Period assumption
the assumption that reports are prepared for a particular period of time, such as a month or a year, in order to obtain comparability of results

The **Going concern assumption** assumes that the business will continue to operate in the future, and its records are kept on that basis. The life of the business is assumed to be continuous.

This assumption is important because it allows us to record transactions that affect the future of the business. It allows the business to recognise transactions that occur over more than one period such as credit transactions. For instance, if we sell goods on credit we will not receive the cash for those goods until a later date. However, if we assume that our business will continue, then at some stage in the future we are likely to receive the cash from credit sales, and this allows us to record Accounts Receivable (amounts owed to us by credit customers) as an asset at the time of the sale. The same applies to amounts we owe to our Accounts Payable for our credit purchases. It also helps us to determine if an item should be treated as an asset or an expense. An expense will be consumed within one reporting period; however, an asset will provide benefit to future reporting periods. An example would be an expense like Wages, which has no ongoing benefit compared to assets like Vehicles, which will provide benefits into the future.

Further, based on this assumption we can recognise long-term assets and liabilities and distinguish them from the short-term ones. This will allow the owner/manager to see the financial position of the business much more clearly and ensure that there are sufficient short- and long-term assets to meet the short- and long-term liabilities.

Period assumption

The **Period assumption** states that reports are prepared for a particular period of time, such as a month or a year, in order to obtain comparability of results.

This assumption is inextricably linked to the idea that the business is a going concern. Because the life of the business is assumed to be continuous, it is necessary to divide that life into arbitrary periods so that reports can be prepared. We cannot wait until the end of the business's life to calculate profit, because we are assuming that will never come, so we calculate profit for the month or year. A reporting period can be as short as the owner requires but cannot be longer than a year to meet taxation requirements. Many businesses will complete a Business Activity Statement (BAS) once per quarter, meaning their reporting period is three months.

Review questions 1.3

1 **Explain** the role of the Accounting assumptions.
2 **State** and **explain** the four Accounting assumptions.
3 **Explain** why a business is assumed to have a life separate from its owner.
4 **Define** the length of a reporting period. (Beware: this is a trick question!)

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1.4 Qualitative characteristics

While the Accounting assumptions govern the way Accounting information is recorded, reports are prepared under the guidance of what is known as the *Conceptual Framework for Financial Reporting* established by the International Accounting Standards Board (IASB). This framework identifies what the reports should include and the qualities the reports should possess. If we follow and implement the Accounting assumptions when we are recording, then our Accounting reports should possess certain **Qualitative characteristics**.

Qualitative characteristics
the qualities of the information in Accounting reports

The Qualitative characteristics are basically the qualities we would like our Accounting information to possess. The six Qualitative characteristics of Accounting reports are:

- Relevance
- Faithful representation
- Comparability
- Verifiability
- Timeliness
- Understandability.

Study tip

'Assumptions' apply mainly to records, while 'qualities' apply to reports. Any of the 'ability' ones are qualities rather than assumptions.

Relevance

Relevance states that financial information must be capable of making a difference to the decisions made by users of the report. This information needs to be related to an economic decision at hand. Relevant information either helps users to *form predictions* about the outcomes of events, or *confirm* (or change) their previous evaluations, or both.

Relevance
financial information must be capable of making a difference to the decisions made by users by helping them to form predictions and/or confirm or change their previous evaluations

This characteristic is really telling us what to include in our reports and will be present if we follow the Accounting entity and Period assumptions. For example, when preparing a Balance Sheet for the business, it is not relevant to include the personal assets of the owner, as these are not being used by the business to earn revenue and thus are not useful for making decisions about future business activities. Similarly, the Income Statement should include only revenue and expenses from the current reporting period – last year's wages or next year's sales figures will not help us assess this year's profit.

Therefore, financial reports should disclose all significant information that is capable of affecting decision-making and omit details that will not affect decision-making. Relevance also relates to what to include in the reports in terms of what is *material*. Information is regarded as material if its exclusion or inaccuracy could affect users' decision-making. This refers to the level of detail in which that information is shown. For example, the asset 'Accounts Receivable' must be included in a Balance Sheet, but it would not be material to list every single Account Receivable and the amount each owes, as this information will not affect decision-making. In fact, all it will do is make the report more difficult to read. (A business might have a hundred Accounts Receivable – to list them all individually in the Balance Sheet would make the report an extra five pages long!) A similar application allows us to omit cents from our reports as such a minor detail is not significant in terms of decision-making.

Study tip

All items – even something as small as a sixty-cent stamp – must be recorded, but they might not have to be disclosed separately in the Accounting reports.

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Faithful representation the financial information reported is a faithful representation of the real-world economic event it claims to represent: complete, free from material error and neutral (without bias)

Comparability useful information is provided when the financial reports of a business can be compared over time and compared with similar information of other businesses

Verifiability ensures that different knowledgeable and independent observers can reach the same conclusion that a particular depiction of an event is faithfully represented

Faithful representation

Faithful representation states that the financial information reported is a faithful representation of the real-world economic event it claims to represent. It therefore can be depended on as the financial information presented will be complete, free from material error and neutral (without bias).

This characteristic aims to ensure that the financial information presented is a true depiction of the economic events of the business, and therefore users can be assured that they can make informed decisions on the basis of that information without the fear of being misled.

Comparability

Comparability states that useful information is provided when the financial reports of a business can be compared over time and compared with similar information of other businesses. This can only occur if the business has been consistent with its Accounting procedures. This enables users to identify similarities and differences in items in the financial reports and be able to investigate the cause. This is more efficient if users are aware that the similarity or difference is not due to a change in Accounting procedures. Otherwise, it is difficult to tell whether changes in Accounting reports are the result of changes in business performance or simply changes in Accounting procedures. Where Accounting procedures are changed, this should be stated clearly in the reports (or 'disclosed') so that the users can make more informed assessments of what the reports are telling them.

Verifiability

Verifiability helps to assure users that the information presented faithfully represents what it claims to exemplify. It ensures that different knowledgeable and independent observers can reach the same conclusion that a particular event is faithfully represented. Therefore, independent individuals can check the supporting evidence to show that the financial information is free from bias and provides a Faithful representation.

This characteristic is telling us that in relation to the amounts we show in our reports, we should avoid the use of estimates. The best way to ensure that information is free from bias is to make sure it is evidenced by reference to a source document. Verifiable information has proof to support its accuracy and should extend to all transactions that the business will record and report; any item in any of the financial reports should be able to be traced back to its origin; that is, its source document. This way there is no room for subjectivity or guesses.

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Timeliness

Timeliness states that stakeholders must have financial information available in time to impact their decision-making. Generally, the older the information the less useful it is regarding decision-making. Therefore, to make the most informed decision, the stakeholder requires the most current financial information.

Understandability

Understandability states that financial information should be comprehended by users that have a reasonable understanding of business and economic undertakings. To ensure it is understood, it needs to be presented clearly and concisely.

It is important to remember that the most basic function of Accounting reports is to communicate information to the user. Most business owners are not accountants, and it is therefore pointless to present reports in a form that they cannot understand. For this reason, it may be more effective to present information in graphs, tables or charts, or simply in language that is free from Accounting jargon.

Timeliness
financial information should be available to decision-makers in time to be capable of influencing their decisions

Understandability
financial information should be understandable or comprehensible to users with a reasonable knowledge of business and economic activities, and presented clearly and concisely

Review questions 1.4

1. **Define** the six Qualitative characteristics.
2. **Explain** how the application of the Accounting entity and Period assumptions ensures Relevance in the Accounting reports.
3. **Explain** how the application of Verifiability assures Faithful representation in the Accounting reports.
4. **Explain** the importance of Timeliness and how it could conflict with Verifiability and Faithful representation.

Where have we been?

- The purpose of Accounting is to provide financial information to assist decision-making.
- The users of Accounting information include the owner, Accounts Receivable, Accounts Payable, banks and other lenders, employees, prospective owners and the government through the ATO.
- The Accounting process involves collecting source documents, recording the transactions and then reporting financial information before advice is provided.
- Accounting assumptions are the generally accepted rules governing the way Accounting information is recorded, and include: Accounting entity, Going concern, Period and Accrual basis.
- Qualitative characteristics are the qualities we would like our Accounting reports to possess, and include: Relevance, Faithful representation, Comparability, Verifiability, Timeliness and Understandability.

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Exercises

Exercise 1.1
The Accounting process

W B page 3

Reorder the following stages of the Accounting process:

a. recording transactions in journals and inventory cards
b. collecting source documents like receipts and EFT payment receipts
c. providing advice to the owner of the business
d. preparing financial reports.

Exercise 1.2
The Accounting process

W B page 4

Identify which stage of the Accounting process is performed by each of the following actions:

a. preparing an Income Statement
b. filing sales invoices
c. entering transactions in a cash journal
d. presenting the owner with alternative sources of finance.

Exercise 1.3
Accounting assumptions

W B page 5

Michael's business is his band – Inside Out – which provides music for functions. In each of the following situations, **identify** and **explain** which Accounting assumption has been breached.

a. Michael bought his mum a new computer for her home using cash from the business's bank account.
b. Michael thinks that the band (the business) might disband in a year or so and therefore has decided to list all their assets as current (meaning they will be used up or consumed within 12 months) and any further asset purchases as expenses.
c. The band has just completed a three-year tour and will now prepare financial reports to determine the success of the tour.
d. Michael has decided to list all the liabilities of the firm as current (meaning that all debts will be paid/settled within 12 months), despite a loan that is due in three years.
e. Michael received a cash payment for a function his band will play at in the next financial year. He decides to report it as revenue in this financial year.
f. Michael's business produced an Income Statement for the year that only reported the last six months of revenue but a year's worth of expenditure.

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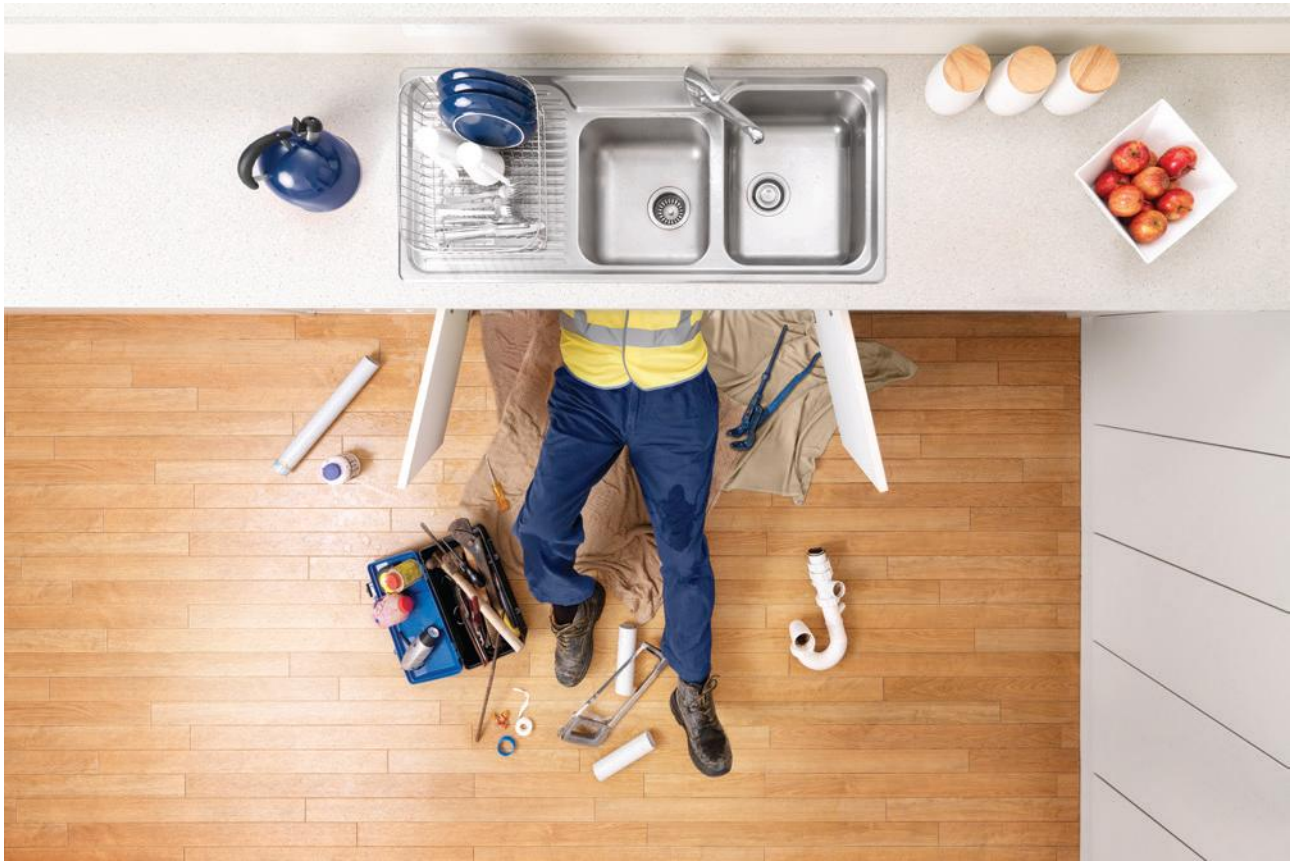
Exercise 1.4
Qualitative characteristics

WB page 7

Pat Silcox owns a plumbing business. For each of the following examples, **identify** and **explain** the Qualitative characteristic that has been breached.

a. All 35 individual Accounts Receivable are listed in the Balance Sheet.
b. In 2029 the reports were prepared using one method, but in 2030 a different method was used.
c. Pat reported the amount for electricity based on what he thought he had paid.
d. Some business expenses were paid out of Pat's personal savings account and so do not appear in the reports.
e. Some plumbing equipment has been reported in the Balance Sheet at its replacement value to bolster the Balance Sheet.
f. In determining whether to purchase a new building to expand operations in 2030, Pat was using financial statements from 2026 to 2027 as that was all that was available.
g. Pat's accountant prepared financial statements full of Accounting jargon and did not prepare any graphs or supporting materials.



Exercise 1.5
Qualitative characteristics

WB page 9

Betty believes that once transactions for the business have been recorded, there is no need to keep the source documents, as they take up too much storage space.

Required

a. **Identify** and **define** the Qualitative characteristic that will be breached if Betty fails to keep the source documents.

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Exercise 1.6
Accounting assumptions and Qualitative characteristics

WB page 10

During July 2030, the owner of Perfect Painting discovered a receipt for a sale that occurred two years ago and included the transaction in the reports for July 2030.

Required

a. Referring to one Qualitative characteristic, **explain** why the owner must not include this transaction in the reports for July 2030.

b. Referring to one Accounting assumption, **explain** when the transaction should have been reported.

Exercise 1.7
Accounting assumptions and Qualitative characteristics

WB page 11

Beria Munir has withdrawn $500 cash to pay the deposit on a family holiday. Since she is the owner of the business, she sees no need to record the transaction.

Required

a. Referring to one Accounting assumption, **explain** the problem with Beria's approach.

b. **Identify** and **explain** the Qualitative characteristic that will be undermined if this transaction is not reported.

Exercise 1.8
Flushable wipe makers misleading consumers alleges ACCC

Ethical considerations

WB page 12

This is an excerpt of the online article: 'Flushable wipe makers misleading consumers alleges ACCC' from the ABC News website.

By business reporter Thuy Ong

The consumer protection watchdog is trying to clean out what it has alleged are false claims that various personal hygiene and bathroom wipes are "flushable".

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The Australian Competition and Consumer Commission said its Federal Court action is a world first, as sewerage authorities struggle with the wipes, which it is alleged do not degrade as quickly as promised.

The allegations are against Pental, which makes the White King brand of bathroom cleaning products, and Kimberly-Clark Australia, which produces hygiene wipes under the Kleenex brand.

"These products did not, for example, disintegrate like toilet paper when flushed," ACCC chairman Rod Sims said in a statement.

"Australian water authorities face significant problems when non-suitable products are flushed down the toilet as they contribute to blockages to household and municipal sewerage systems."

Mr Sims told the ABC that the ACCC is alleging the two companies were engaged in making false or misleading representations to consumers.

"The word flushable must mean something. I think most people would think it means that it's got similar characteristics to toilet paper," he said.

"But, even if they don't think that, then they'd think that it would break down in a reasonable time frame, otherwise why would it have that label?"

Mr Sims said the regulator is seeking penalties and corrective notices, as well as injunctions to stop the continued marketing of these products with such claims.

"They've got slightly different products out, but they still are selling such products and, certainly, a group of water authorities in various countries take a view that the only thing you should be flushing down is toilet paper," he added.

Hygiene wipes have been a headache for water management facilities, with Sydney Water saying clean-up efforts cost around $8 million annually.

In October 2015, consumer advocacy group CHOICE's tests found flushable wipes did not disintegrate like toilet paper, with the wipes holding together for 21 hours, while toilet paper dissolved in a few minutes.

"We used the results of our test to make a complaint to the ACCC back in 2015, because we felt Kleenex was breaching the Australian Consumer Law by misleading customers about the nature of its products," said CHOICE head of media Tom Godfrey in a statement.

"Consumers rightly expect that a product labelled 'flushable' won't damage their pipes or our waterways."

The products subject to the ACCC's proceedings are Kimberly-Clark's Kleenex cottonelle flushable cleansing cloths, and Pental's White King Power clean flushable toilet wipes.

In a statement sent to the ABC, a Kimberly-Clark spokesperson said the company stands by claims it has made about the flushability of their Kleenex cottonelle cloths, which were supplied up until May 2016.

"Our claims that these products are flushable are accurate and the proceedings will be defended on that basis," she said.

"These products and the current Kleenex cottonelle flushable wipes meet or exceed the requirements set out in the INDA/EDANA flushability guidelines, which are the only widely accepted guidelines for assessing flushability."

Source: 'Flushable wipe makers misleading consumers alleges ACCC', ABC News website, 12 December 2016.

The ACCC has investigated false claims that various bathroom wipes are flushable; however, it was alleged that these wipes do not decompose as quickly as stated.

Required

a. **Identify** and **explain** an ethical consideration that has been breached.

b. **Explain** the consequences (legally / socially / financially / environmentally) the company may have faced regarding these practices.

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Exercise 1.9
Work, price and profits in supermarkets

Ethical considerations

page 13

The two biggest supermarkets in Australia have been accused of various unethical behaviours over time. They have had action taken against them by the Fair Work Ombudsman and the Australian Competition and Consumer Commission (ACCC). They also recently had to face a Senate inquiry regarding their pricing and profits during a cost-of-living crisis and period of economic stress for consumers.
The areas of concern that had been or are currently being investigated relate to:

- deceptive pricing practices and price gouging
- the underpayment of employees
- the use of market power for unfair dealings with farmers and suppliers
- representations regarding home brand products that were false, misleading and deceptive.

Required

a. Choose one of the points above and **identify** and **explain** how that action has breached an ethical consideration.
b. **Explain** why the supermarkets may have engaged in that behaviour and what they were hoping to achieve.
c. **Explain** the consequences (legally / socially / financially) the supermarkets may face or have faced regarding these practices.

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Exercise 1.10
Ethical considerations – case study

Ethical considerations

WB page 14

This is an excerpt of the online article: 'ACCC takes court action alleging Qantas advertised flights it had already cancelled' from the Australian Competition and Consumer Commission (ACCC) website.

> The ACCC today launched action in the Federal Court of Australia alleging Qantas Airways (QAN) engaged in false, misleading or deceptive conduct, by advertising tickets for more than 8,000 flights that it had already cancelled but not removed from sale.
>
> The ACCC alleges that for more than 8,000 flights scheduled to depart between May and July 2022, Qantas kept selling tickets on its website for an average of more than two weeks, and in some cases for up to 47 days, after the cancellation of the flights.
>
> It is also alleged that, for more than 10,000 flights scheduled to depart in May to July 2022, Qantas did not notify existing ticketholders that their flights had been cancelled for an average of about 18 days, and in some cases for up to 48 days. The ACCC alleges that Qantas did not update its "Manage Booking" web page for ticketholders to reflect the cancellation.
>
> This conduct affected a substantial proportion of flights cancelled by Qantas between May to July 2022. The ACCC alleges that for about 70 per cent of cancelled flights, Qantas either continued to sell tickets for the flight on its website for two days or more, or delayed informing existing ticketholders that their flight was cancelled for two days or more, or both.
>
> **Source:** 'ACCC takes court action alleging Qantas advertised flights it had already cancelled', ACCC website, 31 August 2023.

Required

a. **Identify** and **explain** what ethical considerations Qantas has allegedly disregarded.
b. **Explain** what consequences (legally / socially / financially) Qantas may face regarding this alleged behaviour.

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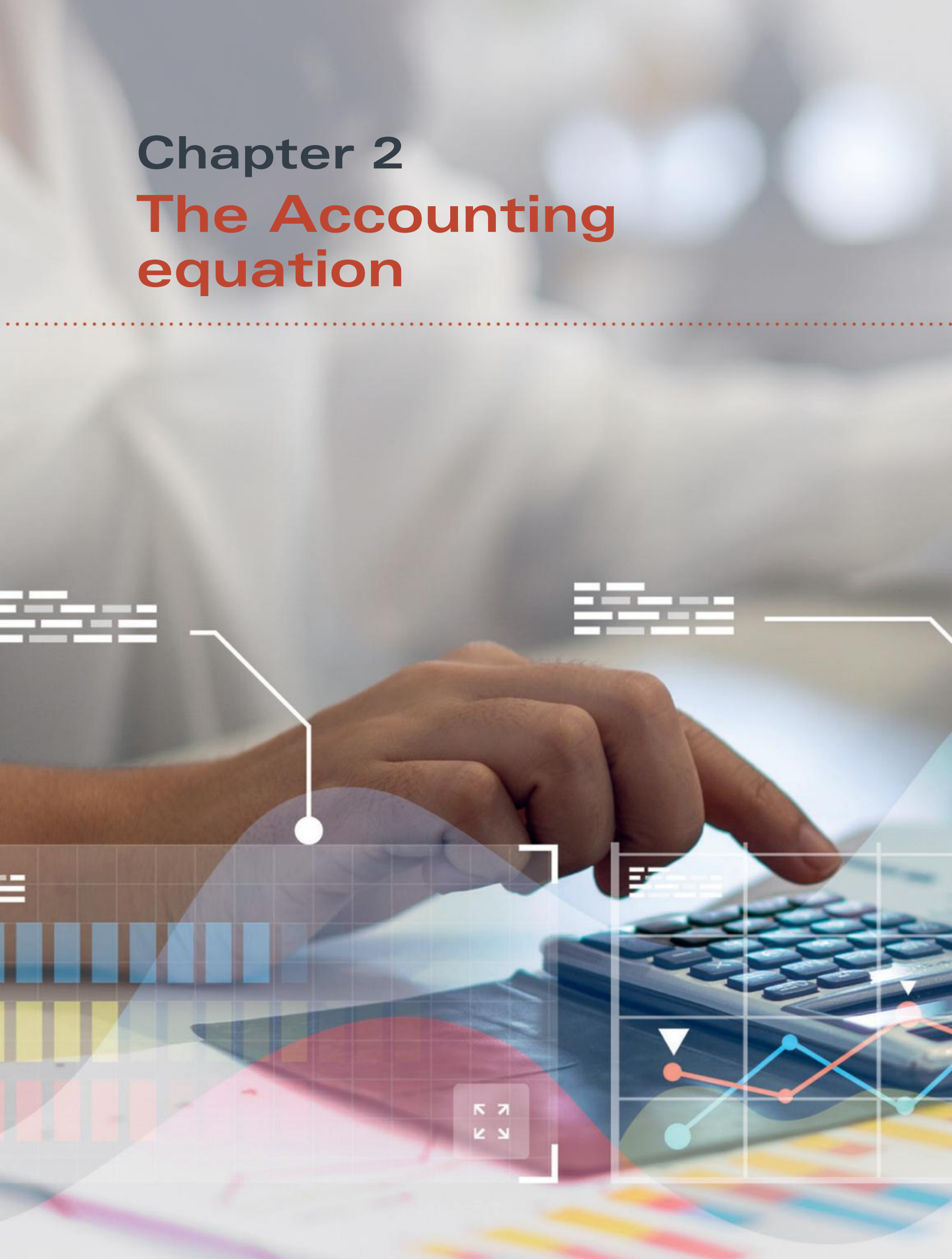
Chapter 2
The Accounting equation



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Learning intentions

After completing this chapter, you should be able to:

- **identify** and **define** assets, liabilities and owner's equity
- **explain** the relationship between the elements of the Accounting equation
- **calculate** owner's equity using the Accounting equation
- **explain** the relationship between the Accounting equation and the Balance Sheet
- **identify** and **define** current and non-current items
- **prepare** a fully classified Balance Sheet
- **apply** the rules of double-entry Accounting
- **identify** how transactions affect the Accounting equation and the Balance Sheet
- **explain** liquidity and **calculate** the Working Capital Ratio
- **explain** stability and **calculate** the Debt Ratio.

Key terms

After completing this chapter, you should be familiar with the following terms:

- asset
- liability
- owner's equity
- equities
- Balance Sheet
- classifying/classification
- current asset
- non-current asset
- current liability
- non-current liability
- indicator
- liquidity
- Working Capital Ratio (WCR)
- stability
- Debt Ratio.

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2.1 Assets, liabilities and owner's equity

The role of an accountant is to provide advice to business owners so that they can make more informed decisions. When consulting the accountant, one of the first questions the owner should ask about their business is: what is our current financial position? The financial position of a business can be represented in two ways:

- in the form of an equation – the Accounting equation
- by preparing a formal Accounting report known as a Balance Sheet.

Although the presentation will be different, in each case the assessment of the firm's financial position will consider the economic resources it controls (its assets) and its obligations (its liabilities), thus allowing owners to assess their owner's equity – the net worth of their investment in the business.

Assets

asset
a present economic resource controlled by the entity (as a result of past events) that has the potential to produce future economic benefits

An **asset** is a present economic resource controlled by the entity (as a result of past events) that has the potential to produce future economic benefits.

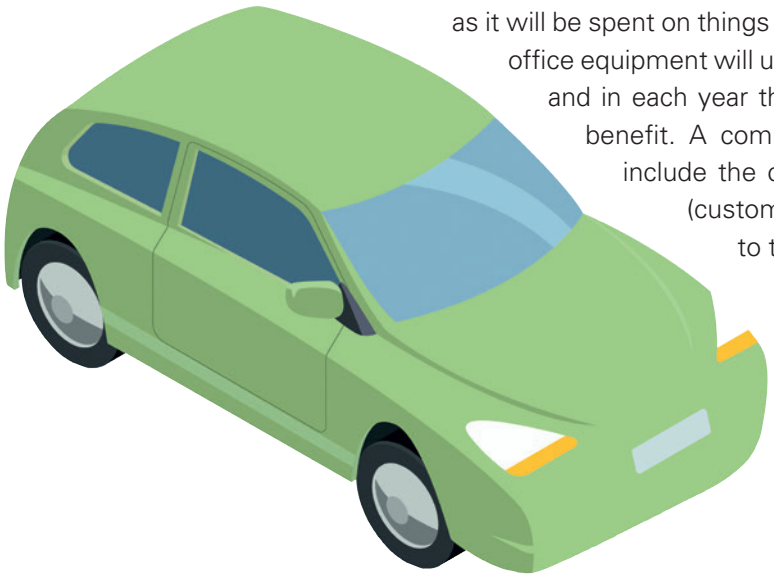
Thinking of assets as 'what the business owns' is okay as a starting point, and the items the business owns are certainly assets, but the definition above is far more sophisticated (and thus a little more complex). Let's break the definition down into its main components.

A present economic resource controlled by an entity

From an Accounting viewpoint, resources are items, physical (such as a motor vehicle) and intangible (such as a trademark), that assist the business to actually carry out its operations to earn revenue. In many cases the business will *own* these resources, but this is not necessary for the item to be classified as an asset: all that is required is that the business has *control* of the item. This means the business must be able to determine how and when the item is used. For instance, it is up to the business to determine how and when the cash in its bank account will be spent, and how and when the vehicles will be used.

Potential to produce future economic benefits

To be considered as an asset, an item must be capable of bringing the firm an economic benefit sometime *in the future*. That is, it must represent some sort of benefit that is yet to be received. For example, cash in the bank will provide a future economic benefit as it will be spent on things the business will need to function. An item such as office equipment will usually be used for a number of years into the future, and in each year that it is used it will bring some form of economic benefit. A common list of assets for a service business might include the cash in its bank account, its Accounts Receivable (customers who owe the business for services provided to them on credit), the supplies it has on hand, and its equipment, vehicles and perhaps premises.



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Liabilities

Liabilities are present obligations of the entity (arising from past events) to transfer an economic resource.

Once again, a simplistic view of liabilities as 'what the business owes' will do only as a starting point: the definition is much broader.

liability
a present obligation of the entity (as a result of past events) to transfer an economic resource

Present obligations of the entity

If the business has an *obligation* to settle a debt, then this debt is likely to be a liability. In the case of a bank overdraft (a debt owed to the bank) or Accounts Payable (a debt owed to suppliers), the business is obliged to repay the amount owing, so these items should be classified as liabilities.

In contrast, next year's wages are not a liability, as there is no obligation to pay the employees until they perform the work. Only those debts the business is presently *obliged* to settle should be recognised as liabilities.

Study tip

Look for opposites in definitions – like benefit versus obligation – to make them easier to remember.

To transfer an economic resource

The fact that a liability is to result in a transfer of economic resources means that the transfer is yet to occur. In this way, a liability could be seen as requiring a *future economic resource transfer*. This means the firm will 'give up' an economic resource, which in most cases will be cash. (However, there will be circumstances where other economic resources, like inventory or even a vehicle, are used to settle a liability.)

A common list of liabilities might include a bank overdraft, Accounts Payable, loans and mortgages (loans secured against property).

Owner's equity

Owner's equity is defined as the residual interest in the assets of the entity after the deduction of its liabilities. In effect, owner's equity is what is left over for the owner once a firm has met all its liabilities, or the owner's claim on the firm's assets. (Given that the owner and the firm are considered to be separate *entities*, it can also be described as the amount the business owes the owner.)

owner's equity
the residual interest in the assets of the entity after the liabilities are deducted

Review questions 2.1

1 **Define** the following terms:
   - asset
   - liability.
2 **List** four assets and four liabilities that would be common to most small businesses.
3 **Define** the term 'owner's equity'.
4 Referring to one Accounting assumption, **explain** why owner's equity is said to be what the 'business owes the owner'.

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2.2 The Accounting equation

equities
claims on the assets of the firm, consisting of both liabilities and owner's equity

What liabilities and owner's equity have in common is that they are both **equities** – claims on the assets of the firm. That is, liabilities are what the business owes to external parties, while owner's equity is what the business owes to the owner. And both of these claims must be funded from the business's assets.

This relationship between assets, liabilities and owner's equity is described by the Accounting equation:

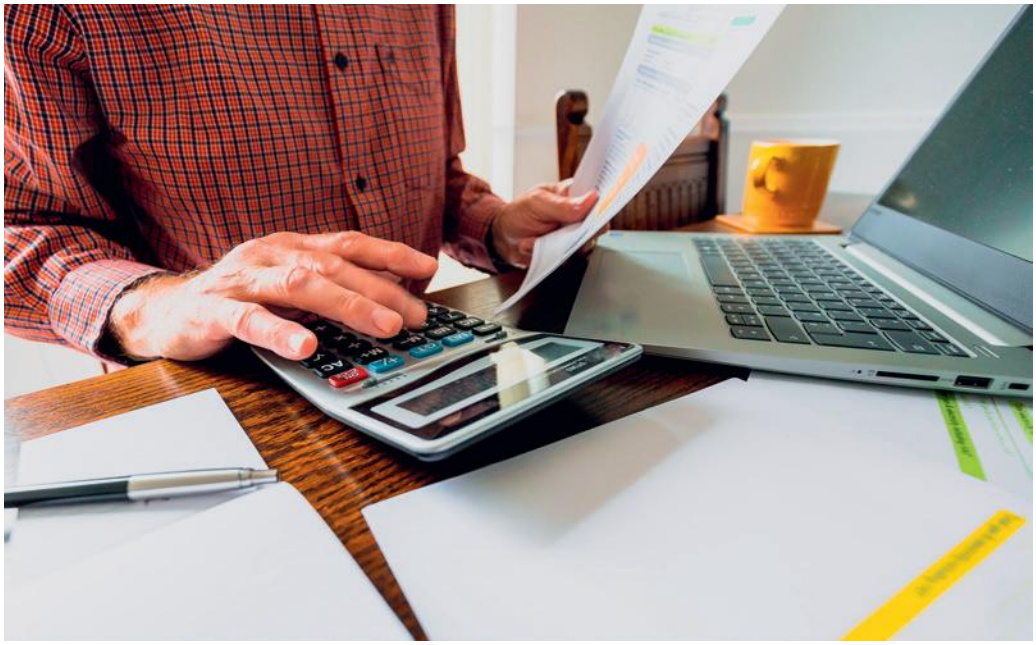
Assets = Liabilities + Owner's equity

The Accounting equation has exactly the same impact on small businesses as it does on multinational corporations, and all reporting entities are subject to one fundamental Accounting law: *the Accounting equation must always balance*. That is, assets must always equal liabilities plus owner's equity; it is not possible for the equation to be out of balance.

For instance, if a firm has assets of $162 000 and liabilities worth $110 000, its owner's equity *must* be the residual (what is left over): $52 000. It is not possible for owner's equity to equal an amount *greater* than this, because there would be insufficient assets to pay the owner. Conversely, it is not possible for owner's equity to equal an amount less than this. If liabilities claimed $110 000 and the owner claimed only $35 000, that would leave an amount not claimed by liabilities nor by the owner – who would then claim this remaining $17 000 worth of assets? The answer is that the owner would be entitled to this extra, so owner's equity would have to be $52 000 rather than $35 000.

Review questions 2.2

1. **Define** the term 'equities'.
2. **Explain** the difference between liabilities and owner's equity.
3. **State** the Accounting equation.
4. Referring to the definition of owner's equity, **explain** why the Accounting equation must always balance.



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2.3 The Balance Sheet

The relationship between assets, liabilities and owner's equity, as described by the Accounting equation, is at the heart of the Balance Sheet.

Assets	= Liabilities + Owner's equity
Assets	Liabilities Plus Owner's equity
Total Assets	**Total Equities**

Balance Sheet
an Accounting report that details a firm's financial position at a particular point in time by reporting its assets, liabilities and owner's equity

The **Balance Sheet** is an Accounting report that details a firm's financial position at a particular point in time by listing its assets and liabilities and the owner's equity. Figure 2.1 shows the unclassified Balance Sheet for a service firm – Handsome Hair:

Figure 2.1 Balance Sheet for a service firm

HANDSOME HAIR
Balance Sheet as at 31 December 2030

Assets	$	$	Equities	$	$
Assets			**Liabilities**		
Cash at Bank	3000		Accounts Payable	7000	
Inventory of shampoo	9000		Loan – PSA Bank	12000	19000
Accounts Receivable	4000		**Owner's equity**		
Fixtures and fittings	18000	34000	Capital – Henrietta		15000
Total Assets		**34000**	**Total Equities**		**34000**

Study tip

The title of all Accounting reports must state who, what and when.

Note how the title of the report refers to *who* the report is prepared for (Handsome Hair), *what* type of report it is (a Balance Sheet) and *when* it is accurate (as at 31 December 2030). This reference to **as at** 31 December 2030 is important, because it reflects the fact that a Balance Sheet is only ever accurate on the day it is prepared. The following day, the assets and liabilities it reports will probably change, meaning a new Balance Sheet is required.

The elements of the Accounting equation (assets, liabilities and owner's equity) provide the headings within the Balance Sheet, with individual items reported under those headings. The actual item representing the owner's claim is known as Capital, with the name of the owner listed next to it. (Any profits earned by the business, and thus owed to the owner, would also be listed under this heading of owner's equity, as would the owner's drawings.)

Review questions 2.3

1. **Explain** the role of the Balance Sheet.
2. **List** the three pieces of information that must be present in the title of each Balance Sheet.
3. **State** one reason why a Balance Sheet is titled 'as at'.
4. **Explain** the relationship between the Balance Sheet and the Accounting equation.

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2.4 Classification in the Balance Sheet

classifying/ classification
grouping together items that have some common characteristic

current asset
a present economic resource controlled by the entity (as a result of a past event) that is expected to be sold, consumed or converted into cash within 12 months after the end of the reporting period

non-current asset
a present economic resource controlled by the entity (as a result of a past event) that is expected to be used by the business for a number of years and is not held for the purpose of resale

current liability
obligations of the entity (arising from past events) that are reasonably expected to be settled in the next 12 months after the end of the reporting period

non-current liability
obligations of the entity (arising from past events) that are not expected to be settled in the next 12 months after the end of the reporting period

Given that Accounting exists to provide financial information to assist decision-making, accountants are always seeking ways to improve the usefulness of the information they provide. One simple, but very effective, way of improving the usefulness of the Balance Sheet is by **classifying** the information it contains.

Classification involves grouping together items that have some common characteristic. In relation to the Balance Sheet, the assets and liabilities have already been grouped together, but within these groupings the items can be classified according to whether they are 'current' or 'non-current'. This further classification enhances the quality of the information that will allow further analysis and more informed decisions to be made.

Current versus non-current assets

All assets are defined as having the potential to produce economic benefits, but it is the definition of 'potential' that determines whether they are 'current' or 'non-current'. Put simply, assets are classified as 'current' or 'non-current' according to the length of time for which the benefit is expected to flow.

If the asset is expected to be sold, used up or turned into cash within a year; that is, if it is expected to provide an economic benefit for *12 months or less* after the end of the reporting period, then it should be classified as a **current asset**. Common current assets include the cash in the business's bank account, any inventory of supplies it is holding for completing a job, and the amounts owed to it by its Accounts Receivable. Any assets that are expected to provide an economic benefit for *more than 12 months* after the end of the reporting period, such as business equipment, vehicles or shop fittings, should be classified as **non-current assets**. These are expected to be used by the business for a number of years and are not held for the purpose of resale.

Current versus non-current liabilities

The same 12-month test applies to liabilities. Items that are expected to be settled sometime *in the next 12 months*, such as obligations to Accounts Payable, are classified as **current liabilities**. A bank overdraft would also be classified as a current liability, not so much because it *will* be met in the next 12 months as because it *can be*. (Although it is unlikely to occur, it is possible that an overdraft could be called in for repayment on very short notice.)

By contrast, **non-current liabilities** are present obligations that must be met sometime *after the next 12 months*. Longer-term loans like mortgages are the most common non-current liabilities.

Loans

When classifying loans, it is important to recognise that some of the amount owing may be current and some non-current. For example, with a loan like a mortgage, the lender (usually a bank) would expect the borrower (the business) to make regular instalments to pay off the principal rather than pay one massive amount at the end of the loan. In such a case, the amount that is due for repayment in the next 12 months would be classified as a current liability, with the remainder (which does not have to be repaid until after 12 months) classified as a non-current liability. As a result, the amount owing on a long-term loan may need to be split between current and non-current liabilities.

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Classified Balance Sheet

Assuming the Loan – PSA Bank is repayable in equal instalments of $3000 per year (or per annum), then the classified Balance Sheet of Handsome Hair would be as is shown in Figure 2.2:

Figure 2.2 Classified Balance Sheet

HANDSOME HAIR
Balance Sheet as at 31 December 2030

Assets	$	$	Equities	$	$
Current Assets			**Current Liabilities**		
Cash at Bank	3000		Accounts Payable	7000	
Inventory of shampoo	9000		Loan – PSA Bank	3000	10000
Accounts Receivable	4000	16000			
			Non-Current Liabilities		
Non-Current Assets			Loan – PSA Bank		9000
Fixtures and fittings		18000			
			Owner's equity		
			Capital – Henrietta		15000
Total Assets		**34000**	**Total Equities**		**34000**

Study tip

Check the date when a loan has to be repaid – this is the key to whether it is current or non-current.

In this example, the Loan – PSA Bank for $12000 has been split between current and non-current liabilities: $3000 must be repaid in the next 12 months, with the remaining $9000 due for repayment sometime after that.

(Note also the use of columns – where necessary, the left-hand column on each side of the Balance Sheet has been used for listing *individual* amounts, leaving only the total of each classification in the right-hand column. This is a simple mechanism for improving the layout of the report and making it more user-friendly.)

Review questions 2.4

1. **Define** the term 'classification'.
2. **Distinguish** between a current asset and a non-current asset.
3. **List** three assets that would be classified as current and three that would be classified as non-current.
4. **Distinguish** between a current liability and a non-current liability.
5. **List** three liabilities that would be classified as current and two that would be classified as non-current.

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2.5 Transactions and the Accounting equation

When a firm exchanges goods and/or services with another entity, its Accounting equation will change in a variety of ways. In fact, every transaction will change at least two items in the Accounting equation, but after those changes are recorded, the Accounting equation must still balance. This is known as *double-entry Accounting*.

1 Every transaction will affect at least two items in the Accounting equation.
2 After recording these changes, the Accounting equation must still balance.

Because the Balance Sheet is based on the Accounting equation, the same two rules of double-entry Accounting also apply to the Balance Sheet.

Example

The following transactions for Rupert's Roof Repairs occurred during January 2030.
Jan. 1 Rupert contributed $16 000 cash to commence business as Rupert's Roof Repairs
Jan. 2 Purchased supplies on credit from Vic Traders for $23 000
Jan. 3 Paid $14 000 to purchase new safety equipment

Video 2.1
Transactions and the Accounting process

Jan. 1 Rupert contributed $16 000 cash to commence business as Rupert's Roof Repairs

As a result of this transaction, the business now has $16 000 in its bank account – an increase in its assets of $16 000. In addition, because that cash came from the owner (who is assumed to be a separate Accounting entity), the owner's equity has increased by $16 000.

The Accounting equation for Rupert's Roof Repairs after this transaction would be:

Assets	=	Liabilities	+	Owner's equity
↑ Bank $16 000				↑ Capital $16 000

The Balance Sheet would show:

Figure 2.3 Balance Sheet (1)

RUPERT'S ROOF REPAIRS
Balance Sheet as at 1 January 2030

	$		$
Assets		**Liabilities**	
Bank	16 000		
		Owner's equity	
		Capital – Rupert	16 000
Total Assets	**16 000**	**Total Equities**	**16 000**

Note how the transaction has changed two items – Bank (asset) and Capital (owner's equity) – both of which have increased by $16 000. As a result, the Accounting equation still balances.

Jan. 2 Purchased supplies on credit from Vic Traders for $23 000

This time it is not the Bank that increases, but a different asset called Inventory of supplies. On the other side of the Accounting equation, a liability called Accounts Payable is created, which represents the amount owed to Vic Traders. The effect on the Accounting equation for Rupert's Roof Repairs after this transaction would be:

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Assets	=	Liabilities	+	Owner's equity
↑ Inventory of Supplies $23 000		↑ Accounts Payable – Vic Traders $23 000		

The Balance Sheet for Rupert's Roof Repairs after this transaction would be:

Figure 2.4 Balance Sheet (2)

RUPERT'S ROOF REPAIRS
Balance Sheet as at 2 January 2030

	$		$
Assets		**Liabilities**	
Bank	16 000	Accounts Payable – Vic Traders	23 000
Inventory of Supplies	23 000	**Owner's equity**	
		Capital – Rupert	16 000
Total Assets	**39 000**	**Total Equities**	**39 000**

While there is no change to Bank, the new asset Supplies increases the assets to $39 000. On the other side of the Balance Sheet, Accounts Payable increases equities to the same amount, and once again the Balance Sheet, and the Accounting equation on which it is based, balances.

Jan. 3 Paid $14 000 to purchase new safety equipment

This transaction creates a third asset, Safety equipment, but in the process decreases Bank. Thus, the amounts of the individual assets change without changing the total assets figure. There is in fact no change on the equities side, proving that although two items must change, they can both be on the same side of the Accounting equation/ Balance Sheet, provided that the result still balances. The effect on the Accounting equation for Rupert's Roof Repairs after this transaction would be:

Assets	=	Liabilities	+	Owner's equity
↓ Bank $14 000				
↑ Safety equipment $14 000				

The Balance Sheet for Rupert's Roof Repairs after this transaction would be:

Figure 2.5 Balance Sheet (3)

RUPERT'S ROOF REPAIRS
Balance Sheet as at 3 January 2030

	$		$
Assets		**Liabilities**	
Bank	2 000	Accounts Payable – Vic Traders	23 000
Inventory of Supplies	23 000	**Owner's equity**	
Safety equipment	14 000	Capital – Rupert	16 000
Total Assets	**39 000**	**Total Equities**	**39 000**

Each and every transaction will have at least two effects on the Accounting equation, and after these effects have been recorded, the equation must balance. If it does not balance, then the recording is incorrect.

Review questions 2.5

1 **State** the two rules of double-entry Accounting.

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2.6 Financial indicators and the Balance Sheet

indicator
a measure that expresses profitability, liquidity or stability in terms of the relationship between two different elements of performance

liquidity
the ability of the business to meet its short-term debts as they fall due

Working Capital Ratio (WCR)
a liquidity indicator that measures the ratio of current assets to current liabilities to assess the firm's ability to meet its short-term debts

The classification of the items in the Balance Sheet as current or non-current enhances the usefulness of the report because it allows for the calculation of performance **indicators**. These indicators, or ratios, compare items within the Balance Sheet in order to assist management in determining the financial health of their business. Specifically, the Balance Sheet allows for the calculation of indicators to assess the firm's profitability, liquidity and stability.

Liquidity

Liquidity refers to the ability of a business to meet its short-term debts as they fall due, which is essential to its survival. One of the most popular measures of liquidity is the **Working Capital Ratio (WCR)**. This indicator compares a firm's current assets and current liabilities to determine whether the business has sufficient economic resources to cover its present obligations. Figure 2.6 shows how the Working Capital Ratio is calculated:

Figure 2.6 Formula: Working Capital Ratio (WCR)

$$\text{Working Capital Ratio (WCR)} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$
$$= \text{Ratio Current Assets : 1}$$

Example

As at 28 February 2030, the Balance Sheet of Millsy's Music Lessons showed current assets of $7 500 and current liabilities of $5 000.

The Working Capital Ratio would be calculated as shown in Figure 2.7:

Figure 2.7 Calculation: Working Capital Ratio (WCR)

$$\text{WCR} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$
$$= \frac{\$7\,500}{\$5\,000}$$
$$= 1.5 : 1$$

This indicates that the firm has $1.50 of current assets for every $1.00 of current liabilities.

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Assessing the Working Capital Ratio

What is a suitable level for the WCR? As long as the ratio is above a minimum of 1:1, then this would indicate sufficient liquidity, as there are enough current assets to cover the current liabilities of the business. Obviously, a WCR of less than 1:1 is worrying; however, the owner should also be wary of having a WCR that is *too high* as this may indicate that the business has an overabundance of current assets that are not being employed effectively.

Stability

Whereas liquidity focuses on the short-term, **stability** concentrates on the firm's ability to meet its obligations in the longer term. A good indicator of stability is the **Debt Ratio**, which measures what percentage of the firm's assets are funded by external (outside) sources. In this way, it measures the firm's reliance on outside finance. Figure 2.8 shows how the Debt Ratio is calculated:

stability
the ability of the business to meet its debts and continue its operations in the long term

Debt Ratio
measures the proportion of the firm's assets that are funded by external sources

Figure 2.8 Formula: Debt Ratio

$$\text{Debt Ratio} = \frac{\text{Total Liabilities}}{\text{Total Assets}} \times 100$$

Example

As at 30 June 2030, the Balance Sheet of Choice Physios showed Total Liabilities of $170 000 and Total Assets of $200 000.

The Debt Ratio would be calculated as shown in Figure 2.9:

Figure 2.9 Calculation: Debt Ratio

$$\text{Debt Ratio} = \frac{\text{Total Liabilities}}{\text{Total Assets}} \times 100$$

$$= \frac{\$170\,000}{\$200\,000} \times 100$$

$$= \mathbf{85\%}$$

This means that **85%** of the firm's assets are financed by external debt (liabilities), with the remaining 15% funded by the owner's capital.

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Study tip

The Debt Ratio considers all of the assets and liabilities, not just the non-current items.

Assessing the Debt Ratio

There is no set level at which the Debt Ratio is said to be satisfactory, but it is a good indicator of financial risk. A high Debt Ratio means that a high proportion of the firm's assets are funded by external sources. This in turn means there is pressure on the firm's cash flow to meet principal and interest repayments, and therefore a greater risk of the business facing financial collapse.

The Debt Ratio will increase from increased borrowing by the business; however, changes in owner's equity will also affect the Debt Ratio, not just changes in the assets and liabilities. Excessive drawings that decrease owner's equity will increase the Debt Ratio and the risk to the business as well as affecting the level of liquidity. However, capital contributions by the owner can reduce the Debt Ratio and the financial risk of the business as well as providing short-term relief to liquidity.

Review questions 2.6

1. **Explain** one benefit of classifying the items in a Balance Sheet as current or non-current.
2. **Define** the term 'liquidity'.
3. **State** what is measured by the Working Capital Ratio. **Show** how it is calculated.
4. **Explain** how the Working Capital Ratio can be used to assess whether liquidity is satisfactory or not.
5. **Define** the term 'stability'.
6. **State** what is measured by the Debt Ratio. **Show** how it is calculated.
7. **Explain** how a high Debt Ratio can have negative consequences for liquidity.

Where have we been?

- An asset is a present economic resource controlled by the entity (as a result of past events) that has the potential to produce economic benefits.
- A liability is a present obligation of the entity (as a result of past events) that will result in the transfer of economic resources.
- Owner's equity is the residual interest in the assets of the entity after the liabilities are deducted.
- The relationship between assets, liabilities and owner's equity is described by the Accounting equation, which must always balance.
- The Balance Sheet details the firm's financial position at a particular point in time by listing its assets and liabilities, and the owner's equity.
- Every transaction will change at least two items in the Accounting equation, but after those changes are recorded, the Accounting equation must still balance.
- Assets and liabilities can be classified as current or non-current, depending on whether they will exist for more or less than 12 months.
- Classification in the Balance Sheet as current or non-current enhances the usefulness of the report because it allows for the calculation of performance indicators.
- Liquidity refers to the ability of a business to meet its short-term debts as they fall due and can be measured using the Working Capital Ratio, which should be above 1:1.
- Stability refers to the ability of a business to meet its long-term obligations and remain a Going concern.
- The Debt Ratio measures the percentage of the firm's assets that are funded by external (outside) sources and is a good indicator of financial risk.

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Exercises

Please note: asterisks indicate that an answer for that question is available in the Selected Answers section at the end of this book.

Exercise 2.1
Assets, liabilities and owner's equity

WB page 16

Classify each of the following items as an asset, a liability or owner's equity:

a. Inventory of supplies
b. Mortgage
c. Cash at bank
d. Accounts Receivable
e. Loan
f. Accounts Payable
g. Equipment
h. Bank overdraft
i. Vehicle
j. Capital

Exercise 2.2
Accounting equation

WB page 17

For each of the following examples, use the Accounting equation to **calculate** the value of owner's equity.

a. Mark's Dog Washing Service has $4 500 in assets but owes $500 to the local newspaper for advertising.
b. Bianca owns and operates Bianca for Hair. The firm has $5 600 in assets but owes a supplier $250.
c. Andrew is the owner of an Accounting firm. He owns a car worth $1 500, a stereo worth $800, clothing worth $750 and other assets worth $1 000. His firm owns office equipment worth $15 000 and a vehicle worth $2 000 but owes $600 to an employee.
d. Sasha Enterprises has $4 500 in the bank but owes $1 000 on a loan it took out to buy equipment. The equipment is worth $1 500, and a company car is worth $17 000. A client still owes $500 for work done by the firm, and Sasha owes $150 on her Visa card.

Exercise 2.3
Accounting equation

WB page 18

For each of the following examples, use the Accounting equation to **calculate** the value of the assets.

a. John knows that his equity in his firm is $300 and that his firm owes $600 to a supplier.
b. Ella has equity of $10 000 in her business and has $5 000 worth of personal assets. She owes Branko $500, and the firm has debts of $3 000.

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Exercise 2.4
Classification

page 19

Classify each of the following items as a current asset, non-current asset, current liability or non-current liability:

a. Accounts Payable
b. Cash on hand
c. Equipment
d. Premises
e. Inventory of supplies
f. Wages owing to employees
g. Capital
h. Accounts Receivable
i. Mortgage owing on premises
j. Bank overdraft
k. Vehicles

Exercise 2.5
Accounting equation

page 20

For each of the following examples, use the Accounting equation to **calculate** the missing figures:

	Current Assets	Non-Current Assets	Current Liabilities	Non-Current Liabilities	Owner's equity
a	14 200	10 400		6 400	10 300
b		15 800	400	2 000	17 800
c	12 000	18 000	600	1 600	
d	41 300	25 200	19 900		29 600

Exercise 2.6
Classified Balance Sheet

page 21

As at 31 May 2030, the assets and liabilities of Paris for Hair were as follows:

Inventory of hair care products	$42 000
Accounts Payable	$3 400
Loan – nab (repayable $6 000 per annum)	$30 000
Shop fittings	$22 000
Bank overdraft	$4 900
Accounts Receivable	$8 600
Office equipment	$15 300

The shop fittings were purchased three years ago for $22 000, but the owner has estimated their current value at $8 200.

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Required

a. Referring to one Qualitative characteristic, **explain** why the shop fittings must be valued at $22 000.

b. **Calculate** owner's equity as at 31 May 2030.

* **c.** **Prepare** a classified Balance Sheet for Paris for Hair as at 31 May 2030.

d. Referring to your answer to part **c**, **explain** your treatment of office equipment.

Exercise 2.7
Classified Balance Sheet

page 22

Noel Season is the owner of Noel's Plumbing and has provided the following list of assets and liabilities as at 1 February 2030:

Accounts Payable	$8 500
Inventory of parts	$12 000
Wages owing	$400
Tools	$12 000
Mortgage (due 2035) (repayable $8 000 per year)	$80 000
Cash at Bank	$3 000
Premises	$90 000
Loan – nab (due Dec. 2030)	$20 000
Company vans	$30 000
Accounts Receivable	$1 500
Owner's equity	?

Required

* **a.** **Prepare** a Balance Sheet for Noel's Plumbing as at 1 February 2030.

b. Referring to your answer to part **a**, **explain** your treatment of:

- Inventory of parts
- Loan – nab.

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

d. **State** two external users who may be interested in the Balance Sheet of Noel's Plumbing.

Exercise 2.8
Classified Balance Sheet

page 24

Robert James owns and operates Rob's CD Library and has provided the following list of the firm's assets and equities as at 31 December 2030:

Wages owing	$1 200
Mortgage (repayable $500 per month)	$80 000
Equipment	$12 000
Accounts Receivable	$1 500
Owing to suppliers	$4 500
Cash at Bank	$1 000
Inventory of CDs	$24 000
Premises	$95 000
Owner's equity	?

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Required

a. **Calculate** Rob's owner's equity as at 31 December 2030.

* **b.** **Prepare** a Balance Sheet for Rob's CD Library as at 31 December 2030.

c. Referring to your answer to part **a**, **explain** your treatment of:

- Accounts Receivable
- Wages owing.

d. **State** one reason why liabilities and owner's equity are classified as equities.

Exercise 2.9
Transactions and the Accounting equation

W B page 26

Jan Philpott is the owner of Jan's Public Relations and has supplied the following details relating to the firm's transactions for February 2030:

Feb.	1	Purchased office supplies on credit from EZ Supplies worth $1000
	2	Made a loan repayment of $700
	3	Jan took home office supplies worth $40 for personal use
	4	Paid $450 for a new data projector
	5	Paid EZ Supplies $300

Required

a. **Show** the effect of each transaction on the Accounting equation of Jan's Public Relations.

b. Referring to one Accounting assumption, **explain** why the transaction on 3 February 2030 results in a decrease in owner's equity.

c. Referring to one Qualitative characteristic, **explain** why it is important that Jan keeps the source document for the new data projector.

Exercise 2.10
Transactions and the Accounting equation

W B page 28

Murray Cook is the owner of Cook's Catering and has supplied the following details relating to the firm's transactions for April 2030:

April	1	Purchased ingredients worth $3000 on credit
	2	Received $300 from an Account Receivable
	3	Paid $700 for a kitchen trolley
	4	Murray donated his personal computer to the firm (it was worth $1200)
	5	Borrowed $100 from the Patterson Bank

Required

a. **Show** the effect of each transaction on the Accounting equation of Cook's Catering.

b. Referring to one Qualitative characteristic, **explain** why the transaction on 4 April 2030 results in an increase in owner's equity.

c. **Explain** how the ingredients should be classified in the Balance Sheet of Cook's Catering.

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Exercise 2.11
Working Capital Ratio

page 30

As at 30 June 2030, McCormack Motors had current assets of $40 000 and current liabilities of $30 000.

Required

a. **Calculate** the Working Capital Ratio for McCormack Motors as at 30 June 2030.
b. Referring to your answer to part **a**, **explain** whether the liquidity of McCormack Motors is satisfactory or unsatisfactory.
c. **Explain** the role of a classified Balance Sheet in calculating the Working Capital Ratio.

Exercise 2.12
Debt Ratio

page 31

As at 31 January 2030, All Suits Dry Cleaning had total liabilities of $120 000 and total assets of $300 000.

Required

a. **Calculate** the Debt Ratio for All Suits Dry Cleaning as at 31 January 2030.
b. Referring to your answer to part **a**, **explain** what this indicator measures.
c. **Explain** why the Debt Ratio is a good indicator of risk.

Exercise 2.13
Indicators

page 32

Quick as a Flash processes photos and has presented the following report as at 31 May 2030:

QUICK AS A FLASH
Balance Sheet as at 31 May 2030

	$	$		$	$
Current Assets			**Current Liabilities**		
Processing supplies	3 800		Accounts Payable	2 000	
Accounts Receivable	1 000		Mortgage	18 000	20 000
Bank	200	5 000			
			Non-Current Liabilities		
Non-Current Assets			Mortgage		85 000
Imaging equipment	45 000				
Premises	160 000	205 000	**Owner's equity**		
			Capital – Bright		105 000
Total Assets		**210 000**	**Total Equities**		**210 000**

Required

a. **Calculate** the Working Capital Ratio for Quick as a Flash as at 31 May 2030.
b. **Comment** on the liquidity of Quick as a Flash as at 31 May 2030.
c. **Calculate** the Debt Ratio for Quick as a Flash as at 31 May 2030.
d. **State** one action the owner could take to improve both the Working Capital Ratio and the Debt Ratio.

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Exercise 2.14
Indicators

page 33

Maria Khallouff owns Checked Pages, an editing business, and has provided the following report as at 31 August 2030:

CHECKED PAGES
Balance Sheet as at 31 August 2030

	$	$		$	$
Current Assets			**Current Liabilities**		
Bank	14 000		Accounts Payable	12 000	
Accounts Receivable	6 000		Mortgage – ANZ	6 000	18 000
Inventory of materials	16 000	36 000			
			Non-Current Liabilities		
Non-Current Assets			Mortgage – ANZ		72 000
Vehicle	10 000				
Printing equipment	59 000		**Owner's equity**		
Land and building	120 000	189 000	Capital – Khallouff		135 000
Total Assets		**225 000**	**Total Equities**		**225 000**

Required

a. Referring to one Qualitative characteristic, **explain** why the Balance Sheet does not identify each individual Account Payable of Checked Pages.

b. **Calculate** the Working Capital Ratio for Checked Pages as at 31 August 2030.

c. Referring to your answer to part **b**, **explain** whether this level of liquidity is satisfactory or unsatisfactory.

d. **Calculate** the Debt Ratio for Checked Pages as at 31 August 2030.

After inspecting the Balance Sheet, Maria has decided to use $11 000 cash to purchase another vehicle.

e. **State** the effect (increase/decrease/no effect) of this decision on:
- Working Capital Ratio
- Debt Ratio.

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Exercise 2.15
Classified Balance Sheet

page 34

The unclassified Balance Sheet for Andrew's Painting Service as at 30 September 2030 showed the following information:

ANDREW'S PAINTING SERVICE
Balance Sheet (unclassified) as at 30 September 2030

	$		$
Cash at Bank	1 200	Accounts Payable	5 000
Accounts Receivable	1 000	Wages owing	500
Painting equipment	12 000	Loan – ANZ (repayable $6000 p.a.)	30 000
Vans	25 000	Owner's equity – Andrew	?
Inventory of paint	10 000		
Total Assets	**49 200**	**Total Equities**	**49 200**

In the first week of October, the following transactions occurred:

Oct. 1 Paid $1 000 to an Account Payable
2 Borrowed $8 000 from Barry's Bank (loan to repaid in September 2031)
3 Received $400 from an Account Receivable
4 Bought paint on credit: $2 000
5 Andrew withdrew $200 for paint for his own purposes
6 Sold $1 500 worth of equipment for cash
7 Paid the wages owing
8 Andrew contributed to the firm's assets his personal computer worth $4 000

Required

a. **Calculate** capital as at 30 September 2030.
b. **Show** the effect on the Accounting equation of each transaction for October 2030.
* c. **Prepare** a classified Balance Sheet for Andrew's Painting Service as at 8 October 2030.
d. **Explain** one benefit Andrew will derive by classifying the Balance Sheet.

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Chapter 3
Business ownership

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Learning intentions

After completing this chapter, you should be able to:

- **identify** the types and sizes of businesses
- **list** the reasons for owning a business
- **identify** the alternatives to establishing a business
- **identify** the resources required to establish a business
- **identify** the personal qualities of a successful business owner
- **distinguish** between businesses based on the nature of their operations - **identify** and **explain** the advantages and disadvantages of various ownership structures
- **identify** and **explain** the advantages and disadvantages of establishing a small business or buying an existing business or a franchise
- **explain** why some businesses succeed where others fail
- **identify** sources of assistance for business owners exploring alternative investments to commencing a business.

Key terms

After completing this chapter, you should be familiar with the following terms:

- small business
- cost price
- Australian Business Number (ABN)
- sole proprietorship
- unlimited liability
- partnership
- proprietary company
- public company
- limited liability
- goodwill
- franchise
- franchisee
- franchisor
- capital gain
- income stream
- term deposit
- bond
- debenture
- security/collateral
- prospectus
- negative gearing
- capital gains tax
- managed property fund
- share
- dividend
- franking credit
- capital loss
- managed share fund
- return on investment.

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3.1 Business ownership

There are many characteristics that can be used to distinguish types of businesses – size is one criterion. The size of a business is normally determined by its number of employees.

The Australian Bureau of Statistics defines a small business as a business employing fewer than 20 people. Small businesses can be further broken down to include the following classifications:

- non-employing businesses (sole proprietorships and partnerships without employees)
- micro-businesses (employing between 1 and 4 people)
- other small businesses (employing between 5 and 19 employees).

small business
a business in which the owner and manager is the same person and which employs fewer than 20 people

Therefore, a simple definition of a **small business** is any business in which the owner and manager is the same person (or people) and which employs fewer than 20 people. The number of employees is a useful feature to distinguish a small business from a medium or large business. A medium business would employ 20 or more people but less than 200, while a large business would employ 200 or more people.

Small businesses also have a number of common characteristics:

- They are independently owned and operated.
- They are closely controlled by the owner/manager, who also contributes most, if not all, of the operating capital.
- The principal decision-making is made by the owner/manager.

However, with the exception of a 'sole proprietorship', which has one owner, the size of the business should not be taken as evidence of its business structure. Small, medium and large businesses can all be sole proprietorships, partnerships or companies. (This will be covered in detail later in this chapter.)

The small business sector

Politicians and economists frequently cite small businesses as the engine room of the Australian economy, but just how important are they? In June 2023, there were 2 589 873 businesses operating within Australia, of which 1 004 871 were engaged in employing people other than themselves.

Of all Australian businesses in June 2023, 97.3% were small businesses.

Type of business	Number of businesses	Percentage (%)
Non-employing	**1 585 002**	**61.2%**
Employing		
Micro (1 to 4)	704 445	27.2%
Small (5 to 19)	230 499	8.9%
Medium (20 to 199)	64 747	2.5%
Large (200+)	5 180	0.2%
Total employing	**1 004 871**	**38.8%**
Total	**2 589 873**	**100%**

Source: ABS Counts of Australian Business, Table 13a, August 2023 and ASBFEO calculations (excludes businesses that are not registered for GST)

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Small businesses play a vital role in the Australian economy as they employ over 5 million people, which is over 40% of all private sector employment. They also contribute strongly to Australia's level of economic activity and production, as well as exports, which (most importantly from the government's perspective) are a major source of tax revenue.

Review questions 3.1

1 **Define** the term 'small business'.
2 **State** three characteristics that distinguish a business as small.
3 **Explain** two reasons why small businesses are important to the Australian economy.
4 **Identity** the factor that determines a business's size. **State** the four sizes of businesses and **explain** why they are categorised as that size. **Give** examples of each.

3.2 Becoming a business owner

Unfortunately, the list of successful small business owners is dwarfed by those that fail (see later in this chapter). The decision to become a business owner should thus not be taken lightly but rather be the product of a careful assessment of the prospective owner's motivation, strengths and weaknesses, and the costs and benefits of ownership itself.

Reasons for becoming a business owner

The reasons why people choose to own their own business are as many and varied as the businesses they operate. Some of the more common reasons are listed below.

Profit motive

Rightly or wrongly, many people think that owning a small business is a gateway to financial riches and see becoming an owner as the best way to improve their income. Although wealth and security are by no means guaranteed, the profit motive is a powerful factor in the decision to purchase or start a business.

A desire for greater freedom/independence – to be your own boss

Many people become frustrated as employees, either because they think they have a better way of doing things or because they feel that their efforts are under-recognised. By owning their own business, small business owners gain their independence as well as all the financial rewards that their hard work has gained. This extends to being able to choose the hours they work and the way that work is done.

Identifying a market opportunity

A business opportunity can sometimes present itself in a way that an ambitious or creative person cannot ignore. An idea for a new or cheaper/better quality product or a service that is not currently being provided can be a strong incentive to go into business for yourself so that the market demand is satisfied (not to mention the recognition – and hopefully profits – that will eventuate).

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Unemployment

Due to retrenchment or other factors, some individuals may discover that self-employment is their only option. The old saying about one door closing and another one opening is apt for those who are forced into what can turn out to be a highly rewarding small business.

While there are certainly benefits to be gained from owning a small business, there are also costs and risks involved. The independence that comes with being the owner is accompanied by extra responsibilities, meaning many hours of hard work and periods of stress. The loss of a secure income and other benefits (like paid holidays, sick pay and employer-funded superannuation) that go with salaried employment must be considered, as must the risk owners take by investing their own funds in the business; if the business fails, this investment will be lost.

Review questions 3.2

1 **List** four reasons why an individual might want to own their own business.
2 **List** three costs involved with leaving salaried employment to become a business owner.

3.3 Resources required to establish a business

Having explored all alternatives, an individual may still come to the decision that commencing their own business is their best option. The individual then needs to identify the resources required to commence their own business. These will consist of:

- *personal resources* – the qualities and traits the individual can bring to the business
- *financial resources* – how the business is to be financed. This will be discussed in detail in Chapter 4: Sources of Finance.
- *external support resources* – how professionals such as accountants and solicitors, government and professional organisations provide advice to assist small business owners to succeed.

Personal qualities of successful business owners

Even among those who are prepared to accept the risks, not all people are suited to being business owners. Successful business owners share certain personal attributes, including:

- *expertise* – a detailed knowledge of their product or service and the market into which it is being sold, as well as a range of other management issues including marketing, management, human resources, finance, the law and accounting
- *entrepreneurship* – the ability to recognise a business idea, accept the risk and transform it into an actual functioning and successful business
- *determination* – a willingness to persevere in the face of hardships and setbacks
- *confidence* – the self-belief to make decisions and then accept the consequences
- *cordiality and patience* – an ability to develop good relationships with customers and employees and resolve disputes in a pleasant manner
- *humility* – a willingness to recognise their own limitations and seek expert assistance in areas in which their knowledge is lacking.

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This may seem like a daunting list, and not all business owners possess all these qualities when they start. However, a willingness and desire to develop these qualities will allow the owner, and therefore their business, the best chance of success.

External support resources

As shown later, one of the main reasons for small business failure is a lack of managerial experience and an unwillingness to seek assistance. It is those owners who can identify their shortfalls or lack of expertise and seek professional assistance who will ensure their small business survives. There are many professionals who can assist small businesses, and some of these are listed below:

Accountants

Accountants are no longer simply bookkeepers (recorders of financial information); they are experts in providing advice and direction on ownership structures, pricing policies, tax minimisation, superannuation obligations, tax obligations regarding pay-as-you-go (PAYG) tax and Goods and Services Tax (GST), and strategies for improving business performance.

Lawyers

A small business owner can contact a solicitor or the Law Institute of Victoria to assist them in any form of legal matter. This could involve the establishment of an ownership structure such as a partnership or proprietary company, representation in civil cases, registering for necessary licenses or assistance with the lodging of a registered trademark.

Bank managers

A bank manager can provide specific advice regarding business finance and suggest alternatives in terms of financing options.

Sponsored assistance programs

In addition to these traditional sources of assistance, there are many private and government-sponsored programs to assist small businesses to survive and thrive, including:

- *TAFE courses* – courses that address specific aspects of running a small business, from food handling and Work Health and Safety (WHS) to cash management and budgeting
- *Industry associations* – groups whose members operate in a particular industry, and so are well placed to provide advice and assistance specific to that industry; for example, the Australian Retailers Association (ARA)
- *Business Victoria* – a state government initiative that provides a comprehensive online resource that is designed to help prospective owners to start, operate and develop their business (use the following link for more information: http://cambridge.edu.au/redirect/8221)
- *Small Business Mentoring Service (SBMS)* – an independent, non-profit organisation providing experienced volunteer business mentors and coaches to Victorian businesses (use the following link for more information: http://cambridge.edu.au/redirect/8222)

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- *Australian Business Licence and Information Service (ABLIS)* – provides information about licences your business may require (use the following link for more information: http://cambridge.edu.au/redirect/8224)
- The Australian Government's own website, which provides a wealth of information in regard to starting a business (use the following link for more information: http://cambridge.edu.au/redirect/8223).

Review questions 3.3

1 **Explain** the personal qualities shared by successful small business owners.
2 **List** five areas in which a small business owner must have detailed knowledge.
3 **Explain** the importance of seeking additional advice to ensure the successful running of a small business.
4 **List** and **describe** four sources that small business owners may turn to for advice.

3.4 Planning

One of the most important steps before venturing into a business is to formulate a business plan. The more information that is gathered before the business commences operations, the greater its chances of success. (In particular, a business plan may make it easier to convince a financial institution to provide finance.)

A comprehensive business plan should include:

- *a description of the business and the most appropriate business structure* (covered in detail later in this chapter)
- *a description of the product or service* – what the business will be selling or providing as a service to its customers
- *a market analysis that would include marketing strategies* – assists the business to find a target market and helps to determine the best business location
- *an analysis of the personal strengths and weaknesses of the owner* – assists the owner to identify areas where assistance or expert help will be required
- *a detailed list of establishment costs and the expected sources of finance* (covered in Chapter 4)
- *projected sales figures and estimated running costs* – breaking down these costs into fixed and variable costs would allow for the forecasting of the firm's cash and profit/loss to determine when the business can support itself from its own operations (covered in Chapter 5).

Review question 3.4

1 **List** the issues that must be addressed in a comprehensive business plan.

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3.5 Nature of business operations

The market and type of products or services offered by a business determine the nature of its operations.

Retail/trading

This type of business purchases finished goods for the sole purpose of resale. Inventory is purchased from wholesalers/manufacturers at a **cost price** and then sold to consumers through a retail outlet at a higher selling price. Trading businesses sell just about everything including clothing, hardware, CDs and sound bars, groceries and books, and they may be well known, like certain supermarket chains and clothing stores, or local businesses in shopping centres.

cost price
the original purchase price of inventory

Service

This type of business performs a service for the customer, so in fact what is being sold is the time, labour and expertise of the business. There is no physical exchange of goods. The service industry is the fastest growing sector and can include services such as cleaning, gardening and other home maintenance, and services supplied by plumbers, electricians, carpenters and mechanics.

Manufacturing

This type of business actually produces the goods it sells, using a production process (which could be on an assembly line) to transform raw materials into a finished product. This would include the makers of goods such as cars, biscuits, clothing and toys. Many of these manufacturers sell predominantly to trading businesses, but an increasing number of factory outlets sell direct to the public.

Mixed businesses

In certain cases, a business will combine one or more types of operation. For example, hairdressers not only perform a service (cutting your hair) but also sell a variety of haircare products, and car dealerships not only sell cars but also provide service centres for tune-ups.

There are also other ways of classifying operations, including mining, agriculture and hospitality, but for our purposes the ability to distinguish between trading, service and manufacturing firms, or those which combine more than one of these operations, is sufficient.

Review questions 3.5

1 **Explain** how a trading firm earns profit. **State** two examples of trading firms in your area.
2 **Explain** how a service firm earns profit.
3 **Suggest** two reasons why manufacturing firms sell predominantly to trading firms rather than to the general public.
4 **Suggest** one reason why manufacturing firms may open a factory outlet to sell direct to the public.

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3.6 Ownership structures

Video 3.1
Ownership structures

Once a potential small business owner has determined the nature of their business venture and is satisfied that they have the personal qualities, there is still more to consider. One of the most important decisions facing an individual who wishes to commence a small business is which ownership structure to adopt. This choice can have an impact on:

- the owner's personal accountability for the debts of the business
- the owner's tax liability
- the firm's ability to raise capital
- the costs of establishing the business and compliance with government regulations
- the ability to shut down the business
- control over decision-making in the business.

Whichever ownership structure is chosen, for a business to carry out its operations, it must have a registered business name (which can be used Australia wide) and an **Australian Business Number (ABN)**. An ABN is an 11-digit number used by the community and the government to identify a business. It assists with various tax and business transactions. To register for an ABN and your business name, go to the Australian Business Register (ABR) website.

Australian Business Number (ABN)
a unique 11-digit number used to identify a business

Sole proprietorship

A **sole proprietorship** is owned by a single individual, operating the business in their own right under their own name (Peter Romer) or a registered business name (Romer's Roof Repairs). It is the most straightforward and inexpensive way of structuring a business. A sole trader is not a separate legal entity, so the owner would be taxed as an individual and would have to declare all income earned from the business in their personal tax return and face personal income tax rates. Examples of a sole trader business could be a milk bar, fish and chip shop or a plumber.

sole proprietorship
a business owned by a single individual, operating their business in their own right under their own name or a registered business name

Advantages

- It is easy and cheap to set up. At the time of writing, to register a business name through the Australian Securities and Investments Commission (ASIC) costs $42 for one year and $98 for three years.
- The owner has full control over decision-making within the business.
- The owner receives all profits and has full access to the capital of the business.
- It is simple to sell or wind up. There is no charge to deregister a business name.

Disadvantages

- The owner has **unlimited liability** and is thus personally responsible for all debts and liabilities incurred by the business. This can also extend to personal assets jointly owned with another person, for example, the family home.
- The business has a limited life; the continuity of the business is in danger if the owner should die.
- There is limited access to capital, as all start-up capital must come from one person. This may limit the finance available to the business as it has to rely on the owner's financial resources and their credit rating if they wish to borrow funds.
- Since there is essentially only one person running the business, these skills may be limited and may not cover every area that is required to run a successful business.

unlimited liability
the legal status of sole proprietorships and partnerships is that they are not recognised as separate legal entities, so the owner(s) is/are personally liable for the debts of the business

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- The owner may have to endure personal hardship as they have to work excessively long hours to ensure the continued operation and success of the business. Since they are operating on an individual basis, finding time for a holiday or taking time off may be difficult and detrimental to the business.

Partnership

A **partnership** is two or more persons in business together operating under their own names (Sue Dorman and Barry Pratt) or a registered business name (Dorman and Pratt Consultancy Services) with a view to making a profit. Partnerships are generally made up of 2 to 20 legal persons but can extend beyond this number under special circumstances. (For example, accountancy firms have many partners, at least partly to spread the liability.) A partnership is not a separate legal entity; however, it requires its own Tax File Number (TFN) and a partnership tax return must be submitted to the ATO each year. The partners would be taxed as individuals on the profit from the business that they received in their personal tax return and face personal income tax rates. Examples of partnerships could include doctors, lawyers and accountants. Although not legally necessary, it is strongly recommended that a partnership be set out in writing as a legal document by a solicitor in the form of a partnership agreement. This is guided by the Partnership Act 1958. The agreement should cover all aspects of the operation of the partnership and include things such as the role of each partner, the proportion of ownership and the resolution of disputes.

partnership
a business owned by two or more persons in business together with a view to making a profit

Advantages

- It is relatively cheap to set up. To register a business name through ASIC for three years costs only $98, and a partnership agreement would attach a solicitor's fee.
- It is relatively simple to wind up and reclaim an individual's investment in the business (if a proper partnership agreement was established at the start).
- There is greater access to capital and skills. With more partners there is a greater source of financial resources to fund the business's start-up costs and future expansion. Also, there is greater access to expertise and knowledge to ensure the smooth running of the business.
- Tax advantages can exist where the partners are married, as the profits can be split between them, effectively giving them two tax-free thresholds. This reduces their tax debt but not their household income.

Disadvantages

- Control over decision-making is shared among the partners. This may lead to disagreements and personality clashes.
- The owners have unlimited liability and are thus personally responsible for all debts and liabilities incurred by the business. This liability extends to debts incurred by the other partners in the business's name, meaning each partner is personally responsible for all debts and liabilities incurred by the other partners.

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- The partnership has a limited life – if one of the partners should die, be declared insane or decide to leave the business, the partnership is dissolved.
- Profits are shared among the partners. This is normally set out in the partnership agreement but, if not, could be another reason for a dispute between the partners.

Proprietary company (Pty Ltd)

proprietary company
a business that exists as a separate legal entity that is entitled to do business in its own right

A **proprietary company** is a registered legal entity with the right to do business in its own right. It comes into existence by incorporation under the Corporations Act 2001. A solicitor normally prepares the necessary documents required for incorporation. It can be owned and operated by one person being both shareholder and director; however, it can have no more than 50 non-employee shareholders. All directors need to apply for a director identification number (director ID) through the Australian Business Register Services (ABRS). It is its own separate legal entity and so can sue and be sued, and also is subject to taxation in its own right. Examples of proprietary companies are Boost Juice Bars Pty Ltd and Don Smallgoods Co. Pty Ltd.

Advantages

limited liability
the legal status of a company that exists as a separate legal entity, so the owners have no further responsibility for liabilities incurred by the business

- **Limited liability** means the owners (shareholders) have no further responsibility for any liabilities incurred by the business unless they sign personal guarantees. Also, directors have no personal responsibility for any debts unless they caused the debts recklessly, negligently or fraudulently.
- There is a greater ability to attract capital to the business as there is limited liability.
- The life of the business is ongoing due to it being a separate legal entity. It does not cease to exist even if a director/shareholder decides to leave or dies. It exists until it is wound up.

Disadvantages

- Establishment costs are high. To register a proprietary company can cost anywhere from $576 to about $1 000.
- There may be difficulty attracting additional capital because a proprietary company cannot publicly advertise for funds. This also can make it difficult for shareholders to sell their shares and recover their investment in the company, as there may be limitations on who can purchase the shares.
- There are higher compliance costs as a result of the need to comply with tax laws. This can include fees paid to external tax advisers, time spent by personnel within the business dealing with tax matters and other related costs.
- Because it is regulated by ASIC as well as the ATO and a separate tax return is required by both these bodies each year, the degree of regulation is much higher than that imposed on sole proprietorships or partnerships.

Proprietary companies (Pty Ltd) are also referred to as ‘private companies’. Because their ownership tends to be of a smaller nature, their ownership is more difficult to transfer, but they do not have to make their financial reports available to the public.

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Public company (Ltd)

A public company (Ltd) is a large business structure that is also incorporated, so it also has its own legal existence but derives the 'Public' name because it can publicly raise funds by advertising and selling shares through the Australian Securities Exchange (ASX). It is also open to the scrutiny of the public by being listed on the stock exchange and has to make its financial reports public. It is for this reason that the regulations and compliance surrounding a public company are more stringent than those under which a proprietary company operates. There is no limit on the number of shareholders a public company can have. However, it must have a minimum number of officeholders consisting of three directors and at least one secretary. All directors must have a director ID through the ABRS.

Advantages

- Limited liability means the owners (shareholders) have no further responsibility for any liabilities incurred by the business unless they sign personal guarantees. Also, directors have no personal responsibility for any debts unless they caused the debts recklessly, negligently or fraudulently.
- There is a greater ability to attract capital to the business as they can publicly advertise for funds through share issues on the ASX.
- Greater transferability of ownership as shares are easily traded on the ASX.
- The life of the business is ongoing due to it being a separate legal entity. It does not cease to exist even if a director/shareholder decides to leave or dies. It exists until it is wound up.

Disadvantages

- Establishment costs and ongoing administration and compliance costs are high.
- Due to the nature of a public company being public, there is much more scrutiny. The company's constitution/charter, company officers and financial records all have to be made public.
- To publicly advertise for funds, the public company needs to produce a prospectus, which is a legal document provided to the public and ASIC outlining information about the company and the intended use of the funds raised.
- There is a greater separation between ownership and control. The majority of those who own shares in a public company would have nothing to do with the daily running of it.
- There are higher compliance costs as a result of the need to comply with tax laws. This can include fees paid to external tax advisers, time spent by personnel within the business dealing with tax matters and other related costs.
- Because it is regulated by ASIC as well as the ATO and a separate tax return is required by both these bodies each year, the degree of regulation is much higher than that imposed on sole proprietorships, partnerships and proprietary companies, such as the requirement to have financial reports externally audited or reviewed.
- There are greater statutory obligations with the possibility of fines and penalties if not met.
- There are greater disclosure requirements such as annual general meetings (AGM), providing all shareholders with financial reports (via mail or email) and making its constitution available to all of its shareholders.

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Review questions 3.6

1 **Define** the following types of ownership structure:
   - sole proprietorship
   - partnership
   - proprietary company
   - public company.
2 **List** the advantages and disadvantages of each type of ownership structure.
3 **Distinguish** between a private company and a public company.
4 **Distinguish** between limited and unlimited liability.
5 Referring to one Accounting assumption, **explain** the effect of unlimited liability on the recording of transactions for a sole proprietorship or partnership.

3.7 Starting versus buying

Study tip

Some of these factors could be an advantage or disadvantage, depending on your point of view.

Once a prospective owner decides to go into business for themselves, three options exist:

- starting a new business
- buying an existing business
- buying a franchise.

Starting a new business

Starting a new business involves starting a new business from scratch, and if there is no business for sale, it may very well be the only option for a prospective business owner. Its great advantage is also its main disadvantage – there will be nothing in place, meaning the owner has to decide on a location and ownership structure, purchase assets, hire staff and develop business practices before trading can begin.

Advantages

goodwill
an intangible asset representing the value of the firm's reputation, clientele, viability and future growth prospects

- Almost total freedom in determining how the business operates.
- Freedom to set customer expectations.
- No need to pay for **goodwill**.
- Rewarding for the owner knowing they have created the entire business.

Disadvantages

- No track record, so there is a greater risk of failure.
- No customer base, which could mean low cash inflows in first months or years of operation.
- Large start-up capital required that will essentially have to be provided by the owner.
- More difficult to obtain finance.

Buying an existing business

In order to overcome the uncertainties of starting a new business, another option is to buy a business that already exists. A potential buyer would need to conduct careful research into the history of the business, its future potential and the reasons the owners are selling.

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Advantages

- A proven track record can increase the chances of success.
- All assets, practices, suppliers and customers are already established.
- An immediate income stream is available.
- Previous owner(s) and current employees can assist in the change of ownership as they can provide helpful advice.

Disadvantages

- Previous success may have been dependent on the skills of the previous owner(s) and their relationship with customers.
- Difficult to change existing procedures, staff and customer expectations.
- Must pay for goodwill (which is difficult to value accurately).
- Existing assets may require major renovation, repair or even replacement.

Buying a franchise

Buying a **franchise** is an increasingly popular way of entering the world of small business, as it offers the support and advice of a large financial corporation that has a vested interest in ensuring the success of the franchisee. Under a franchise arrangement, the small business owner (the **franchisee**) purchases the right to use the name and business systems of a larger business (the **franchisor**) in return for a certain fee. Some popular and successful franchises operate in the fast-food and home gardening industries.

Like with any small business venture, the potential buyer must do their homework to ensure that the franchise operation is sound and that the company is reputable. The franchise agreement will set out the terms and conditions relating to franchise fees, operating arrangements, territory in which the franchisee can operate and the life of the agreement.

franchise
an arrangement under which one party (the franchisor) grants to another party (the franchisee) certain rights, including the use of the franchise name and business practices

franchisee
the entity that purchases the right to operate under the franchise agreement

franchisor
the entity that holds (and sells to the franchisee) the rights to operate under the franchise agreement

Advantages

- Recognised brand name/national advertising.
- Established (and proven) reputation and business practices.
- All equipment necessary to commence operations.
- Bulk buying power through the franchise group.

Disadvantages

- High purchase price, ranging from $15 000 for a lawn-mowing business to upwards of a million dollars for a fast-food restaurant.
- Ongoing franchise fees (frequently based on sales) to cover expenses such as advertising and administration.
- Rigid guidelines for operations.
- Competition from fellow franchisees.
- Dependence on the operations of the franchisor.

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Review questions 3.7

1 **List** the advantages and disadvantages of starting a business from scratch.
2 **Define** the term 'goodwill'.
3 **Explain** how goodwill can bring both benefits and costs for the purchaser of an existing small business.
4 **List** the advantages and disadvantages of buying an established business.
5 **Define** the term 'franchise'.
6 **Suggest** two reasons for the growth in the popularity of franchising.
7 **List** the advantages and disadvantages of buying a franchise.

3.8 Reasons for success and failure

Given that so many small businesses fail, a prospective small business owner must be aware of the factors on which small business success are likely to depend. Successful small businesses have:

- *high demand for their product or service*
- *a location that is visible and easily accessible for customers*
- *a thorough business plan* that details all aspects of the firm's operations
- *sufficient starting capital* that can support the business and the owner until the business is functioning in a profitable manner
- *an owner that exhibits the following qualities:*
  - a strong knowledge of the good or service that they are selling
  - business acumen – insight or good judgement when it comes to business dealings and decisions
  - humility – not being afraid to seek assistance for any areas that they feel they do not have the required level of expertise; for example, legal or financial matters
  - friendly and fair – when dealing with the public, whether that is employees or customers
  - resilience – the ability to withstand failures, learn from mistakes and resolve issues and move on.

Unfortunately, an estimated 20% of new small businesses will fail in their first year, and approximately 60% of all small businesses fail within their first five years of operation, according to the ASBFEO (Australian Small Business and Family Ombudsman), due to factors such as:

- **Competition from other small and large businesses**
  Some businesses will purposely cut prices to drive out new competitors because they can afford to endure small margins or losses for a period of time whereas new businesses cannot. It can also be difficult for new businesses to attract customers away from established businesses, especially larger ones that could offer a wider range of goods or services.
- **Poor location**
  The location could be represented by poor visibility or poor access in terms of parking. It could also be in the wrong demographic area for the customers you are trying to reach. For example, you would not establish a shop selling children's play equipment in a demographic area where the average age of the population is 60!

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- **Insufficient start-up capital to support the business or the owner(s) until sales are established**
  Initial capital not only needs to cover setting up the business in terms of its premises, fixtures and fittings, signage and inventory, but it also needs to cover the operating and ongoing expenses such as electricity, telephone, wages and advertising. Starting small business owners may also have unrealistic expectations of their initial sales figures.
- **Poor marketing, targeting either the wrong people or no one at all**
  In an ever-competitive market, getting your business to be known by the right people is all-important. The significance of modern technology highlights the need for a website and being linked to a good search engine, otherwise no one will know of your business's existence.
- **Poor management skills and a lack of willingness to seek professional advice**
  There are very few people, if any, that are experts in all fields covered by business. However, there are those that think they can do it all themselves that soon discover, to their own detriment, that they cannot.
- **Poor customer relations**
  There is an old saying in business that the 'customer is always right'; however, there are small business owners who obviously disagree and can treat customers in ways that can be seen as aggressive, unhelpful or rude. Customers will not return to a business for poor treatment.

Study tip

Use opposites here – the reasons for success are the opposite of the reasons for failure and vice versa.

Review questions 3.8

1 **List** the common characteristics of successful small businesses.
2 **List** the reasons why 60% of small businesses fail in the first five years of operation.

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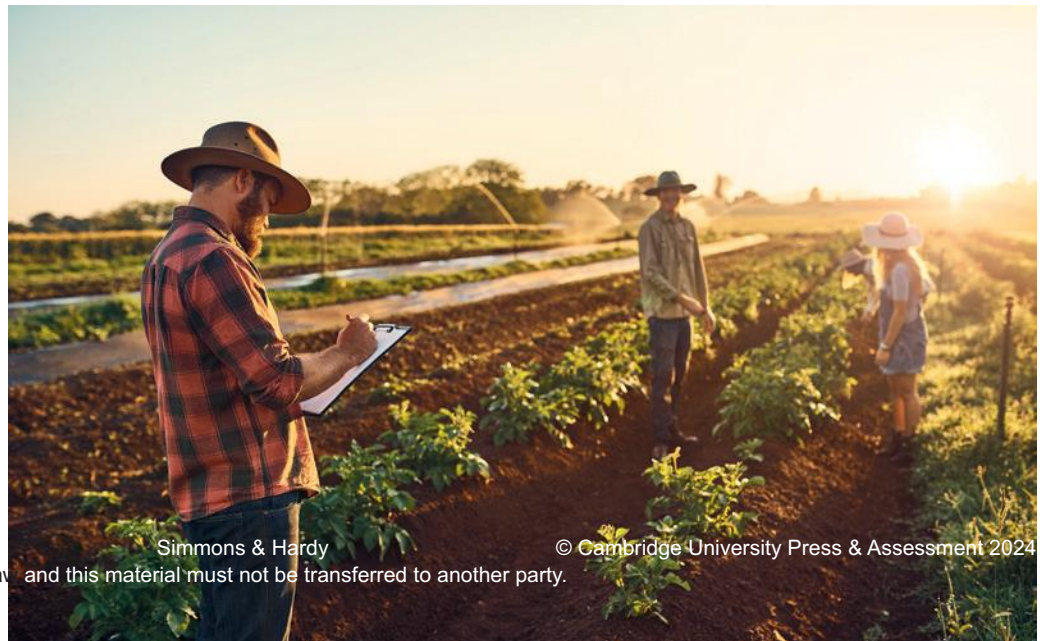
3.9 Ethical considerations when commencing a business

Ethical considerations

When commencing a business, the owner(s) have decisions to make that will ultimately have an impact on the performance of the business and determine whether or not the business remains a Going concern. There is a close relationship between the ethical performance of a business and whether or not it is meeting its legal requirements. Ethical considerations go beyond following legal requirements and reducing legal risk, as a firm with sound ethical practices will build strong goodwill for their business in the form of a strong customer base, loyalty and growing profits. An ethical business can also ensure that employees are content, thus reducing possible staff turnover and the costs of hiring.

Ethical considerations could include:

- **Treatment of employees**
  The business should ensure employees have safe working conditions and are paid correctly. In recent years, some convenience stores have received a lot of negative publicity in regard to underpaying their employees and making them work excessive hours. Some food delivery companies, though popular with customers, also faced negative press over their methods of employment, by not recognising their workers as employees but forcing them to be subcontractors so the business would not have to guarantee set hours or pay sick leave, superannuation or other benefits.
- **Products sold**
  The business should ensure that:
  - products are sourced from suppliers that provide safe working conditions and fair wages, for example, not 'sweat shops' nor those engaging in child labour. A manufacturer of athletic clothing faced severe criticism when it was discovered that in developing countries it was employing children as young as 10 to make its products.
  - products meet minimum required safety standards. This can include standards for performance, composition, components, packaging and labelling. There are mandatory standards that exist to ensure information and safety features exist for consumers. If a business deals with foods or perishable items, proper food handling and storage needs to take place.
  - products are of a particular quality and do what has been advertised and might include: Is it actually organic? Has it been sustainably sourced? Has it been genetically modified? Was it grown in Australia?
  - products are purchased from local suppliers and the suppliers support the local community or economy.



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- **Type of service**
  The business should ensure that:
  - customers are sold only what they require and not forced or charged for purchasing unwanted extras. The 2018 Banking Royal Commission discovered a toxic culture of sales techniques and that some financial institutions had lied to the corporate regulator, ASIC, and were charging fees for advice that was not actually being provided.
  - there is an avenue for complaints and that they are acted upon, and that warranty, refund or repair processes are upheld and followed through.
- **Impact on society and the environment**
  The business should ensure that:
  - products, packaging and production methods meet environmental standards and allow for sustainable production and minimal waste. The removal of plastic bags by major food retailers was a positive step for the environment, yet plastics will still be the looming environmental problem for years to come.
  - privacy is maintained if a business has personal details of their customers.
  - it sells products that have a positive social impact rather than negative, for example, tobacco and alcohol.
  - waste is correctly disposed of, for example, chemicals, oils, technology (printer cartridges, batteries, mobile phones).
- **Methods of Accounting and financial reporting**

If a business chose not to follow these and other ethical considerations but instead chose to try to cut costs or profiteer and was subsequently caught out, then the impact would be twofold:

1 damage to the business's reputation, leading to a decline in sales, profits and market share
2 large costs in the forms of fines and other penalties for breaches of the law.

Review questions 3.9

1 **Outline** two ethical considerations that a new business owner may consider and **explain** how these considerations could lead to a successful business.
2 From the following list, **discuss** an actual example where a business did not conduct itself ethically:
   - privacy
   - safety standards
   - misleading advertising.

Ethical considerations

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3.10 Alternative investment opportunities to business ownership

As stated previously, the potential business owner accepts a large financial risk if he or she commences their own business. The individual has their savings at risk, so it would not be unreasonable for that person to explore alternatives. Later, we explore a profitability indicator called *Return on Owner's Investment (ROI)*. ROI measures the return (profit) generated for the owner on the capital they have invested. Specifically, it shows the profit earned per dollar invested by the owner, so it is useful in assessing how profitable the business is as an investment. This also allows a direct comparison with other alternative investments.

The return on an investment refers to the gain made by the owner, and this can come in the form of:

1. a **capital gain** where the value of the asset in which funds have been invested increases over time so that it can be sold for more than its purchase cost
2. an **income stream** where the asset generates some type of income (such as interest, rent or dividends).

capital gain
a return generated from an investment in the form of an increase in the value of an asset that can therefore be sold for more than its purchase cost

income stream
a return generated from an investment in the form of ongoing income such as interest, rent or dividends

Investors must be clear about their objectives, as some investment options will provide for one, but not both, of these types of return.

Given the number of alternatives, it can be difficult to choose an investment option. Each investment has its own specific levels of risk, achievable rates of return for the owner, and advantages and disadvantages, and all these factors must be considered. Risky investments are likely to offer a higher return on investment. Investing carries not only the risk that a return will not be earned, but also the risk that the initial investment may be lost. Some investors would rather play it safe and achieve a moderate return on their funds, whereas others want to achieve a greater return on their funds and are willing to take the risks associated to achieve that return.

Another factor that an investor must consider is the term (length) of the investment. For investment options subject to business cycles and other fluctuations, a long-term investment may be required to generate an adequate return.

Similarly, the investor must also consider the liquidity of the investment: how easily it can be converted back into cash if the individual needed their funds urgently.

These are some examples of asset groups that could be used as investment options:

- cash
- property
- shares
- cryptocurrency.

Within each asset grouping, there are many different individual investment options, each with its own advantages and disadvantages. This list is by no means exhaustive and only highlights a number of investment options available to investors.

Review questions 3.10

1. **Define** the following types of return on an investment:
   - capital gain
   - income stream.
2. **Explain** the relationship between risk and return as it applies to investments.
3. **Explain** how the term of an investment option can affect its suitability.
4. **Explain** why an individual should explore alternative investments when considering starting their own small business.

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3.11 Investment option 1: cash

To make a cash investment means placing your cash into an instrument that will provide an income stream in the form of interest. These forms of investment are in fact you lending your money to either the government (bonds), a bank (term deposits) or a company (debentures/unsecured notes) for a specified return. Each will have their own risks and associated rates of returns. Bonds are the only form of cash investment that has the potential to provide the investor with a capital gain.

Study tip

There are no capital gains to be made with the first two investment types.

Bank accounts

The most basic and common form of cash investment is to put money in the bank or a similar institution such as a building society or credit union. It has the advantage that the cash is readily accessible and that there is virtually no risk of the business losing its investment as the government guarantees all bank deposits. However, basic business bank accounts pay a very low return, with interest on deposits earned at only 0.5% to 1.5%. (It is highly possible that when account-keeping fees are factored in, the return on a bank account could actually be negative.)

Term deposits

Term deposits are an investment option available from a bank that provides a higher rate of interest in return for agreeing to invest for a set term. The term can vary, ranging from months to years. If the investor requires the funds before the end of the term, they may be available, but this would be at the cost of any interest that would have been earned plus additional costs for early termination of the investment.

term deposit
an investment option that requires the investor to agree to invest for a specified length of time

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Bonds

bonds
a mechanism used by governments to raise funds from the general public in return for a fixed interest rate

Bonds are issued by governments when they wish to raise funds by borrowing from the public, usually over a very long period of time (such as 20 years). Because the government has to compete with banks and other financial institutions for the public's funds, it has to ensure that the rate of interest it offers is competitive. However, because they are backed by the government, bonds are very secure as an investment.

Once purchased, a bond is a tradeable investment that can be bought and sold at its market value. If the market interest rate is below the rate offered on the bond, its market value will increase; however, if the market interest rate should exceed the rate paid on the bond, then the value of the bond could fall below its face value (purchase price).

Debentures

debentures
a mechanism used by companies to raise funds from the general public in return for a fixed interest rate

security/collateral
an asset that is used to guarantee the repayment of a debt and must be given if the organisation is unable to repay the debt

prospectus
a document that provides information about a financial product to assist the investor to make an informed decision

Whereas governments issue bonds to raise cash, a company can issue **debentures**. This provides companies with an alternative means of raising funds without the need to go to banks and other financial institutions. Unlike shareholders, owners of debentures do not become owners of the company or derive the right to share its profits; they become secured creditors.

The company issuing the debentures uses its assets as **security**, so it is wise to determine the level of debt and risk associated with the company before investing. Because debentures are associated with a higher level of risk, they need to offer a higher return on investment to entice investors. Debentures are not tradeable commodities but are good investments in terms of providing a steady income stream.

Prior to issuing debentures, a company must complete a **prospectus**, which is a report stating how much money the company wishes to raise, the purpose for which it will be used, and the performance and position of the company at the time. This is to give the investor as much information as possible so that they can weigh up the risks and returns.

Unsecured notes

This is a form of debenture that is not secured against the assets of the business, which increases the risk and thus requires a higher rate of interest to entice investors. If the business should become insolvent, the holders of unsecured notes would have to line up with all the other creditors to claim the debt owed to them. However, as unsecured creditors, they would be among the last to be paid (if at all).

Review questions 3.11

1 **Explain** the main difference between a bank account and a term deposit.
2 **Explain** the difference between a bond and a debenture.
3 **Explain** the function of a prospectus.
4 **Explain** the difference between a debenture and an unsecured note.
5 **Explain** how security/collateral decreases the risk associated with an investment.

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3.12 Investment option 2: property

Investing in property essentially means buying real estate of some type, which can provide both a capital gain and an income stream in the form of rent. Some investors actually borrow to invest in property in order to earn a capital gain from the increase in its market value. In addition, as long as the rental income is less than the cost of the property (including the interest payments on the loan), the investor will make a 'loss', thus reducing their taxable income. This is known as **negative gearing**.

negative gearing
a strategy used by investors to reduce their taxable income by purchasing property that generates rental income that is less than the costs it incurs

Risks of owning property

Given the dual returns available from property, it can seem like a very attractive option. However, there are some factors that can make property a risky investment.

The property market

The general wisdom has it that property prices double every seven years, but this is not guaranteed. The property market is subject to fluctuations, meaning that timing is crucial: purchasing at the height of the market (when prices have peaked) may mean that the investor suffers a short-term loss or a smaller capital gain. Also, growth rates can vary dramatically according to the location of the property, meaning that investors must conduct careful and thorough research before making their investments.

Interest rates

Property prices are dependent on the ability of buyers to pay, which is in turn dependent on the cost of borrowing. If interest rates rise, buyers are less willing to pay high prices, meaning the market value of the property may fall. This will reduce any capital gain the investor may make. Further, the costs associated with paying loans may become unmanageable for the investor, who may then be forced to sell in unfavourable circumstances or market conditions.

Rent

Unfortunately, rental income is not guaranteed. Some investors can find it difficult to find a tenant for their property or to achieve their desired rental income. Bad tenants can create costs ranging from a loss of rental income to the cost of fixing damage or neglect.

Liquidity

Property must be viewed as a medium, to long-term investment, because disposal is not only costly, but also time-consuming. Once a buyer is found and the property is sold (which can take time), it can then take up to 90 days for settlement.

Although property can provide good returns in the form of capital gains, this gain can only be realised if the property is sold, and any profit is then subject to **capital gains tax**. On its own, the rental income from property is unlikely to match the return on other less risky investments. However, the combination of the two forms of return makes it a good investment tool, especially as a long-term investment.

capital gains tax
a form of taxation charged when a gain is made on the sale of an asset

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Managed property funds

An alternative to direct property investment is investment in a managed fund that pools the resources of a number of investors into one fund that is then invested into a range of properties, known as a **managed property fund**. This has a number of advantages:

managed property fund
an investment option that pools the resources of a number of investors to purchase property

1. It allows investors who cannot afford to purchase property on their own to access this form of investment with a much smaller outlay.
2. It allows investors to diversify into a number of property assets.
3. The investment is more liquid – investors are able to liquidate their investment much more easily.
4. Responsibility for managing the investment rests with the fund rather than each individual investor.

Although this form of investment allows for diversification, thus lowering the risk of the overall investment, it is still prone to the risks associated with the property market.

Review questions 3.12

1. **List** the main returns to be gained from investing in property.
2. **Explain** the main benefit of negative gearing.
3. **Explain** the factors that can make property a risky investment.
4. **Define** the term 'managed property fund'.
5. **List** the advantages of investing in a managed property fund compared to direct investment in property.

3.13 Investment option 3: shares

When an investor buys **shares**, they are buying part-ownership of a business, giving the shareholder some say in the running of the company. In terms of a return, it gives the shareholder access to an income stream in the form of **dividends** (a share of the firm's profit). In addition, the ability to trade shares through the stock exchange gives the shareholder a potential for capital gains if the market value of the shares increases.

share
a document that verifies part-ownership in a public company

dividend
a share of the profit earned by a company that is distributed to shareholders

Benefits of owning shares

Owning shares can bring a variety of benefits, including the following.

Greater returns

Various studies have shown that Australian shares have out-performed other forms of investment. Many investments taken with a long-term perspective tend to provide higher and more consistent returns, and shares happen to top this list.

Tax benefits

Many dividends are paid to investors from profits that have already had company tax deducted from them, reducing the tax that must be paid by the investor. This is referred to as a **franking credit**. Only if the investor is in a tax bracket higher than the company tax rate of 30% will they have to pay any tax on the dividend income. In addition, if the shares have been held for more than 12 months, they can qualify for a 50% reduction in capital gains tax. (Any shares sold at a capital loss can be used to offset any other capital gains.)

franking credit
dividend income received by the investor on which the company has already paid tax

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Diversification

There are about 2400 different companies' shares listed on the stock exchange, allowing an investment in a variety of markets and industry areas all at the one time. This means that if one segment of the market is under-performing, it may be offset by strong performance in another. Similarly, a risky investment in one company that promises a high return can be offset by a safer investment in a company offering a less lucrative return.

A growing area in terms of share investment is in companies that are socially and economically responsible or reflect the investors' own ideals and ethics. Companies are screened via their positive or negative impact on society and the environment. Positive screening would highlight companies that focus on things like renewable energy, organic produce, social responsibility (donations to or support for developing countries with investment) or recycling. Conversely, negative screening would highlight companies involved in mining (oil, coal or uranium), tobacco, logging and gambling, for example. Even managed funds and superannuation funds can be specifically geared towards investing in companies that are developing goods and services that contribute to make the world a better place.

Flexibility

Shares themselves are quite liquid and can be sold quickly to return cash to the investor if it is required.

capital loss
the loss incurred when an asset is sold at a price less than its initial purchase price

managed share fund
an investment option that pools the resources of a number of investors to purchase shares in a variety of companies

Risks of owning shares

Investing in shares carries risks similar to those involved with property, with the dividend return dependent on the profitability of the company, and the capital gain dependent on the share market. An investor who holds shares in an unprofitable company will see little or no return in terms of dividends and is also likely to suffer a **capital loss** as the market value of their shares falls below their purchase price.

Fluctuations in the market value of shares are a daily occurrence. Speculative or short-term investors attempt to predict these fluctuations by purchasing shares in new industries and businesses and then selling them when the market price is high. Investors who take this approach are more interested in a capital gain than dividends. Long-term investors, on the other hand, are more likely to purchase shares in companies that have a history of earning good profits and distributing them as dividends. (A **managed share fund** – which operates similar to a managed property fund – will reduce these risks but not eradicate them.)

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Review questions 3.13

1 **List** the benefits of becoming a shareholder.
2 **Explain** the benefits of investing in shares rather than other investment options.
3 **Explain** the risks associated with owning shares.
4 **Explain** how a managed share fund can reduce the risks associated with owning shares.
5 **Explain** how investors can make an ethical choice in terms of investing in shares.

Ethical considerations

3.14 Investment option 4: cryptocurrency

Cryptocurrency is a digital or virtual form of currency. It is secured by blockchain technology on a network that is distributed across a vast number of computers. There is no central issuing or regulating body overseeing or controlling the cryptocurrency market.

The first and most recognised cryptocurrency is Bitcoin (BTC); however, there are anywhere from 9 000 to 20 000 different types of cryptocurrencies available, as they are quite easy to create with an understanding of the technology. Some of the other more recognised cryptocurrencies are Ethereum (ETH) and Tether (USDT).

It is also important to understand there are many different types of cryptocurrencies and to ensure it fits the purpose that you are looking for. A cryptocurrency that has a purpose is likely to be less risky than a cryptocurrency that has no use.

One aspect that can be used to distinguish cryptocurrencies is the difference between crypto coins and crypto tokens. Crypto coins are currency that can be used for digital payment, whereas crypto tokens can be used to indicate an interest in an asset and/or enable transactions on a blockchain. Some of the different types of tokens that exist on blockchains include reward, utility, security, governance and asset tokens. Due to its digital and unregulated nature, there is a variety of ways that you can earn returns via cryptocurrency:

- capital gains – speculative and long-term investors may choose to purchase cryptocurrency to take advantage of the volatility of the crypto market and hope to see an increase in the value of their investment. However, volatility can cause prices to move in both directions, so investors could expect a capital loss also.
- dividends – some cryptocurrencies can offer dividends to their investors in the form of crypto tokens.
- rewards – cryptocurrencies can provide rewards for:
  - staking (essentially lending your cryptocurrency on a contract where it is essentially put to work verifying transactions and cannot be traded – this carries its own risks)
  - mining (mining new coins)
  - airdrops (free tokens for holding a particular type of cryptocurrency).

To invest in cryptocurrency, investors can:

- purchase cryptocurrency directly via a crypto exchange, using an app or through a broker. An investor can purchase a well-established currency such as Bitcoin or an unknown coin that has just been released.
- invest in cryptocurrency companies that support cryptocurrency, for example PayPal, or invest in companies that have significant holdings of cryptocurrency on their Balance Sheet. Otherwise an investor could invest in a cryptocurrency-focused fund (like a managed share fund).

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- become a crypto miner or validator. The investor will earn rewards in crypto, which they can hold on to as an investment or exchange for another currency.

Advantages

- Cryptocurrencies are decentralised and are not controlled by any regulatory body or government and therefore are not subject to government intervention or regulation, allowing freedom in transactions.
- Cryptocurrencies can be used to make safe online transactions without having to go through an institution, such as a bank, making it a faster and cheaper payment method.
- Cryptocurrencies use strong encryption processes such as cryptographic systems, making it virtually impossible to counterfeit or double spend, ensuring security.

Disadvantages

- Cryptocurrencies are well known for their significant price volatility, making them a high-risk investment.
- Due to its decentralised nature and the fact that cryptocurrency is not backed by any private or public entities, its use as legal tender (money) can be questioned. It also makes the investment more prone to fraud and scams. Furthermore, with governments seeking to track transactions and regulate cryptocurrency exchanges, it could remove the main features that make it valuable. If governments choose to ban cryptocurrency, then your investment becomes worthless.
- Due to its unregulated nature, cryptocurrency has been used in many illegal activities. This will increase pressure for it to be regulated.
- Due to its digital nature, it is more prone to cyber security attacks, and the investor could lose everything if hacked.
- There is a negative impact on the environment as cryptocurrency mining consumes a lot of energy.
- The Australian Government see cryptocurrency as an investment and as such it will be subject to capital gains tax if sold for a profit.

Review questions 3.14

1 **Explain** what distinguishes cryptocurrency as a different form of investment compared to traditional investment methods.
2 **Explain** the benefits of investing in cryptocurrencies rather than other investment options.
3 **Explain** the risks associated with owning cryptocurrency.
4 **Explain** how a crypto-focused fund can reduce the risks associated with owning cryptocurrency.

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3.15 Measuring the performance of investments: return on investment

return on investment the percentage of the amount invested that is returned to the owner in the form of income or capital gains

The Return on Investment is an analysis tool used to evaluate the performance of a business as an investment. The indicator compares the Net Profit earned by the business (the income stream for the owner) against the owner's equity (the amount invested) to allow the owner to assess the business against alternative investments. Therefore, it stands to reason that the owner should calculate a similar **return on investment** on each of these alternative investments. Figure 3.1 shows the formula to calculate the return on investment:

Figure 3.1 Formula: Return on investment

$$\text{Return on investment} = \frac{\text{Income/capital gain}}{\text{Amount invested}} \times 100$$

Example

In 2025, Byron's Beds made three separate investments of $10 000 each in:

- a five-year term deposit earning 8% interest p.a, which by 30 June 2030 had earned $4 000 interest
- a portfolio of Australian shares, which by 30 June 2030 was worth $22 000 (dividends were reinvested in more shares)
- a managed property fund, which by 30 June 2030 was worth $7 000 (the fund made no dividend payments).

Obviously, the managed property fund operated at a loss as its current value is less than its original value), but was the term deposit or the share portfolio the more profitable investment? Figure 3.2 shows the return on investment on each investment:

Figure 3.2 Comparing return on investment

Investment	Income/Capital gain	Return on investment
Term deposit	$4 000 interest	$4 000 / 10 000 × 100 = 40%
Share portfolio	$22 000 current value less $10 000 investment = $12 000 capital *gain*	$12 000 / 10 000 × 100 = 120%
Managed property fund	$7 000 current value less $10 000 investment = $3 000 capital *loss*	($3 000) / 10 000 × 100 = (30)%

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Clearly, the share portfolio has earned a higher return on investment, but the level of risk associated with each investment must also be considered. The term deposit has a lower return on investment, but this return is guaranteed, as is the amount invested. The shares, on the other hand, depend for their return on the profitability and stability of each company in which the shares are held, so there is a greater risk that a return will not be earned and that the amount invested might be lost.

Review questions 3.15

1 **State** the two types of return that can be generated by an investment.
2 **Show** the formula to calculate the return on investment.
3 **Explain** the relationship between risk and return.

Where have we been?

- Small businesses are owned and managed by the same person and employ fewer than 20 people.
- Small businesses represent roughly 97.5% of all private sector businesses, employ over 5 million people and contribute strongly to Australia's level of economic activity and production, exports and tax revenue.
- Reasons for owning a business include the profit motive, a desire for greater independence, the identification of a market opportunity and employment.
- Most successful business owners are experts in their field, entrepreneurial, determined, confident, cordial, patient and willing to recognise their own limitations and seek assistance.
- A detailed business plan is essential before operations commence.
- Businesses can be classified by the nature of their operations as trading, service or manufacturing businesses.
- The choice of ownership structure will have consequences for a whole host of issues, including the owner's personal accountability for the debts of the business.
- Sole proprietorships and partnerships have unlimited liability; companies have limited liability.
- A prospective business owner can start a new business, buy an existing business or buy a franchise.
- Successful small businesses have a high demand for their product or service, a good location, a thorough business plan, sufficient starting capital and a knowledgeable and resilient owner.
- Small businesses can gain assistance from a variety of sources.
- Four main asset groups that could be used as alternative investment options to starting a small business include cash, property, shares and cryptocurrency.
- Investors must consider the correlation between the level of risk and the return on investment, the term and the liquidity of any alternative investment.

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Exercises

Exercise 3.1
Business ownership

page 38

In 2030, Travis Sands left his job at a call centre to start his own landscape design business called Environ Landscapes. Before commencing operations, Travis drafted a detailed business plan, and as a sole proprietor, Travis has been handling the business records and reports since the business started in 2030.

Required

a. **State** two features that would distinguish Environ Landscapes from a large business.
b. **Suggest** two reasons why Travis may have decided to become a business owner.
c. **State** two personal qualities Travis would need to be a successful business owner.
d. **List** four issues Travis would have addressed in his business plan.

Exercise 3.2
Nature of operations

page 39

For each of the following businesses, **identify** the nature of its operations as one of trading, service or manufacturing:

a. Q-Mart Clothing Emporium
b. Ken Farthington, accountant
c. Mac Walter Textiles Factory
d. First Rate Plumbing
e. The Book Store
f. Digby Recording Studios

Exercise 3.3
Partnerships

page 40

Maxine Smart is the owner and operator of Ninety Nights, a small business that makes and sells designer pyjamas. Maxine started the business in March 2030 after leaving her position as a fashion designer with a major international clothing retailer. Maxine and her husband, Nigel, each contributed $20 000 of their own funds to start the business. However, Nigel was concerned that if the firm was established as a partnership, it would mean that all their personal assets, including their house and belongings, would be listed in the firm's Balance Sheet. As a result, they decided that a sole proprietorship in Maxine's name was the most appropriate business structure.

Required

a. **State** one reason why Maxine might be willing to accept less in profit than she earned as a salary in her previous job.
b. **Identify** the nature of operations of Ninety Nights.
c. Referring to one Accounting assumption, **explain** how Maxine and Nigel's personal assets will be treated in the firm's Balance Sheet.

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d. **Explain** one benefit Maxine and Nigel would derive by registering their business as a partnership rather than a sole proprietorship.
e. **Explain** how Maxine and Nigel could ensure that in the event of bankruptcy, their personal assets will not be seized to pay business debts.
f. **Explain** an ethical consideration Maxine would have considered when commencing her business.

Ethical considerations

Exercise 3.4
Partnerships

page 41

Marco Costa and Vince Carello are cousins who own and operate Ponte Vecchio Jewellers. Vince is a jeweller by trade, so Marco looks after most of the management issues. Because Marco and Vince are cousins, they have established their business as a partnership. Vince said, 'We don't need a formal partnership agreement – we are family.' Marco added, 'And when we die, our kids will take over.'

Required

a. **State** two benefits that Marco and Vince derive from operating their business together as a partnership.
b. **State** one benefit that Marco and Vince would derive from having a formal partnership agreement.
c. **State** one reason why Marco's statement is incorrect.
d. On 1 May 2030, Marco left the partnership to take up a new job. Vince decided to continue trading as a sole proprietor. **State** one reason why Vince's small business may still fail.

Exercise 3.5
Companies

page 42

Lucas George has decided to go into business creating and selling his own space-based computer games. His girlfriend, Sky, is very keen to enter into the business with him, and Lucas is unsure about what type of ownership structure to adopt.

Required

a. **Identify** the nature of operations for this new business.
b. **State** three personal qualities Lucas will require to run his business successfully.
c. **State** one advantage and one disadvantage of establishing the business as a private company rather than a partnership.
d. Assuming that the business is structured as a company, **explain** the effect on the business should the relationship between Lucas and Sky end.
e. **State** one advantage and one disadvantage of establishing the business as a public company rather than a private company.
f. **State** two arguments to support Lucas's decision to start his own business rather than buy an existing business.

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Exercise 3.6
Business issues

page 44

Piece of Cake sells cakes from a shop in Hawthorn. For the past three years it has been owned and operated as a sole proprietorship by Elena St Clair, who left her job as an analyst for a large computer company in search of greater independence. Elena has frequently called on her sister (who is an accountant) for assistance, and recently her sister expressed a desire to join Elena as a joint owner of the business.

Required

a. **State** two reasons (other than a desire for independence) why people leave paid employment to own a small business.
b. **State** two costs to Elena of leaving paid employment to start her own business.
c. **Explain** the difference between a sole proprietorship and a proprietary company in terms of their legal status.
d. **State** one disadvantage of establishing the business as a proprietary company.
e. **State** one benefit Elena would derive from entering into a partnership with her sister.
f. **State** two benefits Elena derived by buying an existing business rather than starting her own.
g. **Explain** one reason (other than insufficient professional advice) why this business may still fail.
h. **State** two sources from which Elena can seek alternative professional advice.

Exercise 3.7
Business issues

page 46

Until 2025, Jane Bronte was employed as a journalist with a local broadsheet newspaper. Although she was quite happy with her job, she left this position to start her own bookshop called Bronte's Books. At the time, a friend had suggested that it would be wise to join a franchise group.

Required

a. **Explain** one risk Jane was taking by becoming a small business owner.
b. **Explain** why the establishment costs for a new business would be less than the purchase price of an existing business.
c. **Explain** one benefit of being a member of a franchise group.
d. **State** one financial and one non-financial cost of joining a franchise group.

During December 2029, Jane decided that in addition to selling a range of classic books, the shop would also provide a small library service that would allow customers to borrow rare and antique books. The library was due to commence operations in January 2030. On 1 January 2030, the business purchased $500 worth of books for the library service.

e. **Explain** the nature of the operations of Bronte's Books in January 2030.
f. **Explain** why the books purchased on 1 January 2030 should be reported as an asset of Bronte's Books.
g. **Explain** one circumstance in which the books should be reported as a current asset as at 31 January 2030.
h. **Explain** one circumstance in which the books should be reported as a non-current asset as at 31 January 2030.

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Exercise 3.8
Alternative investments

page 48

M. Young has $20 000 that he was planning to invest in starting his own business. His friend Kathy stated he should instead invest it for five years earning 6% interest p.a. as it was a safer option.

Required

a. **Explain** two factors (other than the return on investment) that must be considered when evaluating an investment option.

Exercise 3.9
Cash investments

page 49

At the end of January 2030, Mairead had saved $8000 in her bank account towards starting her own business, Mairead's Cycles. She is considering the following investment options to increase her starting capital:

Option 1 Leave the cash in the business's bank account.
Option 2 Invest the cash in a term deposit with Alpha Bank for five years at 5% p.a. interest, which amounts to interest earnings of $2000.
Option 3 Invest the $8000 in cryptocurrency.

Required

a. **State** two advantages of leaving the cash in her bank account.
b. **Explain** why the interest rate on term deposits is likely to be higher than the interest rate on the bank account.
c. **Explain** the inherent risk with Option 3 that does not exist with the other two investment options.

Exercise 3.10
Cash investments

page 50

Con wishes to commence his own business, Con's Clothing, and has saved $50 000 to commence his business. His wife suggests that instead he should invest his savings for the next 10 years. His wife gave him the following investment options:

Option 1 Cash management account – 6% p.a., which earns $40 700 interest.
Option 2 Debenture – 6.5% p.a.
Option 3 Unsecured note – 7% p.a.

Required

a. **Explain** one difference between a debenture and an unsecured note.
b. **State** which option Con should choose. **Justify** your answer.

Exercise 3.11
Cash and property investments

page 51

Adeline has saved $120 000 to commence her own business, Hilltop Art Supplies. Her friend states that running a small business is too much hard work and risky, and that she should invest her savings instead. Adeline's friend gave her the following options to consider:

Option 1 Government bond – 5% p.a. interest
Option 2 Purchase of factory, which currently has a tenant*
Option 3 Share portfolio

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*The tenant has for some time been considering a move to larger premises but is yet to make a final decision. The tenant still has two years on their lease. Adeline considers that she could run her business from the premises as well.

Required

a. **State** two benefits Adeline would derive from purchasing the factory.
b. **Explain** two reasons why property is a riskier investment than government bonds.
c. Apart from the risk and the return, **state** one reason why Adeline may decide to invest in the share portfolio rather than the factory.
d. **Explain** one reason why Adeline may decide to invest a portion of the $120 000 in both shares and government bonds.

Exercise 3.12
Property investments

page 52

On 1 July 2026, Frank Litzenburg invested $240 000 in property instead of commencing his own business. As at 30 June 2030, the property was worth $300 000.

Required

a. **Calculate** the capital gain on the property.
b. **Calculate** the return on investment on the property:
   - over the four years
   - per year.
c. **Explain** why it may be too soon to assess the return on investment on the property.
d. **State** two benefits Frank would derive by investing in a managed property fund rather than directly in property.

Exercise 3.13
Cash and property investments

page 53

Molly O'Flaherty is considering becoming a financial partner in one of two local businesses. By investing $40 000 in Bjorn's Auto Spares, Molly would be entitled to half the profits (which in 2030 amounted to $13 000). Alternatively, Molly could invest $25 000 in Wilma's Pizza House, which would entitle her to a one-third share of the firm's profits (which in 2030 amounted to $15 000). A third option is to invest $40 000 in a term deposit, which earns 5.6% p.a. interest.

Required

a. **Calculate** the return on investment Molly would earn on each investment if the businesses were as profitable in 2031 as they were in 2030.
b. Referring to your answer to part **a**, **identify** the better investment. **Justify** your answer.
c. **Explain** one weakness of assessing the investment options in this manner.
d. **Explain** one reason why Molly might choose to invest in the term deposit rather than either of the businesses.

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Exercise 3.14
Alternative investments

page 55

As at 31 December 2030, David Farrugia decided not to commence his own business, and instead he put his savings into the following investments:

Investment 1 Government bonds – 5% p.a. interest.
Investment 2 Factory – purchased for $150 000 at the start of 2030; worth $162 000 as at 31 December 2031; rental income for 2030 and 2031 was $9000.
Investment 3 Share portfolio – purchased for $20 000 at the start of 2021; worth $53 000 as at 31 December 2031.

David is quite disappointed with the return on the factory and is considering selling this investment and his government bonds and investing the entire amount in shares.

Required

a. **Calculate** the return on investment on each option per year.
b. **Explain** one reason why it may be premature to sell the factory at this time.
c. **Explain** one benefit to be derived from the poor rental return on the factory.
d. **Explain** the tax advantages that come with owning shares.
e. **Explain** one reason why David would be unwise to invest all his funds in shares.

Exercise 3.15
Alternative investments

page 57

As at 30 June 2030, Michael Langton had the following investments:

Investment 1 Debentures – $20 000 earning 5% p.a.
Investment 2 Shares – $90 000 (worth $65 000 one year ago)
Investment 3 Unsecured notes – $80 000 earning 9% p.a.
Investment 4 Cryptocurrency – $10 000 (purchased last year at $15 000)

Required

a. **Explain** the difference between a share and a debenture.
b. **Explain** the difference between a debenture and an unsecured note.
c. **Calculate** the interest or capital gain / (loss) on each investment for the year ended 30 June 2030.
d. **Calculate** the return on investment on each option for the year ended 30 June 2030.
e. **Explain** one benefit of a diversified investment portfolio.
f. **Explain** one weakness in the way Michael has structured his investment portfolio.
g. **Explain** whether Michael should sell his cryptocurrency now. **Justify** your response.
h. **Explain** two benefits Michael would derive by selling 50% of his shares and investing the proceeds in his friend's well-established business, which is looking to expand and is currently returning 20% on capital invested.
i. Referring to your answer to part **h**, **state** one disadvantage of this course of action.
j. **Advise** an alternative course of action that would still allow Michael to invest in his friend's business. **Justify** your response.

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Chapter 4
Sources of finance

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Learning intentions

After completing this chapter, you should be able to:

- **distinguish** between internal and external sources of finance
- **describe** the various forms of finance available to small businesses
- **list** the advantages and disadvantages of each type of finance
- **explain** the guidelines for seeking external finance
- **list** the information necessary to apply for a loan
- **calculate** the Debt Ratio and Return on Owner's Investment
- **explain** the effect on the Debt Ratio of internal and external finance
- **explain** the relationship between the Debt Ratio, risk and return.

Key terms

After completing this chapter, you should be familiar with the following terms:

- internal finance
- capital contribution
- retained earnings
- external finance
- trade credit
- Account Payable
- bank overdraft
- term loan – mortgage
- lease
- lessee
- lessor
- interest-only loan
- principal and interest loan
- Return on Owner's Investment (ROI).

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4.1 Sources of finance

Unfortunately, many fantastic small business ideas never develop into actual businesses, simply because the prospective owner cannot raise sufficient finance to get the idea off the ground. As we saw in Chapter 3, buying an established business with its attendant goodwill can be expensive and requires a large capital outlay from the owner. Starting from scratch means finding enough funds to purchase all the assets the business will need to operate, as well as enough to cover the initial period when the business is unlikely to be earning much in the way of revenue. Even businesses that are already operating will need access to finance to meet their costs or fund an expansion. The question of how to raise finance then becomes an important consideration for a small business owner.

In Chapter 2, the Accounting equation identified that the assets of a business are funded from one of two sources:

1 Internal sources of finance; i.e. owner's equity
Or
2 External sources of finance; i.e. liabilities.

Internal sources of finance

internal finance
funds generated by and within the firm

Internal finance refers to funds that are generated from within the firm itself; that is, from owner's equity. This could consist of the owner contributing more capital or using retained profits to finance business operations.

Capital contribution

capital contribution
an internal source of finance consisting of cash (or other assets) contributed to the business from the personal assets of the owner

In finance terms, a **capital contribution** refers to funds contributed by the owner to commence, support or expand business operations, which creates a claim by the owner on the assets of the business. This would be the most important source of finance when a business is just starting, as banks and other lenders are generally reluctant to extend finance to unproven businesses. The size of the initial investment by the owner(s) is integral to the firm's survival as not only does it have to cover the initial set-up costs, but it also has to cover the operating costs until the business is self-sufficient and can generate its own cash flow.

Advantages:
- no set repayment date
- no interest charge.

Disadvantages:
- limited to the resources of the owner.

Retained earnings

retained earnings
an internal source of finance consisting of funds generated from business profits that are not withdrawn by the owner

Retained earnings refer to business profits that are kept to fund further expansion, so this form of finance is generally only available to businesses that are not only well established, but also profitable. If the owner has chosen to limit the amount they withdraw, this will mean that most profits are retained, providing a source of finance for other activities.

Advantages:
- no set repayment date
- no interest charge.

Disadvantages:
- limited to previous profits (which may not exist!).

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External sources of finance

External finance refers to funds that are sourced from outside the business; that is, from liabilities. This includes various forms of borrowing such as using a bank overdraft, trade credit, a lease or a loan.

external finance
funds generated from sources outside the business

Trade credit

Trade credit refers to the facility offered by suppliers that allows its customers to purchase goods or services immediately and then pay at a later date. As a result of a credit purchase, the supplier becomes an **Account Payable** of the firm making the purchase, because the purchasing business has not yet paid for the goods or services. Credit terms can be 30, 60 or even 90 days, with the due date for payment specified on the purchase invoice that accompanies the goods/services.

trade credit
a form of external finance offered by some suppliers, which allows customers to purchase goods/services and pay at a later date

Account Payable
a supplier who is owed a debt by the business for goods or services purchased from them on credit

Advantages:

- allows immediate access to goods/services
- allows businesses time to generate sales before payment is required
- discounts are available from some suppliers for early payment.

Disadvantages:

- trade credit can only be used for purchases with that supplier.

Bank overdraft

A **bank overdraft** is a facility provided by a bank (or other financial institution) that allows a business to withdraw funds greater than the current balance of its account. The amount overdrawn is then owed to the bank. This type of finance can provide a safety net for firms that have irregular cash flows, with most banks happy for the account to remain overdrawn as long as it does not exceed the overdraft limit. Although an overdraft represents a readily accessible form of finance, it usually incurs a high interest rate (compared to other loans), which is calculated on a daily basis.

bank overdraft
an external source of finance provided by a bank that allows the account holder to withdraw more than their current account balance

Advantages:

- readily accessible
- flexible – can be used for a variety of purposes.

Disadvantages:

- high interest charge
- can be recalled at short notice.

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Term loan

term loan
a form of external finance provided by banks and other lenders for a specific purpose and repaid over time

mortgage
a loan that is secured against property

Term loans are funds provided by a bank or other lender for a specific purpose and repaid over time. Increasing the length of the loan may reduce the amount of each instalment, but it will usually increase the total amount repaid over the term of the loan. In some cases, the lender will require that the loan is secured against a particular asset (this security is usually the asset for which the loan is obtained) so that if the borrower defaults on the loan, the lender is entitled to claim that asset to settle the debt. A **mortgage** is a specific type of term loan that is secured against property. Unsecured loans usually attract a higher interest rate to compensate for the higher risk accepted by the lender.

Advantages:

- makes possible the purchase of expensive assets
- flexible – can be used for a variety of purposes
- secured loans attract a lower interest rate.

Disadvantages:

- interest charges
- requires commitment by business to make repayments for the term of the loan
- principal and interest repayments can put pressure on cash flows.

Leasing

lease
a written agreement that grants to the lessee the right to use a particular asset for a specified period of time in return for periodic payments to the lessor

lessee
the entity that is leasing the non-current asset

lessor
the entity that provides the non-current asset for lease

A **lease** is a form of rental agreement that allows a business to use and control an asset for a length of time in return for specific periodic payments and is very useful for assets that need to be replaced frequently. The business applying for the lease is known as the **lessee** and the business granting the lease is known as the **lessor**. The lessee has full control of the asset for the period of the lease agreement; however, it will never own the asset.

Advantages:

- reduces initial outlay to acquire assets
- allows assets to be updated when they become outdated or technologically obsolete; for example, computers
- reduces maintenance and repair costs.

Disadvantages:

- no ownership of asset
- requires commitment by business for the term of the lease.

Review questions 4.1

1 **Distinguish** between internal and external sources of finance.
2 **List** two forms of internal finance.
3 **State** the main advantages and disadvantages of using internal finance.
4 **Define** the following types of external finance:
   - trade credit
   - bank overdraft
   - term loan
   - lease.
5 **Construct** a chart to show the main advantages and disadvantages of each form of external finance.
6 **Distinguish** between a secured loan and an unsecured loan.

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4.2 Guidelines for seeking external finance

With a variety of options to choose from, businesses must be careful to select the form of finance appropriate to their specific needs.

The term of the finance should match the life of the asset

In general, short-term assets should be purchased using short-term finance, and long-term assets should be purchased using long-term finance. For example, inventory can be purchased with trade credit or by using a bank overdraft as it will be sold quickly, and the funds it generates can be used to repay the debt. However, long-term assets such as premises should be financed using a mortgage so that the business has enough time to generate revenue to repay the loan.

The cost of interest must be considered

The interest rate is equivalent to the cost of using borrowed funds, and the borrower must be able to repay both the principal (the amount borrowed) and the interest charges. Unsecured loans will usually incur a higher interest rate than secured loans, but the method that is used to calculate the interest charge is also important. The conditions of the loan should be tailored to suit the borrower

Generally, the longer the term, the lower the instalments but the higher the total interest charges. **Interest-only loans** only require the borrower to make regular interest payments, with the entire principal repaid at the end of the term of the loan. This will reduce the amount of each regular instalment and may be suitable for the purchase of an asset, which will generate little cash over its life, but much on its sale. **Principal and interest loans** require larger repayments over the borrowing period but reduce the need for a large cash outlay at the end.

interest-only loan
a loan that requires the borrower to make regular interest payments before repaying the entire principal in one lump sum on the last day of the loan period

principal and interest loan
a loan that requires the borrower to make regular repayments of both the principal and interest over the life of the loan

Consider the impact on the Debt Ratio and the firm's ability to borrow further

The Debt Ratio measures the extent to which a business is already reliant on borrowed funds, so a lender will be interested in the firm's Debt Ratio to provide an indication of the firm's ability to repay the debt. Businesses that already have a high Debt Ratio and have a large proportion of their assets already funded by debt could be forced to accept a higher rate of interest (as the risk to the lender is higher) or could be denied further finance altogether.

Review questions 4.2

1 **Explain** why the finance term should match the life of the asset.
2 **Explain** the difference between an interest-only loan and a principal and interest loan.
3 **Explain** how a firm's Debt Ratio can affect its ability to access external finance.

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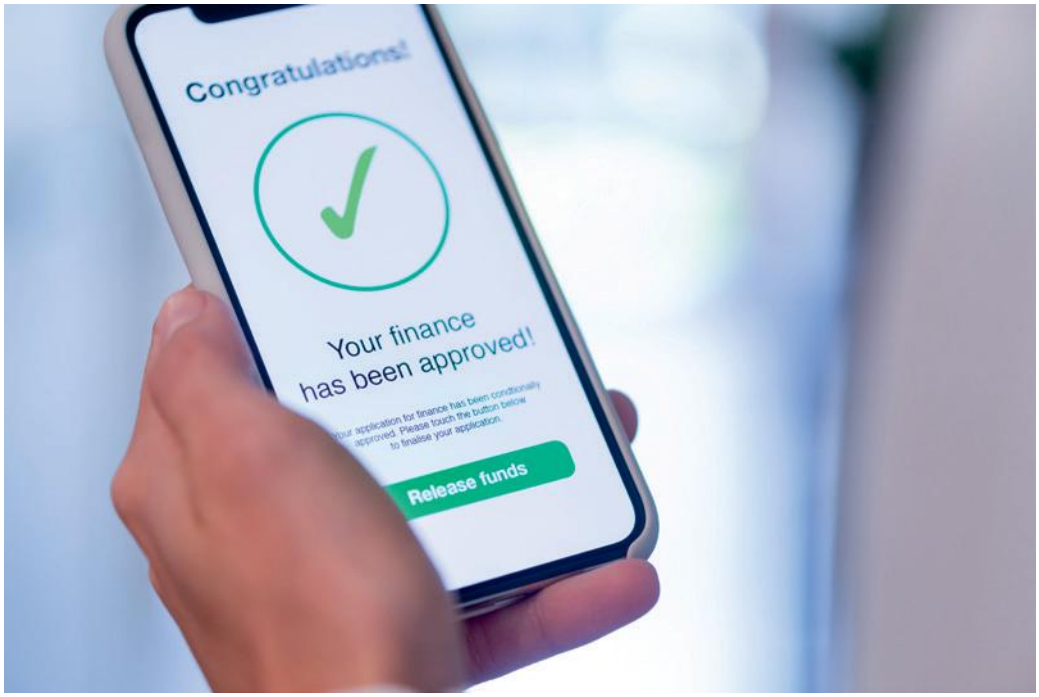
4.3 Applying for a loan

When applying for a business loan, the lender will be interested in information such as:

- *amount and purpose of the loan*
- *business details:*
  - ownership structure (e.g. sole trader, partnership, company)
  - nature of operations (e.g. trading, service, manufacturing)
  - future direction and goals
- *financial statements:*
  - Cash Flow Statement to determine if the business generates sufficient cash flows to be able to meet the debt servicing requirements of the loan
  - Cash Budget to show the likely impact of the loan on the firm's future cash flows
  - Income Statement to determine whether the firm is likely to continue trading into the future
  - Balance Sheet to determine the firm's current Debt Ratio, and the impact that the loan will have on its stability
- *credit rating:*
  - the lender will be keen to see that all previous borrowings by the business have been repaid on time and that there have not been any defaults or a history of bankruptcy
  - if this is the firm's first loan, the bank may focus on the owner's personal credit rating as well
- *deposit:*
  - the amount that will be contributed by the business (or more specifically its owner) towards the purchase
- *security:*
  - the collateral (assets) the business will provide as security in case the loan repayments cannot be met
  - small business owners frequently have to put up personal assets as collateral to ensure that their business can get the loan.



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Review questions 4.3

1 **List** the various types of information that must be provided when applying for a loan.
2 **Explain** the role of the following financial statements in the process of applying for a loan:
- Cash Flow Statement
- Income Statement
- Balance Sheet.

4.4 Debt Ratio and risk

As we noted in Chapter 2 and earlier in this chapter, the Debt Ratio assesses the extent to which a business relies on external finance to funds its assets, by measuring the proportion of its assets that are financed by liabilities. Figure 4.1 shows the formula to calculate the Debt Ratio:

Figure 4.1 Formula: Debt Ratio

$$\text{Debt Ratio} = \frac{\text{Total Liabilities}}{\text{Total Assets}} \times 100$$

Example

The owner of Glendale Plumbing has provided the following information:
Total Liabilities $120 000
Total Assets $160 000

The Debt Ratio would be calculated as is shown in Figure 4.2:

Figure 4.2 Calculation: Debt Ratio

$$\text{Debt Ratio} = \frac{\$120\,000}{\$160\,000} \times 100$$
$$= 75\%$$

This means 75% of the finance used to purchase the asset of Glendale Plumbing is external – it has come from outsiders. Using external finance to purchase assets will increase the Debt Ratio; using internal finance will have the opposite effect.

Dangers of a high Debt Ratio

A high Debt Ratio indicates a high reliance on liabilities and consequently a high risk of financial collapse, as the business must be able to meet not only the loan repayments, but also the interest charges. If expected cash inflows do not eventuate, the business must still meet its repayments: if it cannot, it could result in the financial collapse of the business.

Further, a high Debt Ratio may actually prevent a business from being able to access more borrowed funds as lenders perceive that the risk is too high.

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Benefits of a high Debt Ratio

However, borrowing does give the business access to funds to purchase assets that it may not have been able to afford by only trying to raise funds internally. These assets should allow the business to expand its revenue-earning capability and increase its profits. Further, a high Debt Ratio means a higher return for the owner, as he or she has less capital invested but still earns all the profits. That is, high risk will mean high return for the owner. This is further explained in Section 4.5.

Review questions 4.4

1 **Define** the term 'Debt Ratio'.
2 **Show** the formula to calculate the Debt Ratio.
3 **Explain** how the choice of internal or external finance can affect the Debt Ratio.
4 **Explain** the dangers of a high Debt Ratio.
5 **State** two benefits of a high Debt Ratio.

4.5 Debt Ratio and Return on Owner's Investment

Return on Owner's Investment (ROI) a profitability indicator that measures how effectively a business has used the owner's capital to earn profit

When assessing the level of debt, the owner should also consider its relationship to the **Return on Owner's Investment (ROI)**. Return on Owner's Investment assesses how profitable the owner's investment has been by measuring how many cents profit the business earns for every dollar invested by the owner. Figure 4.3 shows the formula to calculate the Return on Owner's Investment:

Figure 4.3 Formula: Return on Owner's Investment

$$\text{Return on Owner's Investment (ROI)} = \frac{\text{Net Profit}}{\text{Average Capital}} \times 100$$

Example

The owner of Glendale Plumbing has provided the following information:

Net Profit	$10 000
Owner's equity	$40 000

The Return on Owner's Investment would be calculated as is shown in Figure 4.4:

Figure 4.4 Calculation: Return on Owner's Investment

$$\text{ROI} = \frac{\$10\,000}{\$40\,000} \times 100$$
$$= 25\%$$

A Return on Owner's Investment of 25% means that for every dollar of capital invested, the owner has earned 25c profit.

The level of the Debt Ratio will have a direct and significant effect ROI. A high Debt Ratio means high risk, but it should also mean a high ROI because the business is earning profit, but it is using outside funds to do so. That is, the owner still receives all the profit earned by the business, but the owner has had to contribute very little in the way of capital to earn that profit.

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Example

Blue Chip and Speculative both operate in the same industry. They have provided the following information for 2030:

	Blue Chip	Speculative
Net Profit	$25 000	$25 000
Total Liabilities	$20 000	$80 000
Owner's equity	$80 000	$20 000
Total Assets	$100 000	$100 000
Debt Ratio	20%	80%
Return on Owner's Investment	31.25%	125%

Video 4.1
Risk and return

Despite both businesses earning the same Net Profit, the owner of Speculative has earned a ROI of 125% – four times the return by the owner of Blue Chip (31.25%). This has been possible because Speculative has used more external finance (reflected in a Debt Ratio of 80%) to fund the purchase of its assets, meaning a relatively small investment by the owner. Speculative's owner is being rewarded for accepting a very high level of financial risk.

Review questions 4.5

1 **Show** the formula to calculate Return on Owner's Investment.
2 **Explain** why high risk (a high Debt Ratio) leads to a high return (Return on Owner's Investment).

Where have we been?

- Finance for the establishment, operation or expansion of a small business can come from internal sources such as capital contributions and retained profits (owner's equity) or from external sources like a bank overdraft, trade credit, a lease or a loan (liabilities).
- Internal finance has no set repayment date and no interest but is limited in terms of availability.
- Debt Ratio assesses the extent to which a business relies on external finance to fund its assets by measuring the proportion of its assets that are financed by liabilities.
- A high Debt Ratio indicates a high reliance on liabilities, and consequently a potentially high risk of financial collapse.
- A high Debt Ratio means a higher return for the owner, as they have less capital invested but still earn all the profits.

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Exercises

Exercise 4.1
Sources of finance

page 61

For each of the following examples, **identify** the type of finance that would be most appropriate, and provide one reason to **justify** your answer:

a. premises
b. inventory of materials
c. equipment (useful life – two years)
d. wages
e. vehicle (modifications necessary)
f. franchise license (start-up).

Exercise 4.2
Sources of finance

page 62

Marina Andretti is the owner and operator of Perfect Printing, a firm that produces advertising material for other small businesses. Much of her work is done using printing equipment, which is subject to constant technological advancements. Marina has decided to purchase new printing equipment worth $24 000 using internal finance.

Required

a. **Explain** why the new equipment should be classified as a non-current asset.
b. **State** one advantage of using internal finance to purchase the new printing equipment.
c. **Explain** how the use of internal finance to purchase the new printing equipment will affect the Accounting equation of Perfect Printing.
d. **Explain** one benefit that may be derived by leasing instead of purchasing the printing equipment.

Exercise 4.3
Sources of finance

page 63

Mobile Mike is seeking to purchase a new van worth $40 000 to transport all his DJ equipment. If Mike buys the van, he will probably keep it for five years before selling it for about $25 000. Mike has identified the following financing options:

- five-year term loan – with a total interest charge of $20 000
- lease – $100 per week for five years.

Required

a. **State** one advantage of using the loan as a source of finance.
b. **Calculate** the overall cost of using the loan if the vehicle is sold after five years.
c. **Calculate** the cost of leasing the vehicle over the five-year period. **Show** all workings.
d. **Identify** which alternative Mike should use. **State** one reason, besides cost, why he should adopt this method of finance.

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Exercise 4.4
Sources of finance

page 64

Voracious Vines is seeking to expand by purchasing a new van. The van will require modifications to ensure the safe transport of the owner's plants, and (including the modifications) it is expected to cost $30 000. After some investigation, the owner has selected retained earnings as the preferred financing option.

Required

a. **State** one limitation of using retained earnings as a source of finance.
b. **Explain** one reason why it may be inappropriate to use a lease to obtain the van.

Exercise 4.5
Sources of finance and interest

page 65

Vicki Pavidis is the owner of Clear Shot, a small photo-processing lab in Mentone. Vicki is seeking to expand her business by acquiring new digital imaging equipment, the latest in the market for speedy film processing. A salesperson has provided Vicki with a quote for the new acquisition of $120 000, but with the rate of technological change that is present in this line of work, the salesperson estimates that the equipment would have an expected useful life of four years. Vicki has identified three financing options:

- capital contribution
- lease arrangement of $1 500 a fortnight for four years.
- four-year (unsecured) term loan – with a total interest cost of $25 000.

Required

a. **State** one advantage and one disadvantage of using a capital contribution to finance the acquisition of the equipment.
b. **Calculate** the cost of leasing the equipment over the four-year period.
c. **Explain** why the interest rate on an unsecured loan would be higher than that of a secured loan.
d. Referring to the information provided, **explain** why the cheapest option is not necessarily the most suitable.

Exercise 4.6
Debt Ratio

page 66

As at 31 December 2030, the Balance Sheet of Holding Architecture revealed the following:

Total Assets	$250 000
Total Liabilities	$190 000

Required

a. **Define** the term 'Debt Ratio'.
b. **Calculate** the Debt Ratio for Holding Architecture as at 31 December 2030.
c. **Explain** why a high Debt Ratio indicates high risk.
d. **State** the effect on the Debt Ratio if Holding Architecture purchases new equipment using:
   - a capital contribution
   - external finance.

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Exercise 4.7
Debt Ratio and Return on Owner's Investment

page 67

As at 1 January 2030, Feline Grooming had owner's equity worth $75 000. The firm's Balance Sheet as at 31 December 2030 revealed the following:

Total Assets	$120 000
Total Liabilities	$40 000
Profit (for 2030)	$10 000

Required

a. **Calculate** the Debt Ratio of Feline Grooming as at 31 December 2030.
b. **Calculate** the Return on Owner's Investment (ROI) for Feline Grooming for 2030.
c. **Explain** the relationship between risk and return.
d. **Explain** one way the owner could increase her Return on Owner's Investment without changing profit.

Exercise 4.8
Debt Ratio and Return on Owner's Investment

page 68

In the process of applying for a loan, the owner of Woodie's Tree Surgeons has been asked by the bank to provide the firm's financial reports. Woodie feels that the business is in great financial shape as it achieved a Return on Owner's Investment of 20% last quarter.
The Balance Sheet as at 31 March 2030 revealed the following:

Current Assets	$30 000
Non-Current Assets	$290 000
Current Liabilities	$25 000
Non-Current Liabilities	$175 000
Profit (for the quarter ending 31 March 2030)	$12 000

Required

a. **State** one other financial report that the bank would be interested in viewing prior to granting the loan. **Justify** your answer.
b. **Calculate** the Debt Ratio of Woodie's Tree Surgeons as at 31 March 2030.
c. **Calculate** the Return on Owner's Investment (ROI) for Woodie's Tree Surgeons for the quarter ending 31 March 2030.
d. Referring to your answer to part **c**, **explain** whether Woodie should be happy with this Return on Owner's Investment.
e. **Explain** one benefit of a high Debt Ratio.

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Exercise 4.9

Sources of finance, interest and Debt Ratio

page 69

Imelda Avalon is the owner and operator of Traveller's Friend, a travel agent in Horsham. The firm has been operating for three years, but Imelda is looking to expand its operations by hiring another two agents. This will involve moving to larger premises and purchasing a new computer network, as well as a number of other assets. At 30 June 2030, the firm had the following assets and liabilities:

TRAVELLER'S FRIEND
Balance Sheet as at 30 June 2030

	$	$		$	$
Current Assets			**Current Liabilities**		
Accounts Receivable	6500		Bank overdraft	6000	
GST receivable	300		Accounts Payable	1000	
Inventory of brochures	200	7000	Mortgage – nab	3000	10000
Non-Current Assets			**Non-Current Liabilities**		
Vehicle	26000		Mortgage – nab		44000
Computer equipment	5000				
Premises	82000	113000	**Owner's equity**		
			Capital – Avalon		66000
Total Assets		120000	**Total Equities**		120000

Additional information:

- Mortgage – nab is repayable in equal monthly instalments.
- All Accounts Payable are due in 30 days or less.
- The bank overdraft has a limit of $12000.

Required

a. **Calculate** the amount of each monthly instalment on Mortgage – nab.
b. **Explain** why the interest rate will usually be lower on a mortgage than on a term loan.
c. **Calculate** the Working Capital Ratio (WCR) for Traveller's Friend as at 30 June 2030.
d. Referring to your answer to part **c**, **explain** whether this Working Capital Ratio is satisfactory.
e. **Explain** one way that Traveller's Friend could use short-term finance to address its liquidity situation.
f. **Calculate** the Debt Ratio of Traveller's Friend as at 30 June 2030.

Imelda has decided to obtain a new computer network at a cost of $8000 and has identified the three best options as:

Option A Lease the computer network at a cost of $350 per month for two years.
Option B Borrow $8000 and repay over two years from St Jim Finance at 7% p.a., with a total interest charge of $700.
Option C Make a capital contribution of $8000 cash.

g. **Calculate** the total cost of the lease in Option A.
h. **Explain** the effect of Option B on the Return on Owner's Investment of Traveller's Friend.
i. **Explain** the effect of Option C on the Debt Ratio of Traveller's Friend.
j. **Advise** the owner which type of finance should be used to purchase the new computer network.

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Chapter 5
Price-setting strategies

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Learning intentions

After completing this chapter, you should be able to:

- **explain** the importance of appropriate pricing
- **calculate** minimum desired profit
- **calculate** a profit or a loss – prepare a simple Income Statement
- **explain** and **apply** various pricing methods
- **calculate** the mark-up
- **prepare** a cost-volume-profit analysis.

Key terms

After completing this chapter, you should be familiar with the following terms:

- mark-up
- minimum desired profit
- cost-volume-profit analysis
- recommended retail price (RRP)
- break-even point
- competitors' prices
- variable costs
- market reaction
- fixed costs
- quote.

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5.1 Pricing and profit

Once a firm has been legally established, has organised its finance and has paid for its start-up costs, it is ready to begin trading. At this point, the owner needs to make a very important decision: what price should I charge? If prices are set too high, customers may be driven into the arms of the firm's competitors, and insufficient sales will be made. However, if prices are set too low, the business may generate plenty of sales, but those sales will not provide sufficient revenue to meet expenses, and the firm will not be able to earn a profit. It is therefore crucial that the owner is able to determine a suitable price that will provide for a profit and allow the business (and its market share) to expand.

minimum desired profit a lowest acceptable profit figure, usually similar to previous income plus a return on the amount invested

Desired Net Profit

As was indicated in Chapter 3, one of the strongest reasons to become a small business owner is the profit motive. As the manager, the owner would be looking to the business to pay them a wage/salary, and as the owner, they would require some kind of return on their investment in the business. Thus, the owner would have in mind a **minimum desired profit** – a requirement that the business earns a profit comparable with their previous income (usually from paid employment) plus a return similar to what they would have earned had they invested their funds elsewhere.

Example

Mark Griggs has decided to leave paid employment to go into business. As a groundskeeper he was earning $600 per week, and he has managed to save $15 000, which is currently earning 5% p.a. in a term deposit.

Mark's minimum desired profit as a small business owner would be calculated as is shown in Figure 5.1:

Figure 5.1 Calculating minimum desired profit

Wage equivalent	$600 per week × 52 weeks	$31 200
Return on investment	5% × $15 000	750
Minimum desired profit		$31 950

This desired profit can be broken down into quarterly, monthly or even weekly figures to assist the owner to determine if they are on target to achieve their profit goal.

While it is true that a new small business will have minimal profits (and perhaps even losses) as it establishes itself in the marketplace, the owner has to ensure that the business is achieving a return that makes it worth being the owner. If the proposed business venture cannot meet this goal, then the viability of the business itself is in doubt.

Review questions 5.1

1 **Explain** why prices must not be set too high.
2 **Explain** why prices must not be set too low.
3 **State** two reasons why a business owner must set a minimum desired profit.
4 **Show** how the minimum desired profit is calculated.

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5.2 Pricing methods

There is a variety of methods that can be used to set selling prices, and in practice prices will be set using some combination of the following strategies:

- recommended retail price
- competitors' prices
- market reaction
- quotes
- percentage mark-up
- cost-volume-profit analysis.

Recommended retail price

The easiest way for a trading firm to set prices is to adopt the **recommended retail price (RRP)** – the selling price suggested by the manufacturer or wholesaler on goods such as books, magazines and cards. These recommended prices are not mandatory, and it is up to the retailer to decide whether to use them. However, many retailers will use the recommended price, and this may create some pressure to follow suit to ensure that prices remain competitive. It is important to remember that the recommended retail price would include GST.

recommended retail price (RRP)
a selling price that is recommended by the manufacturer or wholesaler

Competitors' prices

Depending on the level of competition in the market, businesses will need to adjust their selling prices to ensure that they are comparable with **competitors' prices**. If prices are set too high, then sales will be lost to cheaper competitors and profit will suffer.

Some (particularly larger) businesses are aggressive in their pricing strategies, promising to not only match but better a lower advertised price by 10%. Small businesses cannot always compete with this type of market power and may choose instead to charge a slightly higher price and compete instead on service, expertise or product range. But even in these cases, they must still be mindful of the prices available elsewhere.

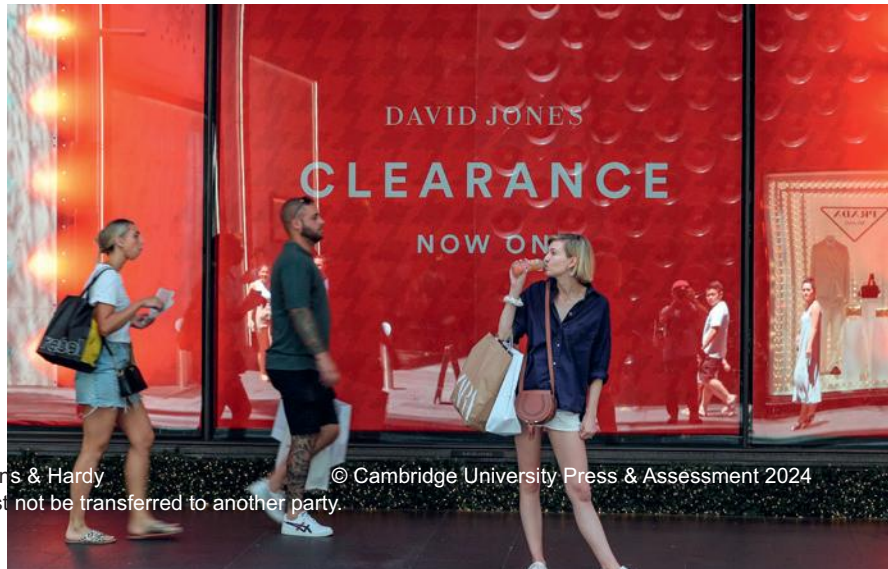
competitors' prices
prices charged by businesses competing in the same market

Market reaction

Almost regardless of the price recommended by the wholesaler or set by a competitor, the **market reaction** can be a powerful factor in setting prices. If demand is particularly high, then selling prices can be set higher, because customers are so keen to get their hands on the product that they are willing to pay a higher price. This is particularly the case with new and fashionable items, like clothing and technology, or toys before Christmas. On the other hand, if there is no demand at a particular price, the business will have no choice but to discount its prices to generate sales. This can be seen at post-Christmas sales where businesses offer large price reductions to clear inventory.

These three methods for setting selling prices are based more on observation than calculation and require the owner to be aware of the market in which the business is operating. However, while they may ensure

market reaction
the response of customers in a particular marketplace to price levels for a particular good or service



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that the firm's prices are competitive and reasonable to the market, setting prices in this way does not ensure that the most basic goal of all – that of earning a profit – will be achieved. For this to occur, the owner must use techniques such as mark-ups or conduct a cost-volume-profit analysis. (See the following pages for a discussion of these techniques.)

Review questions 5.2

1 **List** the various techniques that can be used by a small business to set selling prices.
2 **State** two reasons in favour of using recommended retail price.
3 **State** one reason why recommended retail price cannot be used to set all prices.
4 **Explain** why it is important to account for the prices charged by competitors.
5 **Explain** how the reaction of the market can lead to:
   - increased selling prices
   - decreased selling prices.
6 **Explain** one limitation of relying on recommended retail price, competitors' prices and the market reaction to set prices.

5.3 Quotes

quote
a method of determining a selling price by estimating the costs involved with a particular job, and then adding on a certain amount to provide for profit

For some businesses, setting a standard price for each and every product or job will not be appropriate, because each product/job will be unique. This is particularly the case for service businesses, where the amount of labour involved or the cost of the parts required can vary from job to job. In cases such as this, the preparation of a **quote** may be a more effective way to determine a selling price. A quote involves estimating the costs involved with each individual job, and then adding on a certain amount to provide for profit, so that the price of each job is different.

From the perspective of a service firm, the fee charged for a particular service will depend on the individual job and what is required to carry it out, but each quote must take into account:

- cost of labour
- cost of materials
- desired profit.

Example

JB Electrics has been asked to supply and install 10 new lights, and the owner has estimated the following costs for the job:

Cost of lights	$50 per light fitting
Cost of cable and attachments	$8 per metre
Cost of labour – electrician	$35 per hour

The owner estimates that the job can be completed in four hours, using 20 metres of cable. The owner's minimum desired profit equates to $720 over a 36-hour week.

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The quote for this job would thus be calculated as is shown in Figure 5.2:

Figure 5.2 Preparing a quote

Labour:		4 hours × $35 per hour	$140
Materials:	Lights	10 lights × $50 per light	$500
	Cable and attachments	20 metres × $8 per metre	$160
Desired profit		$720/36 hours × 4 hours	$80
Total price quoted			**$880**

Providing a quote does not mean the owner can ignore the level of competition and the market conditions, and so some flexibility may be required. In some cases, a business may accept less than its quoted price because:

- the business is just starting out and needs to establish its name or reputation.
- there is strong competition in the marketplace, so profit margins may have to be reduced to ensure sales are made
- the client may be a valued customer or have good connections that may ensure a good stream of steady work in the future.

In other cases, it may be a better business decision to refuse to do the job for less than the quote because:

- due to a high demand, the business may have so many jobs lined up that it can afford to reject jobs that are less profitable
- the lower price would mean a loss on the job.

Review questions 5.3

1 **Explain** why service firms are more likely to set prices using quotes.
2 **State** the three main factors involved in calculating a quote for a particular job.
3 **State** three reasons why a business may accept a job at a price lower than the quoted price.
4 **State** two situations in which a business should not accept a job at a price lower than the quoted price.

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5.4 Mark-up

mark-up determining selling prices by adding to the cost price a predetermined profit margin

When costs are well defined and the owner knows the return that they want to achieve on a product, then a **mark-up** can be applied to the cost price. A mark-up is a predetermined profit margin (expressed as a set amount, or a percentage of the cost price) that is added to the cost price of a product to determine its selling price. Figure 5.3 shows the formula for calculating selling prices using a percentage mark-up:

Figure 5.3 Formula: Applying a percentage mark-up

$$\text{Selling price} = \text{Cost price} \times \left(1 + \frac{\text{Mark-up}}{100}\right)$$

Example

Funk Fashions purchased 200 hats for $30 each and wishes to sell them at a 50% mark-up.

The mark-up price would be determined as follows:

Figure 5.4 Calculation: Mark-up price

$$\text{Mark-up price} = \$30 \times \left(1 + \frac{50}{100}\right)$$
$$= \$45$$

Study tip

To calculate the cost price when given the selling price, use the same formula but work backwards. However, remember to remove any GST first!

Funk Fashions would then need to add GST to this amount to determine the price the customer will be required to pay.

The final selling price would be determined as follows:

Figure 5.5 Calculation: Selling price

$$\text{Selling price} = \text{Mark-up price} + 10\% \text{ GST}$$
$$= \$45 + \$4.50$$
$$= \$49.50$$

In businesses such as those that sell electronic or white goods, knowing the mark-up on particular products allows sales staff to discount selling prices to generate sales while still maintaining a minimum profit margin.

Review questions 5.4

1. **Define** the term 'mark-up'.
2. **Explain** the circumstances in which it would be appropriate to use a percentage mark-up to set selling prices.
3. **Show** the formula for calculating selling prices using a percentage mark-up.
4. **State** what must be added to the mark-up price to determine the final selling price for customers.

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5.5 Cost-volume-profit analysis

At various times during this chapter we have considered the implications of the 'Law of Demand' on price setting. This law of economics states that as selling prices rise, demand – or sales volume – will decrease, but as selling prices decrease, demand will increase. At the same time, as the volume of sales increases, so too will some costs (such as the total cost of purchasing the goods that are sold). This means there is a relationship between selling prices, cost prices and the volume of sales (the quantity sold), and this relationship is reflected in a **cost-volume-profit analysis**. A cost-volume-profit analysis can be used to determine the quantity of products a business may need to sell, or the selling price it must charge, to break even. (The **break-even point** is where the business makes neither a profit nor a loss – profit is zero.)

cost-volume-profit analysis
an analysis tool that allows a business to determine a selling price or volume of sales that will let them achieve a specific profit goal

break-even point
the level of sales where total revenue equals total expenses and the business makes neither a profit nor a loss

Fixed and variable costs

Because a cost-volume-profit analysis assesses the relationship between costs and volume of sales, it is important to distinguish between costs that vary with the volume of sales and those that do not.

Variable costs

Variable costs are costs that vary in total directly with the volume of sales. They are expressed as per unit cost because every time a unit is produced and sold, the total cost incurred increases. For example, if it costs $40 to make one cabinet, it will cost $80 to make two, $200 to make five, and so on. The cost of ingredients in a pizza, or the cost of the parts used in making a product, would be considered to be variable costs because if no goods are sold, no costs are incurred.

variable costs
costs that vary directly with the level of activity

Fixed costs

Fixed costs are those that do not vary with the volume of sales, meaning they remain the same regardless of any change in the level of activity. The most common examples of fixed costs are items such as rent, insurance and salaries, which are based on a period of time rather than a number of sales.

Just because costs like these are said to be fixed does not mean they will never change. Rather, they are independent of the volume of sales. Further, they are usually fixed within certain parameters such as:

- *time* – a cost is usually only fixed for a specified period of time, and when this period expires the cost may change. (Once the change occurs, the cost will again be fixed for a specified period, of time.) Rent is a good example of this. It is normally fixed for the contractual period but when that time is up, the rent price can be renegotiated and then it is fixed again for the length of the new contract.
- *range of activity* – a cost is usually only fixed for a specified range of activity, and if the volume of sales exceeds that range, the cost may change. Rent can also be used as an example in this case. If the premises the business owner is renting allow for the production and sale of 100 units per month and then the owner wants to expand production and sales to 200 units per month, they will have to upgrade to bigger premises. This will result in a changed cost.

fixed costs
costs that do not vary with the level of activity

Study tip

Fixed costs are usually expressed in units of time, whereas variable costs are expressed on a per unit basis.

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Cost-volume-profit formula

Figure 5.6 shows the formula that combines all this information in a cost-volume-profit analysis:

Figure 5.6 Formula: Cost-volume-profit

$$\text{Quantity to be sold} = \frac{\text{Total fixed costs + Profit}}{\text{Selling price per unit – Variable cost per unit}}$$

contribution margin the Gross Profit from each sale that goes towards covering fixed expenses and contributing to Net Profit, calculated by deducting variable costs from the selling price

This formula calculates how many products need to be sold in order for the business to earn a certain profit, and at break-even point (where revenue equals expenses) that profit is zero.

The bottom line of the equation calculates how much Gross Profit is generated from every item that is sold. This Gross Profit per item, or **contribution margin**, is what will be available to meet the fixed costs and provide for profit.

(It should be noted that this formula assumes that costs can be clearly identified as variable and fixed, that selling prices and all costs will remain constant, and that all goods produced will be sold. If these assumptions do not hold, the formula is less useful.)

Example

Terry Wilson makes birdhouses. He has done some preliminary costing, and has come up with the following estimates:

Rent of factory space	$300.00	plus $30 GST	per week
Timber	$9.90	including $0.90 GST	per birdhouse
Varnish and paint	$4.40	inclusive of GST	per birdhouse
Hire of market stall	$60.00	plus GST	per week
Transport costs	$40.00	plus $4 GST	per week
Nails, screws, handles etc.	$2.20	including $0.20 GST	per birdhouse

Terry plans to sell each birdhouse for $27.50 inclusive of GST.

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Remember when determining costs that GST is not an expense and must be excluded from the calculation.

The variable cost of each birdhouse would be calculated as follows:

Figure 5.7 Variable cost per unit

Timber	$9	per birdhouse
Varnish and paint	$4	per birdhouse
Nails, screws, handles etc.	$2	per birdhouse
Total variable costs	**$15**	**per birdhouse**

The total fixed costs would be calculated as follows:

Figure 5.8 Total fixed costs

Rent of factory space	$300	per week
Hire of market stall	$60	per week
Transport costs	$40	per week
Total fixed costs	**$400**	**per week**

Substituting these figures into the cost-volume-profit formula allows us to calculate how many birdhouses Terry would need to sell in one week to break even.

Remember that the selling price was inclusive of GST, so we need to remove the GST element as this cannot be included as revenue. We do this as follows:

GST inclusive price × 10/11 = Selling price excluding GST

Therefore

$27.50 × 10/11 = $25

Or we can just divide the GST-inclusive selling price by 11 to determine the GST amount and subtract that from the GST-inclusive price:

$27.50/11 = $2.50

$27.50 – $2.50 = $25

Therefore, the sales figure we use in this calculation is $25.

Figure 5.9 Calculation: Quantity to be sold to break even

$$\text{Quantity to be sold} = \frac{\text{Total fixed costs + Profit}}{\text{Selling price per unit – Variable cost per unit}}$$

$$= \frac{\$400 + \$0 \text{ profit}}{\$25 - \$15}$$

$$= \frac{\$400}{\$10}$$

$$= 40 \text{ birdhouses}$$

In this example, Terry will earn a contribution margin of **$10** per birdhouse. Therefore, in order to make enough Gross Profit to meet his fixed costs of $400 per week and break even, he will have to sell 40 birdhouses each week. If he sells more than 40, a profit will result; if fewer than 40 are sold, it will lead to a loss.

Study tip

Make sure that GST is removed from your selling price and variable and fixed costs before you put them into the equation.

Study tip

Make sure that all fixed costs are expressed in the same unit of time – that is, per week, per month or per year.

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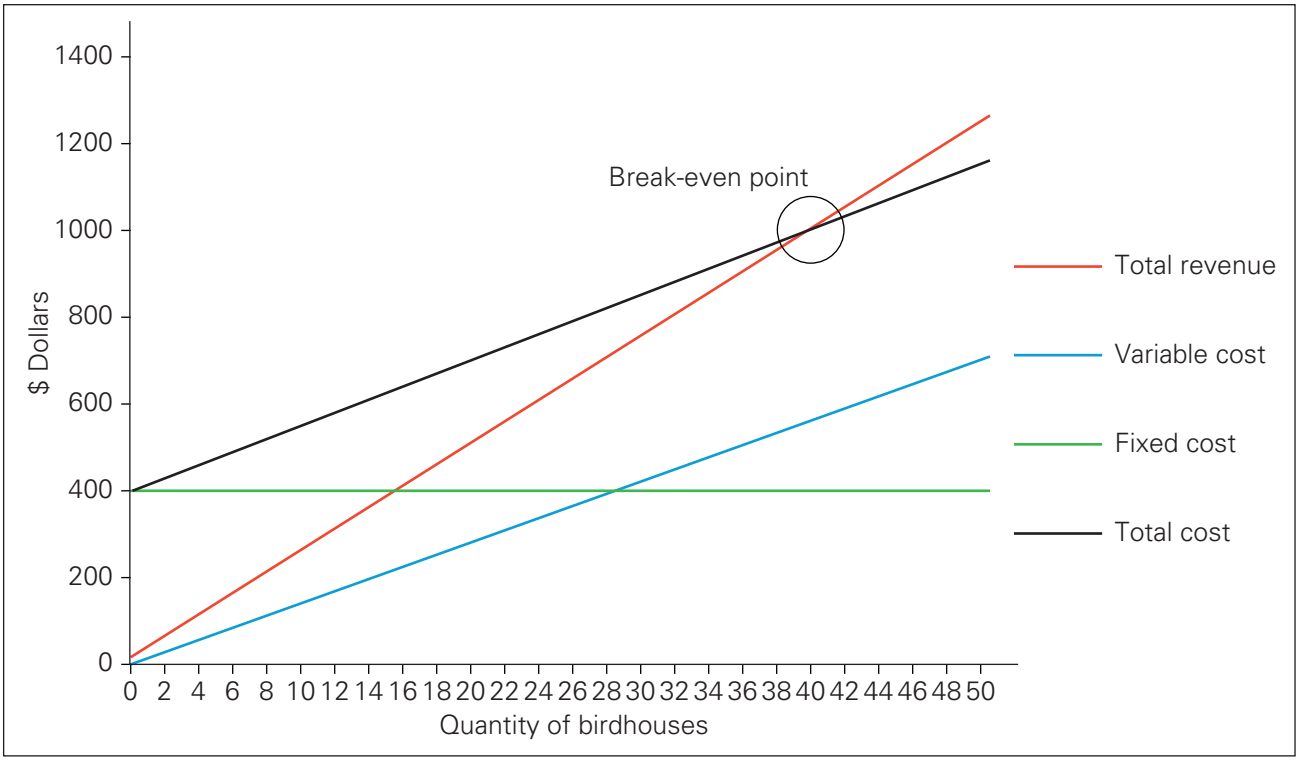
This can be highlighted graphically as shown in Figure 5.10:

Figure 5.10 Cost-volume-profit graph indicating break-even point



The Total revenue line indicates the sales revenue generated as each unit is sold. Notice that the more units that are sold, the higher the Total revenue line goes. As this occurs, the Variable cost line is also increasing as the total Variable cost is dependent on the level of sales. The Fixed cost line is completely flat, as this cost does not change in relation to the level of activity.

The **Total cost** line is a combination of the Fixed cost line plus the Variable cost line. You can see that the Variable cost line and the **Total cost** line are parallel. This is because the Variable cost line has been lifted up by the amount of the Fixed cost. This is also why the **Total cost** line starts at the Fixed cost amount. If there is no activity, Variable costs would be zero but the Fixed costs (which are independent of activity) will still be present and need to be paid. The point where the Total revenue line crosses the **Total cost** line is the break-even point. This occurs, as we calculated, at 40 birdhouses.

Sales revenue

If Terry sells 40 birdhouses, this will generate $1 000 worth of sales revenue, calculated as shown in Figure 5.11:

Figure 5.11 Calculation: Sales revenue

Sales revenue = Selling price × Quantity to be sold
= $25 × 40 birdhouses
= **$1 000**

The fact that he will earn **$1 000** revenue does not mean he will make $1 000 profit: this revenue must be used to meet the total fixed costs of $400 and the total variable costs ($15 per birdhouse × 40 birdhouses = $600), leaving him with an actual profit of zero (which means he will break even, which is what we had calculated would occur in the first place).

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Earning profit

The earlier example showed how the formula can be used to calculate the quantity of units that must be sold to break even. However, the whole point of owning a small business is to earn a profit, so the owner is probably more interested in how many units must be sold to earn the minimum desired profit. This can be done using the same cost-volume-profit formula.

Let's assume that Terry has a desired profit of **$500** per week. The calculation of how many birdhouses would need to be sold to earn this profit is shown as follows:

Figure 5.12 Calculation: Quantity to be sold to make a profit

$$\text{Quantity to be sold} = \frac{\$400 + \$500}{\$25 - \$15}$$

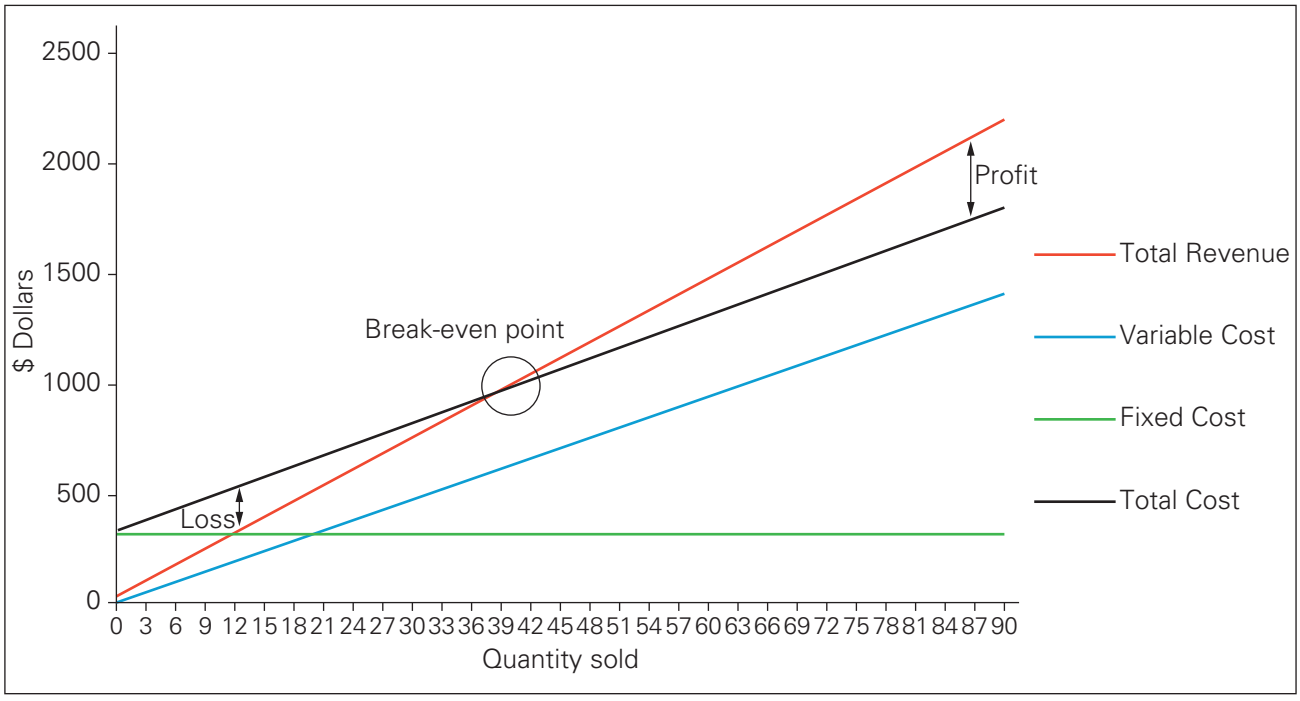
$$= \frac{\$900}{\$10}$$

$$= 90 \text{ birdhouses}$$

Therefore, 90 birdhouses would have to be sold per week for Terry to achieve his desired profit of **$500** per week. (Note how this figure is higher than the number that was required to break even.)

A profit will be made as soon as the Total revenue line crosses the **Total cost** line as shown in Figure 5.13:

Figure 5.13 Cost-volume-profit graph indicating profit margin



While the Total revenue line is *below* the **Total cost** line, the business is making a loss, as the amount from sales is not sufficient to cover the variable and fixed costs. Once the Total revenue line *crosses* the **Total cost** line, the business has broken even and then can go on to make profit. The greater the distance the Total revenue line is *above* the **Total cost** line, the greater the profit made.

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Using spreadsheets

Using your computer, access a spreadsheet programme/app and set up some tables to be able to record the following data:

- Variable Costs
- Fixed Costs
- Selling Price
- Desired Profit
- Break Even/Profit Point

Study tip

For Windows to show all formulas in Excel, press CTRL + ~ (tilde). Do this again to return to numbers. Or, go to the Formulas tab and click on the show formulas button.

As shown below:

Variable Costs	
Timber	9
Varnish & Paint	4
Nails, screws & Handle	2
	15

Fixed Costs	
Rent	300
Hire	60
Transport	40
	400

Selling Price	25	
Desired Profit		
Break Even / Profit Point	40	Units

Use the formulas indicated below so that you can set up a template that can be used for any question:

	A	B	C	D	E
1	**Variable Costs**			**Fixed Costs**	
2	Timber	9		Rent	300
3	Varnish & Paint	4		Hire	60
4	Nails, screws & Handle	2		Transport	40
5					
6					
7		=SUM(B2:B6)			=SUM(E2:E6)
8					
9					
10	Selling Price	25			
11	Desired Profit				
12					
13					
14	Break Even / Profit Point	=(E7+B11)/(B10-B7)	Units		

Auto Sum Σ AutoSum can be found in the right side of the home tab and is a quick way to total columns. Ensure your formula is referencing the correct cells so you get the right answer.

To graphically represent figures, we need to create a table that shows total costs and revenue for a range of units. In a new sheet, set up the following table:

	A	B	C	D	E
1					
2	**No of Units**	**Total Variable Costs**	**Total Fixed Costs**	**Total Revenue**	**Total Costs**
3	1	15	400	25	415
4	2	30	400	50	430
5	3	45	400	75	445
6	4	60	400	100	460
7	5	75	400	125	475
8	6	90	400	150	490
9	7	105	400	175	505
10	8	120	400	200	520
11	9	135	400	225	535
12	10	150	400	250	550
13	11	165	400	275	565

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The first column is the range of units. This will need to be quite substantial; as you can see from our first example, 40 units were needed to be sold to break even. If our data does not extend past 40, we will be unable to show this graphically. The amount for each heading must be calculated and shown for each so that they can be shown graphically. Obviously, the only cost that will not change for a range of units is Total Fixed Costs.

This can be done using the following formulas. Remember to refer to the same cells that hold the relevant data so every time you adjust a cost or selling price the data will update in the spreadsheets. You do not have to keep typing every formula – a handy feature of Excel is to highlight the last line of the data and by dragging the fill handle it will fill the columns with data following the pattern/formula you have put in place. Important tip – part of the formula has to refer to specific values; therefore, you need to freeze the cells for Variable Cost, Fixed Cost and Selling Price. You can do this by pressing F4. You can tell if a cell is frozen if it has the $ signs around it. If you did not freeze the cell, it would look for the next cell beneath it and refer to the wrong data. The Total Costs formula does not need to reference a specific price or value and needs to keep referring to the next cell as it moves down the column. You can see how it changes as you drag it down.

	A	B	C	D	E
1					
2	**No of Units**	**Total Variable Costs**	**Total Fixed Costs**	**Total Revenue**	**Total Costs**
3	1	=Sheet1!$B$7*A3	=Sheet1!$E$7	=Sheet1!$B$10*A3	=B3+C3
4	2	=Sheet1!$B$7*A4	=Sheet1!$E$7	=Sheet1!$B$10*A4	=B4+C4
5	3	=Sheet1!$B$7*A5	=Sheet1!$E$7	=Sheet1!$B$10*A5	=B5+C5
6	4	=Sheet1!$B$7*A6	=Sheet1!$E$7	=Sheet1!$B$10*A6	=B6+C6
7	5	=Sheet1!$B$7*A7	=Sheet1!$E$7	=Sheet1!$B$10*A7	=B7+C7
8	6	=Sheet1!$B$7*A8	=Sheet1!$E$7	=Sheet1!$B$10*A8	=B8+C8
9	7	=Sheet1!$B$7*A9	=Sheet1!$E$7	=Sheet1!$B$10*A9	=B9+C9
10	8	=Sheet1!$B$7*A10	=Sheet1!$E$7	=Sheet1!$B$10*A10	=B10+C10
11	9	=Sheet1!$B$7*A11	=Sheet1!$E$7	=Sheet1!$B$10*A11	=B11+C11
12	10	=Sheet1!$B$7*A12	=Sheet1!$E$7	=Sheet1!$B$10*A12	=B12+C12

Once you have set up this data, go to the insert tab and you will find that Excel provides a variety of charting options. You will need to highlight all your data in rows B, C, D and E. Line graphs were used for this example and provide the best visual representation of the break-even point; however, you may wish to display it in a different way.

Review questions 5.5

1 **Define** the following terms:
   - break-even point
   - variable cost
   - fixed cost
   - contribution margin.
2 **State** two reasons why a fixed cost is not always fixed.
3 **Show** the formula used to conduct a cost-volume-profit analysis.
4 **Explain** what will occur if sales are:
   - above the break-even point
   - below the break-even point.
5 **List** the three assumptions underlying the cost-volume-profit formula.
6 **Show** the formula used to calculate sales revenue.
7 **Explain** why sales revenue and profit are not the same.

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5.6 Applying cost-volume-profit analysis

Determining selling prices

In some cases, the owner will have a good idea of how many units can be sold but will be unsure about what selling price to charge. The same cost-volume-profit formula can be used but solved for a different value.

Let's assume that Terry thinks he can sell 50 birdhouses per week, but he wants to know what selling price he should charge to earn his desired profit of $500. The calculation is shown below:

Figure 5.14 Calculation: Selling price

$$
\begin{aligned}
\textbf{50} &= \frac{\$400 + \$500}{\text{Selling price} - \$15} \\
(\text{Selling price} - \$15) \times 50 &= \$900 \\
\text{Selling price} - \$15 &= \frac{\$900}{50} \\
\text{Selling price} - \$15 &= \$18 \\
\text{Selling price} &= \$18 + \$15 \\
&= \$33 \text{ per birdhouse}
\end{aligned}
$$

Study tip

As a shortcut, swap 'SP – VC' and 'Q' to solve the equation.

Thus, the new selling price would have to be $33 plus $3.30 GST making it $36.30 per birdhouse for Terry to sell 50 birdhouses and still achieve his desired profit of $500.

The Income Statement

The information generated by a cost-volume-profit analysis can be presented as an Accounting report called an Income Statement. This report details the sales revenue the business has earned and the costs or expenses it has incurred in the process. Figure 5.15 shows the Income Statement for Terry's Birdhouses for the first week of March 2030. It assumes that 50 birdhouses were sold at $36.30 including $3.30 GST each.

Figure 5.15 Income Statement

TERRY'S BIRDHOUSES
Income Statement for first week of March 2030

	$	$
Sales revenue ($33 per birdhouse × 50 birdhouses sold)		$1 650
Less Total variable costs ($15 per birdhouse × 50 birdhouses sold)		750
Variable Profit ($18 per birdhouse × 50 birdhouses sold)		**900**
Less Fixed Costs		
Rent of factory space	300	
Hire of market stall	60	
Transport costs	40	400
Net Profit (or Loss)		**$500**

Video 5.1 Cost-Volume-Profit

The variable profit, or Gross Profit, can be determined either as the difference between the Sales revenue ($1 650) and the Total variable costs ($750) or the contribution margin per item (**$18**) multiplied by the number of items sold (50). Both should derive the same answer.

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Combining methods

It is clear that there is no one price-setting method that can guarantee success, so each owner has to consider a variety of pricing options when determining selling prices. A business may use a specific mark-up as a starting point for certain products; however, they would then have to consider what competitors are charging or look at the conditions in the marketplace and adjust their prices accordingly. A business conducting a cost-volume-profit analysis would face a similar situation. The aim is to set a price that will attract as many customers as possible, and generate as much profit per item as possible, to cover expenses and provide for enough Net Profit to satisfy the owner's objective.

Review questions 5.6

1 **Explain** what is reported in an Income Statement.
2 **Show** how each of the following figures in the Income Statement is calculated:
   - Sales revenue
   - Total variable costs
   - Variable profit.
3 Using at least two examples, **explain** why it is usual to use more than one pricing method.
4 **Explain** why GST is not included in the cost-volume-profit calculation and Income Statement.

Where have we been?

- Correct pricing is essential to provide for a profit and allow the business (and its market share) to expand.
- Selling prices can be set using recommended retail price, competitors' prices, market reaction, quotes, percentage mark-up, a cost-volume-profit analysis or some combination of these methods.
- Quotes can be used by service businesses to set selling prices for jobs with different costs.
- When costs are well defined and the owner knows the return they want to achieve on a product, then a mark-up can be applied to the cost price.
- The relationship between selling prices, cost prices and the volume of sales (the quantity sold) is reflected in a cost-volume-profit analysis, which can be used to determine the quantity of products a business may need to sell, or the selling price it must charge, to break even.
- Variable costs vary directly with the volume of sales; fixed costs do not.
- The information generated by a cost-volume-profit analysis can be presented as an Accounting report called an Income Statement, and this can also be represented in a graph.

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Exercises

Exercise 5.1
Quotes

WB page 72

Phil Sparkey runs his own electrical service business called Sparks Electrics and has been asked to do a particular job for the supply and installation of a set of spotlights. The following costs are relevant to the job:

- Cost of spotlights $360
- Cost of wiring $30 per metre
- Cost of labour $55 per hour

Phil estimates that the job can be completed in four hours using 6 metres of wiring, and he expects to earn a profit for himself of $900 over a 36-hour week.

Required

a. **Calculate** the price Phil should quote to the customer.
b. **Explain** why Phil should consider the prices charged by his competitors before submitting his quote.

Exercise 5.2
Quotes

WB page 73

Andrew operates a glazier business and has been asked to do a particular job in Mentone for the supply and fitting of a new glass pane for a shop front window. The following costs have been estimated for the job:

- Glass $400
- Special glue $10 per metre
- Metal framing $20 per metre
- Labour – glazier $40 per hour
- Labour – assistant glazier $20 per hour

Andrew estimates that the job can be done in two hours using 14 metres of framing. He also expects to earn a profit of $3200 for a 40-hour week.

Required

a. **Calculate** the price Andrew should submit as a quote to the customer.
b. The customer has stated that the job can go ahead if Andrew's price is $990 or less. **State** two reasons why Andrew might still accept the job.
c. **Explain** one negative consequence of setting prices too low.

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Exercise 5.3
Quotes

page 74

Simone Cipriotti is a carpenter and has been asked to submit a quote for the construction of a new cubby house for a family in Wodonga. The following costs are relevant to the job:

- Timber $450
- Metal sheeting (for the roof) $25 per metre
- Nails, screws and other hardware $40
- New tools $120

Simone estimates that the job can be completed in four hours and the roof will require 4 metres of metal sheeting. She expects to earn a profit for herself of $720 over a 36-hour week, and because of a construction boom, she is the only carpenter available to build the cubby house.

Required

a. **Calculate** the price that Simone should quote to the customer.
b. Referring to your answer to part **a**, **explain** your treatment of the cost of the new tools.
c. **Explain** one possible danger if Simone's quote is too high.

Exercise 5.4
Percentage mark-up

page 75

Crosstown Tyres has just purchased some inventory that it will fit to customers' cars. The tyres and their cost prices are listed below:

- A16 MaxiGrip $120 (plus $12 GST) each
- Roadrunner 1600 $99 inclusive of GST each
- Mudrunner 2400 $154 including $14 GST each

Required

a. **Calculate** the selling price of each type of tyre if a mark-up is applied at:
  - 40%
  - 50%
  - 100%

b. **State** two reasons why it may be necessary to apply a different percentage mark-up to each line of inventory.

Exercise 5.5
Percentage mark-up

page 76

Arctic Ski Gear has provided the following information relating to some of its inventory:

- Viewmaster goggles Selling price $80 plus $8 GST (mark-up 60%)
- Blinder jackets Selling price $330 including $30 GST (cost price $200 plus $20 GST)
- Yeti boots Cost price $165 inclusive of GST, mark-up 40%

Required

a. **Calculate** the cost price of Viewmaster goggles.
b. **Calculate** the percentage mark-up applied to Blinder jackets.
c. **Calculate** the selling price of Yeti boots that includes GST.
d. **Explain** why not all businesses can use a percentage mark-up to set selling prices.

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Exercise 5.6
Cost-volume-profit analysis

page 77

Ryan King is the owner and operator of King's Desks, a small business that makes and sells children's desks. Ryan has identified the following costs relating to the production of the desks:

- Rent of premises $700 plus GST per month
- Administration expenses $220 including $20 GST per month
- Electricity $330 inclusive of GST per month
- Materials $40 plus $4 GST per desk
- Glue $44 inclusive of GST makes five desks
- Varnish $2.20 including $0.20 GST per desk

Each desk sells for $75 plus GST, and Ryan wants to earn $400 profit per month.

Required

a. **Calculate** the variable cost of one desk.
b. **Calculate** the fixed costs per month.
c. **Calculate** the number of desks Ryan will need to sell per month in order to break even.
d. Referring to your answer to part **c**, **calculate** the sales revenue the firm will earn if this level of sales is achieved.
e. **Calculate** the number of desks Ryan will need to sell per month in order to earn his desired profit.
f. **Calculate** the selling price (including GST) Ryan would have to charge to earn his desired monthly profit if he could only sell 50 desks in a month.
g. Referring to your answer to part **f**, **explain** how profit may be adversely affected if Ryan charges more than this as his selling price.

Exercise 5.7
Cost-volume-profit analysis

page 79

Molly Sprout earned $8400 a year as a part-time florist, but her passion is pottery, so at the end of 2030 she withdrew her savings of $6000 (which was earning 10% interest p.a.) in order to start a small business selling her pots. She expects to charge $25 plus GST per pot and has estimated the following costs:

- Paint $3.50 plus $0.35 GST per pot
- Clay $495.00 including $45 GST makes 100 pots
- Firing (in the kiln) $0.55 inclusive of GST per pot
- Rent of studio $500.00 plus $50 GST per month
- Brushes $15.00 plus GST for 10 (one per pot)
- Hire of market stall $55.00 including $5 GST every Sunday
- Wage for assistant $30.00 every Sunday
- Lighting $70.00 plus $7 GST per month
- Business cards $132.00 GST inclusive per year

There are four markets per month, and Molly thinks she can sell 90 pots per month.

Required

a. **Calculate** the variable cost of one pot and the monthly fixed cost.
b. **Calculate** the number of pots Molly must sell each month to break even.
c. **Calculate** Molly's minimum monthly desired profit.
d. **Calculate** the number of pots that Molly must sell each month to earn her desired profit.
e. Referring to your answer to part **d**, **explain** the problem Molly is likely to encounter.
f. **Calculate** the selling price (plus GST) Molly should charge for each pot in order to earn her desired monthly profit.

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Exercise 5.8
Cost-volume-profit analysis

page 81

Harry Harcourt has been working in a skateboard factory for the past three years. He is very skilful in his job, and many of his friends and family have called on him to make skateboards in his neighbour's rented garage on weekends. Harry has estimated the following costs:

- Fibreglass frame $145 plus $14.50 GST per skateboard
- Administration costs $88 including $8 GST per month
- Protective non-slip coating $5.50 GST inclusive per skateboard
- Electricity $120 plus GST per month
- Wheels and metal frame $20 plus $2 GST per skateboard
- Rent of garage $2 400 per year

The estimated selling price for each skateboard is $220 plus $22 GST, and Harry is hoping to earn an annual profit of $1 800.

Required

a. **Define** the term 'variable cost'.
b. **Calculate** the variable profit per skateboard.
c. **Define** the term 'break-even point'.
d. **Calculate** how many skateboards need to be sold in order to achieve the desired monthly profit.
e. **Calculate** the sales revenue required to achieve the desired monthly profit.

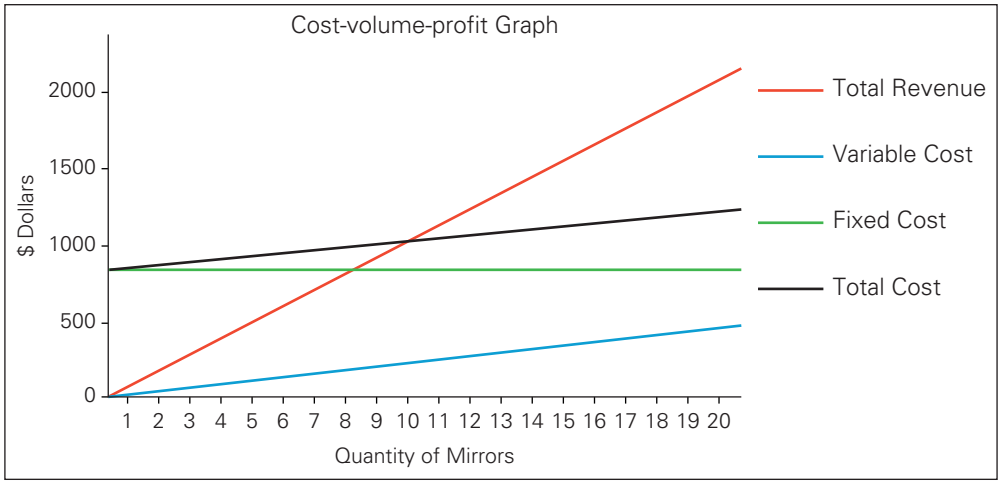
The manufacturer of the skateboard wheels and metal frame (not the fibreglass frame) has decided to increase prices by 10%. Harry believes that he can sell 10 skateboards a month and make $200 profit. (Assume that all other costs remain the same.)

f. **Calculate** the new selling price (including GST) required to earn the predicted profit.
g. **Explain** how an increase in selling price could lead to a decrease in profit.

Exercise 5.9
Graphical representations

page 83

Andrew's business, Mirror Image, makes mirrors. The following graph has been created by his accountants:
Note: the figures used in the graph do not include GST.



Required

a. **Calculate** the selling price for one mirror (including GST).
b. **State** the number of mirrors Andrew needs to sell in order to break even. **Justify** your response.

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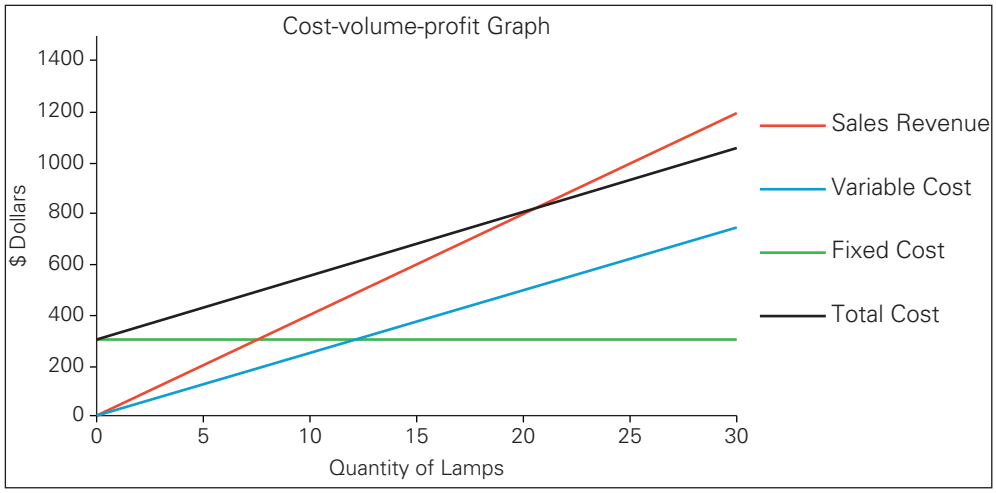
Exercise 5.10
Graphical representations

page 84

Phil Sparkey creates and designs his own funky lamps, Psychedelic Lights, and has provided the following data for the month:
Note: the figures used in the graph do not include GST.



Required

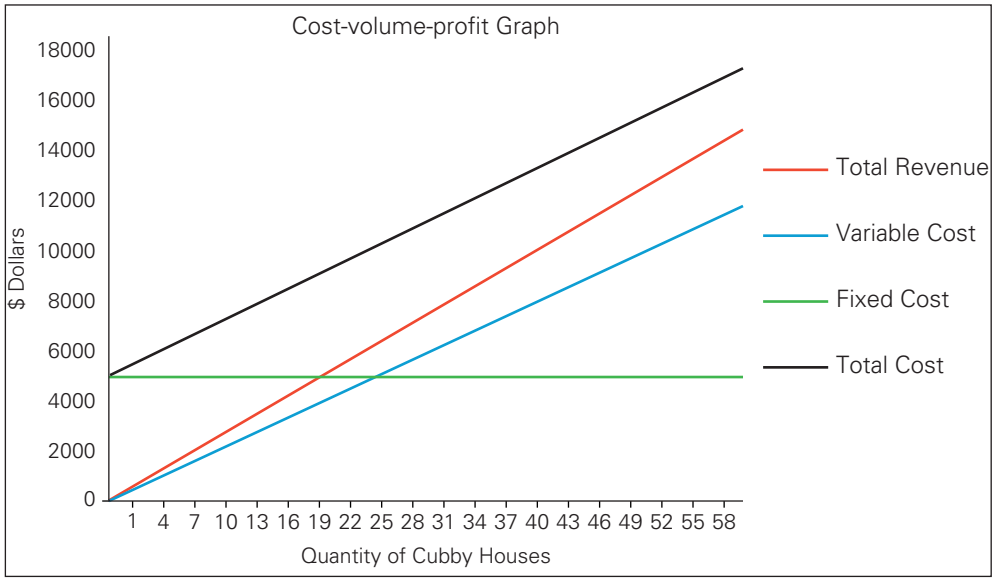
a. **Determine** the following from the graph:
- break-even point (in units)
- break-even point (sales revenue)
- selling price per unit (excluding GST)
- total fixed cost.

b. **Calculate** the variable cost per lamp.

Exercise 5.11
Graphical representations

page 85

Louisa Minor builds and sells cubby houses. Her business is called Minor Manors. The following graph was provided of her business's performance for the year:
Note: the figures used in the graph do not include GST.



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Required

a. If Louisa can only make 50 cubby houses a year, **explain** whether a profit or loss will be made by the business.

b. **Suggest** two ways Louisa could improve the performance of her business.

Exercise 5.12
Income Statement

page 86

Kapila Neelaweera is the owner and operator of Candle Power, a small business that sells candelabras. The Income Statement for April 2030 showed the following:

CANDLE POWER
Income Statement for April 2030

	$	$
Sales	9450	
Less Variable Costs	4050	
Variable Profit		**5400**
Less Fixed Costs		
Wages	1000	
Advertising	500	
Rent	900	2400
Net Profit (Loss)		**3000**

Each candelabra costs $15 plus GST to purchase and sells for $35 plus GST.

Required

a. **Define** the term 'fixed cost'.

b. **Calculate** the number of candelabras sold in April 2030.

c. **Calculate** the number of candelabras Candle Power must sell each month in order to break even.

Kapila has decided that in order to earn his desired profit of $4000 per month he must increase his selling price. He thinks he can probably sell 200 candelabras per month if prices rise, but advertising may have to increase.

d. **Calculate** the selling price (excluding GST) Kapila must charge in order to earn his desired profit.

e. **State** the effect (increase/decrease/no effect) of an increase in advertising on each of the following items:

- contribution margin
- break-even point (in units).

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Exercise 5.13
Income Statement

page 87

Wally White operates Flying High, a kite shop in the windy northern suburb of Greenvale, and has provided the following Income Statement for May 2030:

FLYING HIGH
Income Statement for May 2030

	$	$
Sale of kites	1 800	
Less Cost of kites	1 000	
Variable Profit		**800**
Less Other Expenses		
Wages	500	
Electricity	80	
Rent	300	880
Net Loss		**(80)**

During May, the shop sold 50 kites all at the same price.

Required

a. **Calculate** the selling price charged for each kite including GST.
b. **Calculate** the variable profit (contribution margin) per kite.
c. **Calculate** how many kites the shop would have had to sell during May 2030 in order to break even.
d. **Calculate** the revenue earned at this level of sales.
e. Apart from percentage mark-up and cost-volume-profit analysis, **state** two other methods of price setting that would be suitable for Wally's business.
f. **Calculate** the percentage mark-up used by the business in May 2030.
Wally has been notified that the rent on the shop will be $400 a month as from 1 June 2030 and that wages will increase by 5% from that date.
g. **Calculate** how many more kites will have to be sold in order to break even. (Assume that the selling price remains the same.)

Exercise 5.14
Cost-volume-profit analysis

page 89

Jerome Wishart makes garden benches from his home under the business name Jerome's Garden Furniture. The Income Statement for January 2030 showed the following:

JEROME'S GARDEN FURNITURE
Income Statement for January 2030

	$
Sales revenue	15 000
Less Total Variable Costs	6 000
Variable Profit	**9 000**
Net Profit	**2 000**

Jerome has stated that each garden bench costs $40 to make (this includes the cost of timber, paint and screws).

Required

a. **Define** the term 'fixed costs'.
b. **Calculate** fixed costs for January 2030.
c. **Calculate** the number of benches sold in January.

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Projections for February 2030 suggest that variable costs will remain at $40 per bench, but fixed costs will be $4 500. Jerome is planning to sell each bench for $90 (plus $9 GST) and hopes to make a profit of $3 000 for the month.

d. **Define** the term 'break-even point'.
e. **Calculate** the contribution margin on each bench.
f. **Calculate** how many benches the firm must sell in February 2030 to break even.
g. **Calculate** how many more benches the firm must sell in February 2030 to earn the desired profit.
h. Assuming that the firm can sell 100 benches, **prepare** an Income Statement for February 2030.
i. Assuming that Jerome could sell 60 benches and all other costs remained the same, **calculate** the selling price (excluding GST) that would need to be charged to break even.

Exercise 5.15
Cost-volume-profit analysis

W B page 91

Sophie Andronaco is considering starting her own business selling small children's fairy costumes at the local kindergarten's car boot sale that is held twice a month. Sophie is not sure what price to charge for her costumes. She was told by some of her friends that she should consider calculating the cost-volume-profit point in order to determine an appropriate selling price for her product. Sophie has managed to calculate the following estimated figures relating to the new project:

Estimated selling price	$33 including $3 GST per costume
Rent of car park space	$1 200 per year
Assistant's wages	$50 a month
Material for costumes	$13.20 including GST each
Fairy wings and wand	$7.50 plus GST per costume
Advertising in the local paper	$44 including $4 GST a month
Sparkles for wings	$5 plus $0.50 GST for 10 costumes
Transport costs	$10 plus GST each car boot sale

Required

a. **Explain** to Sophie the function of a cost-volume-profit analysis.
b. **Distinguish** between the terms 'variable cost' and 'fixed cost'.
c. **Calculate** the variable cost per costume.
d. **Calculate** the monthly fixed costs.
e. **Calculate** the number of costumes Sophie will have to sell each month in order to break even.
f. **Calculate** the revenue earned at this level of sales.
g. **Calculate** the number of costumes Sophie will have to sell each month in order to achieve a desired profit of $100.
   Sophie estimates that 100 costumes can be sold in a month.
h. **Calculate** the price (including GST) she would have to charge to her customers at this level of sales to achieve the desired profit of $100.
i. If Sophie's supplier of wings and wands increased their prices to $8.75 plus GST each, **state** the effect (increase/decrease/no effect) on the following (assume that all other prices remain constant):
   - contribution margin
   - break-even point (in units).

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Chapter 6
Source documents

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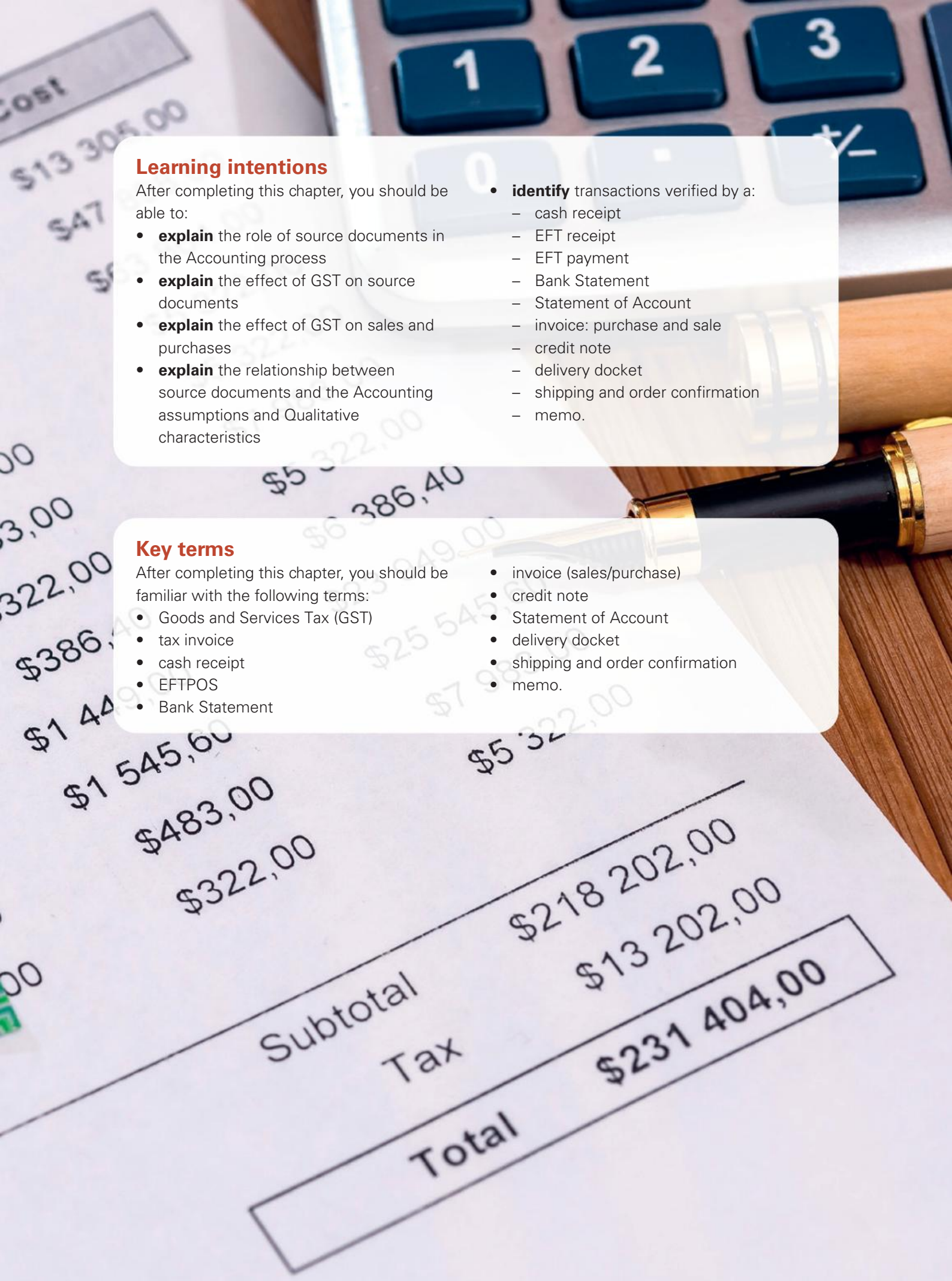

Learning intentions

After completing this chapter, you should be able to:

- **explain** the role of source documents in the Accounting process
- **explain** the effect of GST on source documents
- **explain** the effect of GST on sales and purchases
- **explain** the relationship between source documents and the Accounting assumptions and Qualitative characteristics
- **identify** transactions verified by a:
  - cash receipt
  - EFT receipt
  - EFT payment
  - Bank Statement
  - Statement of Account
  - invoice: purchase and sale
  - credit note
  - delivery docket
  - shipping and order confirmation
  - memo.

Key terms

After completing this chapter, you should be familiar with the following terms:

- Goods and Services Tax (GST)
- tax invoice
- cash receipt
- EFTPOS
- Bank Statement
- invoice (sales/purchase)
- credit note
- Statement of Account
- delivery docket
- shipping and order confirmation
- memo.

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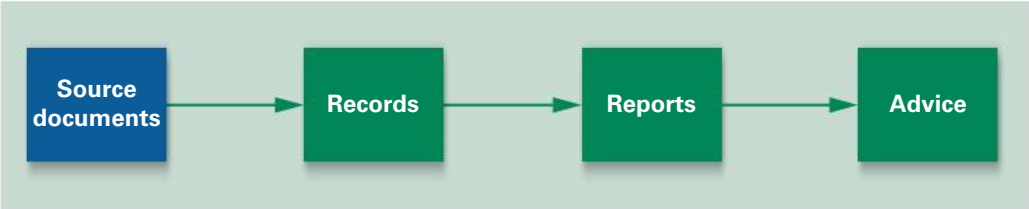
6.1 The role of source documents

Every small business requires information on which to base decisions, and the role of Accounting is to provide that information in the form of Accounting reports. However, financial reports do not automatically generate themselves, they are the end result of the Accounting process, as shown in Figure 6.1:

Figure 6.1 The Accounting process



The information communicated to the owner via the reports is the product of the recording system, which summarises and classifies transactions. But the records themselves are generated from the raw data provided in source documents: they provide the facts on which all subsequent Accounting information will be based.

Source documents have two separate yet related functions:

1. They provide the verifiable evidence of the details of a transaction, thus ensuring that the information in the Accounting reports provides a Faithful representation; that is, it can be depended upon as the financial information presented will be complete, free from material error and without bias.
2. They provide the evidence that is required by the Australian Taxation Office relating to the firm's income tax and Goods and Services Tax obligations.

Storing source documents

Because of their importance and the Australian Taxation Office's (ATO) requirement to keep most records for five years, source documents must be stored and filed in a safe and organised manner. In the past and even currently some businesses use something as simple as an expandable file (also known as an accordion file) or a spike file to keep documents in order, while others will devote whole filing cabinets to the storage of source documents.

However, due to the increasing prevalence of online transactions and the ATO's transition towards the online reporting of tax, the ATO is recommending businesses use electronic record keeping. This allows businesses to digitally record their paper documents. Once a business has a digital image of a source document, they no longer need to keep the paper hard copy (unless a specific law or regulation requires it). Firms that use a computerised recording system (like QuickBooks or MYOB) can store copies of some documents electronically, but even they will have to keep digital or hard copies of documents they have been sent by suppliers and other trading partners.

The use of digital source documents has the potential to save a lot of physical storage for businesses; however, a business still needs to ensure that these digital records are:

- a true representation of the original paper copy, ensuring that all details are captured
- recorded in an organised manner so they are easily accessible
- stored securely (only authorised personnel can access)
- are backed up off-site, e.g. cloud storage.

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The Goods and Services Tax

An ongoing requirement for owners of small businesses has been accounting for the **Goods and Services Tax (GST)**, which applies to most goods (except fresh food, some educational and medical products) and services (except most education and health services). Under this system, the federal government taxes consumers 10% of the price of whatever they have purchased, with the business that sells the goods/services acting as a tax collector for the Australian Taxation Office (ATO). At the same time, any GST the business pays to its suppliers will reduce the amount it owes to the ATO.

Goods and Services Tax (GST)
a 10% tax levied by the federal government on sales of goods and services

The need to verify the amount of GST owed to the ATO means it is essential that the business has accurate information relating to:

- the GST on its sales or services (which it owes to the ATO)
- the GST on its payments and purchases (which reduces the GST owed to the ATO).

Source documents and the GST

The source document used to verify a transaction involving GST is a **tax invoice**. In order to be called a tax invoice and be used to substantiate a GST transaction, a source document must include the following information:

- the words 'tax invoice' stated clearly
- the name of the seller
- the Australian Business Number (ABN) of the seller
- the date of the transaction
- a description of goods/services provided
- the price of the transaction including the GST
- the amount of the GST. (Fees of more than $1 000 must also show the name and address or ABN of the buyer and the GST for each line item.)

tax invoice
a source document that contains specific information required by the ATO to substantiate GST amounts

Without these details, the source documents cannot be used to substantiate GST transactions, and the business may end up paying to the ATO more GST than is required.

Study tip

Do not confuse a tax invoice with invoices that are used to recognise credit transactions. Tax invoices are used to record any transactions that involve GST, and the transactions can be cash or credit in nature.

Calculating the GST amount

Calculating the amount of GST can be done via two approaches; however, to do this requires an understanding of the relationship between:

- the selling price of the good/service (*excluding GST*)
- the GST itself
- the **total price** of the transaction (*including GST*).

The first approach to calculate the amount of GST is to calculate 10% of the selling price and then add it to the selling price to determine the **total price** as shown in figure 6.2.

Study tip

Use this method when a question says 'plus' GST

Figure 6.2 Calculating GST and total price (including GST)

Selling price	+	GST (selling price ×10%)	=	**Total price** (including GST)
$180	+	$18	=	**$198**

If we already have the **total price** and we want to determine the amount of GST then we will need to work *backwards* from the **total price.** To determine the GST we need to find $\frac{1}{11}$ of the **total price** or divide the **total price** by 11. Figure 6.3 shows this relationship:

Study tip

Use this method when a question says 'including' GST.

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Figure 6.3 Calculating GST or selling price from total price

Total price (including GST)	=	Selling price ($\frac{10}{11}$ of **total price**)	+	GST ($\frac{1}{11}$ of **total price**)
$198	=	$180	+	$18

GST Flows

Consider the following example:

Example

Jerry's Temp Agency provides secretarial services, and during March 2030 the following transactions occurred:

- Provided secretarial services to L. Typo for $3000 plus $300 GST
- Paid business rent to Office Landlords for the month of $1980 including $180 GST

Cash sales and the GST

At the time a cash service is performed, the business will receive the cash for the service *plus the GST*, and this must be documented on the receipt. While the business is entitled to keep the cash for the service, the GST is collected on behalf of the Australian Government, so the business owes the GST to the government. For this reason, any GST a small business collects or receives on its sales creates a GST liability to the Australian Taxation Office (ATO).

When Jerry's Temp Agency provides secretarial services for the month of March 2030 to L. Typo at a cost of $3000 plus $300 GST, this transaction will create a $300 GST liability that Jerry's Temp Agency owes to the ATO.

This can be highlighted by showing the effect on the accounting equation:

	Increase/Decrease/No effect	**Amount $**
Assets	Increase (Bank)	3300
Liabilities	Increase (GST liability)	300
Owner's equity	Increase (Revenue)	3000

Cash payments and the GST

At the time a cash payment is made, the business will pay cash for whatever it is purchasing *plus* the GST on the purchase, and this should be shown on the source document. In this example, Jerry's Temp Agency has paid $1800 for the rent *plus* $180 GST to Office Landlords. This means its bank account will decrease by **$1980** in total.

However, if a business has paid any GST to its suppliers, it is allowed to deduct this from the GST it owes. That is, because the GST will be forwarded to the ATO by the firm's suppliers, it is treated as if the business had actually paid the GST straight to the government. Thus, GST paid to suppliers will actually decrease the firm's GST liability.

	Increase/Decrease/No effect	**Amount $**
Assets	Decrease (Bank)	1980
Liabilities	Decrease (GST liability)	180
Owner's equity	Decrease (Rent expense)	1800

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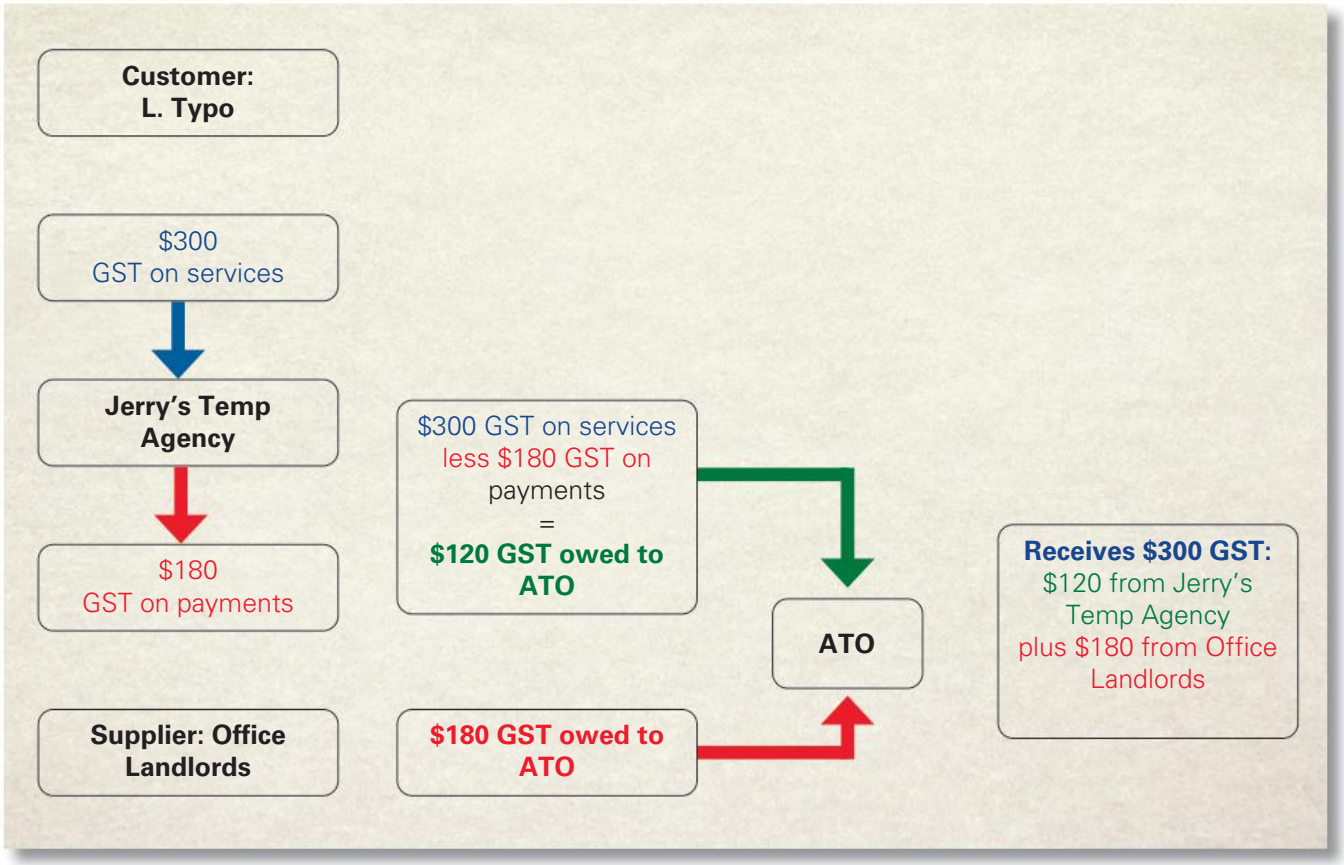
The GST 'flows' for this business are shown in Figure 6.4:

Figure 6.4 GST flows: Jerry's Temp Agency, L. Typo, Office Landlords and ATO



In this case, despite charging $300 GST on sales to its customer (L. Typo), Jerry's Temp Agency would only owe $120 GST to the ATO, as the $180 GST on its rent payment will be transferred to the ATO by the supplier, Office Landlords (ensuring the ATO will still ultimately receive the full $300 GST on sales).

The overall amount owed to the ATO for GST is thus determined as:

Overall GST owing = GST on sales less GST on purchases

Therefore indicating a GST liability of $120 for Jerry's Temp Agency for March 2030.

If a firm pays more GST than it receives, it will end up with a GST asset – it will be due to receive a GST refund from the ATO. It must have the tax invoice from these transactions to be able to claim this GST back. This will be discussed in further detail in Chapter 7.

Review questions 6.1

1 **Identify** the four stages in the Accounting process.
2 Referring to two Qualitative characteristics, **explain** the role of source documents in the Accounting process.
3 **Explain** the importance of source documents in the determination of GST owing to the ATO.
4 **List** the information that must be shown on a source document that includes GST.
5 **Explain** why it is important to store source documents safely and how the nature of that storage is changing.

Continued

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6 **Show** how GST will affect the calculation of:
- total price when given selling price
- selling price when given total price.

7 **Explain** why GST on sales creates a GST liability.

8 **Explain** why GST on purchases leads to a reduction in any GST liability.

6.2 Evidence of cash transactions

The changing nature of transactions

The Reserve Bank of Australia (RBA) has tracked the way consumers make their payments for many years and the trend is showing that the decline in cash use has accelerated. Cash accounted for just 13% of all payments made in 2022. Consumer preferences have changed over time towards electronic payment methods as businesses have adopted new technologies to make payments quicker and easier (tap and go) and are offering their products and/or services online.

The vast majority of the transactions of a small business will be conducted in cash (either by physical cash or via electronic funds transfer (EFT), so being able to recognise and record cash documents is vital. Cash transactions fall into one of two categories: cash receipts and cash payments.

cash receipt (1)
a source document used to verify cash received

cash receipt (2)
a transaction that occurs when cash is received from another entity

EFTPOS
Electronic Funds Transfer Point of Sale – an instant electronic transfer of cash from a customer's debit or credit account to the business's bank account at the time of sale

Cash receipts

The term **cash receipt** can refer to both the *transaction* that occurs when cash is received from another entity, as well as the *source document* that verifies that transaction. All cash received must be evidenced either by:
- a cash receipt (hand-written or generated electronically) or
- a cash register receipt, which can include electronic funds transfer (EFT) details or credit card payment details.

Cash receipts should be issued every time cash is received, whether it is for a cash sale or cash fees, a capital contribution, a receipt of a loan or some other source. The only exceptions are when cash is deposited directly into the firm's bank account, in which case the source document will be the Bank Statement. (Bank statements will be discussed in detail in Chapter 8.)

There is also an increasing variety of methods allowing customers to pay for items online through internet banking or using their credit or debit card accounts. The customer is able to generate a receipt for themselves on the spot and is able to produce verifiable electronic evidence (which can be printed out if need be) that the transfer of cash took place. Methods of online payment include direct transfer, credit card payment and BPAY. Other online payment options include platforms such PayPal, Apple Pay and Google Pay. With improving wireless technology, many businesses use mobile Electronic Funds Transfer Point of Sale (**EFTPOS**) facilities, which allow them to accept cash payments and provide cash receipts anywhere and anytime.

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As a source document, a receipt must specify the date of the transaction, the amount received and the reason for the receipt of the cash. In addition, it should be numbered for easy and accurate identification. Regardless of the type of receipt issued, to meet the requirements of a tax invoice, it must account for GST and contain all the necessary information outlined previously for tax invoices. In most cases, the customer will be given the original, while the business will retain a copy for its own records.

Example

On 16 May 2030, Jerry's Temp Agency provided a secretary for the week to T. Downey – Lawyer for $600 plus $60 GST (Rec. 26.)

The receipt that would provide evidence of this cash sale is shown in Figure 6.5:

Figure 6.5 Cash receipt (hand-written): Cash sale

Tax invoice: 107681
Receipt: 26

Jerry's Temp Agency
Punt Rd, Richmond, Victoria, 3121
ABN: 11 708 656 213

Date: 16/5/2030
Received from: T. Downey
The sum of: six hundred dollars plus sixty dollars GST
Being for: Secretarial services
Amount: $660 **Signed** J. Cartman

Such a receipt could easily be generated electronically, as is shown in Figure 6.6:

Figure 6.6 Cash receipt (electronic): Cash sale

Jerry's Temp Agency
Punt Rd, Richmond,
Victoria, 3121
ABN: 11 708 656 213

Receipt: 26	16/05/2030		14:43
5679	Secretarial services		$660
	Total		**$660**
Your payment		EFTPOS DEBIT	$660
GST 10%	Net $600	Gross	$660
	GST $60		

Tax invoice: 107681
ALL PRICES ARE GST INCLUSIVE

Exactly the same information is provided on both versions:
- 'Tax invoice'
- date of the transaction (16/5/2030)
- the receipt number (26)
- a description of what has been provided (Secretarial services)

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Study tip

The ATO refers to 'cash sales' as the cash received either from the sale of a good or provision of a service.

- the selling price inclusive of the GST (**$660**). This is the amount of cash actually received.
- the amount of the GST ($60). This means the actual service price of the secretarial services is $600.

Some trading businesses (those that sell goods) will not provide an individualised receipt to each and every customer, preferring instead to issue a cash register receipt. This can be dependent on the nature of the goods sold by the business: a business that sells larger, more expensive items might issue an individualised receipt, but businesses that sell goods in large quantities may be more likely to simply issue a cash register receipt. An example of a cash register receipt is shown in Figure 6.7:

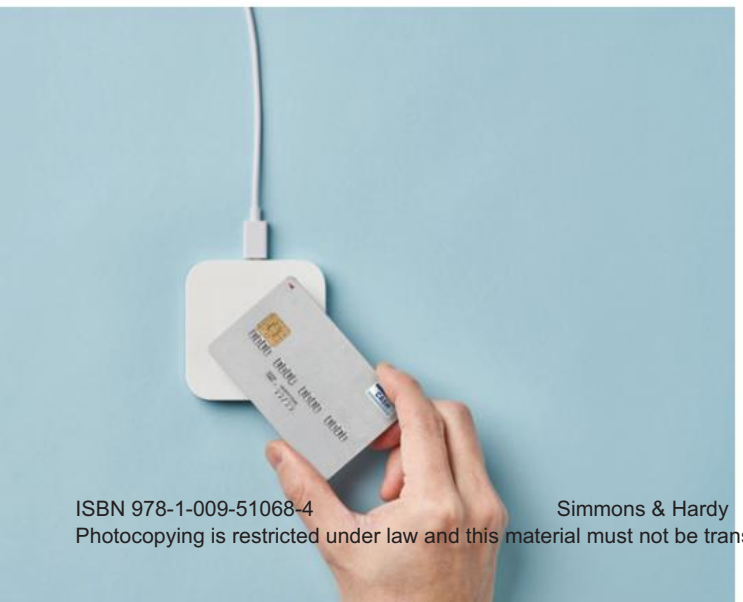
Figure 6.7 Cash register receipt

Fashion House
Shop 45
Chadstone Shopping Centre
Chadstone 3148
Telephone 03 9378 3407

#36/1/5742/9745		21/12/2030	14:43
8934	1 floral shirt		$132
	Total		**$132**
Your payment		EFTPOS DEBIT	$132
GST 10%	Net $120	Gross	$132
	GST $12		

Tax invoice You were served by HANS
ALL PRICES ARE GST INCLUSIVE
Receipt always required for exchange or refund.

When the cash register generates a cash receipt, it produces the original for the customer while keeping another copy for the business. The owner can examine this 'cash register roll', or its electronic equivalent, to generate a summary of the cash received in a single day's trading. If a business sells a variety of items and the cash register is set up to distinguish between certain classes of products, it can also provide a breakdown of the sales, so that the business owner can see which items are generating the most sales. These days many businesses can give customers the option of providing a receipt electronically via email or SMS.



The increasing frequency of electronic transactions is making the technology of EFTPOS accessible to all businesses. Banks and other providers, such as Zeller and Square, supply businesses with a variety of affordable EFTPOS options that allow the transfer of cash rather than the physical handling of cash. Most, if not all, of these devices are Wi-Fi enabled, making them portable, which is great for businesses that are mobile such as trades people, food trucks and coffee vans. EFTPOS machines generate receipts for customers directly from the machine and are either linked to a business app or with a bank account where the business owner can view the transactions for the day and, more importantly, access the funds for business payments.

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Credit card transactions

You may have noticed earlier that credit cards were stated as being used for cash transactions and that when a business accepts a credit card for payment they would hand the customer their tax invoice receipt including payment details from the EFTPOS machine (see Figure 6.8).

Figure 6.8 Credit card receipt

Offiz Werks
Drop Kick Rd, Richmond,
Victoria 3121
ABN: 13 618 962 444

TAX INVOICE

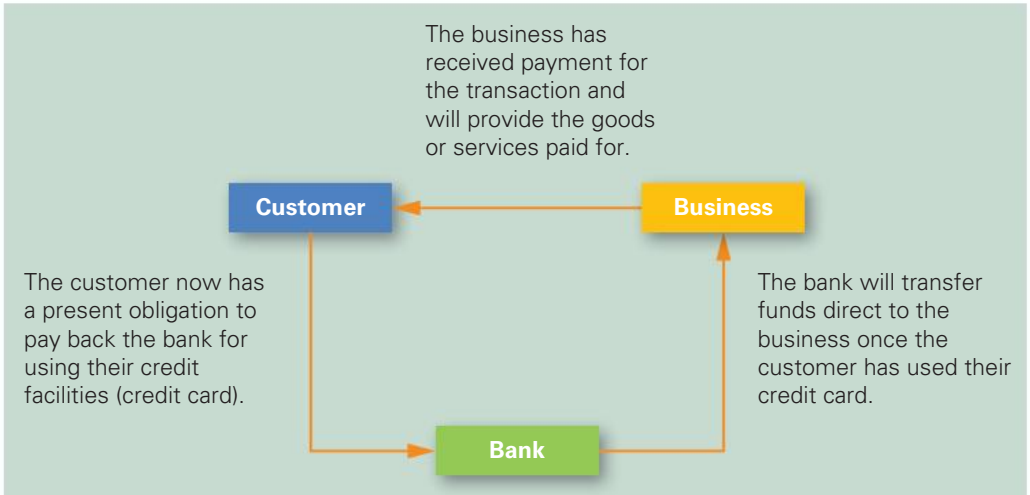
Served by: Victor — Receipt: 7227
Date: 16 March 2030 — Time: 9.18 am

Description	
Reflux A4 Copy paper Carton 5 @ $22.00	$110.00
Total for 5 items	$110.00
EFT	$110.00
GST included in total	$10.00
Transaction	CREDIT
Account: xxxx xxx xxx 4475	VISA
Authorisation	Approved

Thank you for your business!

Credit card transactions are not the same as credit transactions as it is the debt (owing) relationship that indicates a credit transaction. When a business accepts a credit card as a method of payment, the customer's bank, with whom the credit card is held, will transfer cash funds straight to the business's bank account. The business has its cash for the sale and the transaction is complete. There are no further obligations between the business and the customer. It is now up to the customer's bank to seek the repayment of funds to clear the customer's obligation to the bank for their short-term borrowing. It should be evident that the credit relationship is with the bank and not the business, as shown in Figure 6.9.

Figure 6.9 Credit card transaction indicating credit relationship with bank



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Review questions 6.2

1 **State** the source document used to verify cash received.
2 **State** the effect of GST on the amount of cash received for a sale.
3 **Explain** why the GST received on a cash sale creates a GST liability.
4 **Explain** why receiving payment via a credit card is not a credit transaction.

6.3 Cash payments and the changing nature of transactions

Cheques used to be a common form of payment; however, now they only account for 0.2% of non-cash retail payments in Australia. The Australian Government will phase out cheques from the Australian financial system by 2030.

The decline in cheques is also due to the ease and security of online payment methods. When a business receives a tax invoice from a supplier, there are often a variety of payment methods provided that will request payment electronically. See Figure 6.10 for a telecommunications bill example.

You can see in Figure 6.10 that there are several options allowing a business to make a cash payment electronically via their bank account, which transfers the cash to their supplier and provides a record (EFT payment receipt and transaction record) in the paying business' bank account. Suppliers may also provide their bank account details, requesting that a business directly deposit funds into their account via EFT. If a business pays via this method, they need to ensure that they provide a reference, either an invoice number or their business name, so that the supplier knows who they have received funds from.

For small payments (such as buying milk or basic stationery), a petty cash system may be used. Under this system, a small amount of cash is set aside, with individuals reimbursed from the petty cash fund for small amounts they have paid on the firm's behalf. Receipts need to be provided for evidence prior to reimbursement and then, periodically, all payments from the petty cash book are updated summarily to the cash payments journal (discussed in Chapter 7).

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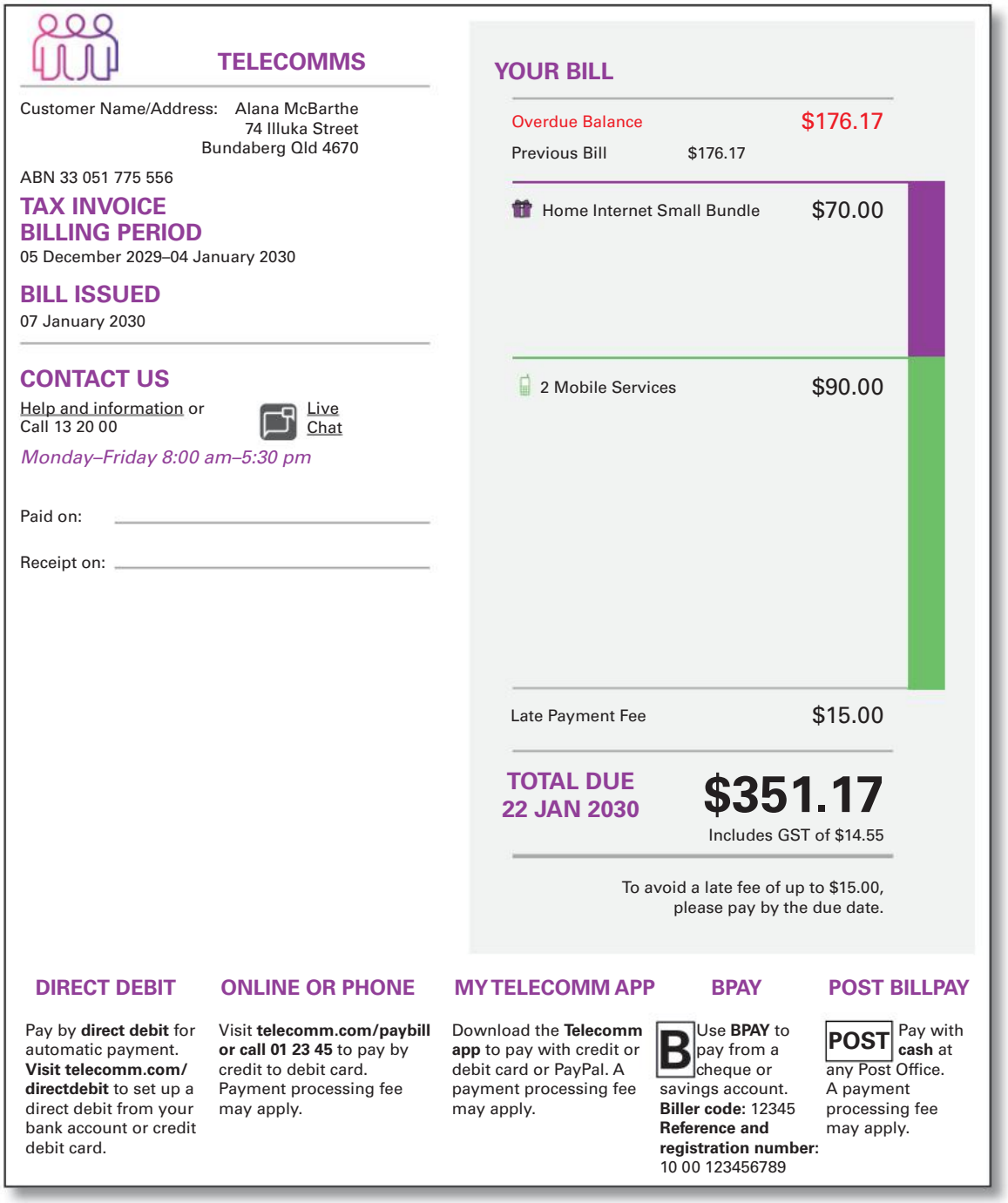
Figure 6.10 Bill example



TELECOMMS

Customer Name/Address: Alana McBarthe
74 Illuka Street
Bundaberg Qld 4670

ABN 33 051 775 556

TAX INVOICE
BILLING PERIOD
05 December 2029–04 January 2030

BILL ISSUED
07 January 2030

CONTACT US
Help and information or Call 13 20 00
Live Chat
Monday–Friday 8:00 am–5:30 pm

Paid on: _____

Receipt on: _____

YOUR BILL

Overdue Balance	$176.17
Previous Bill	$176.17
Home Internet Small Bundle	$70.00
2 Mobile Services	$90.00
Late Payment Fee	$15.00
TOTAL DUE 22 JAN 2030	**$351.17**

Includes GST of $14.55

To avoid a late fee of up to $15.00, please pay by the due date.

DIRECT DEBIT
Pay by **direct debit** for automatic payment. **Visit telecomm.com/directdebit** to set up a direct debit from your bank account or credit debit card.

ONLINE OR PHONE
Visit **telecomm.com/paybill or call 01 23 45** to pay by credit to debit card. Payment processing fee may apply.

MY TELECOMM APP
Download the **Telecomm app** to pay with credit or debit card or PayPal. A payment processing fee may apply.

BPAY
B Use **BPAY** to pay from a cheque or savings account. **Biller code:** 12345 **Reference and registration number:** 10 00 123456789

POST BILLPAY
POST Pay with **cash** at any Post Office. A payment processing fee may apply.

In other cases, the business may use debit or credit cards for purchases. However, even in these cases, the basic principles of cash recording still apply, and source documents must be kept to verify the amount and the use of the cash.

Review questions 6.3

1 **Explain** why cash payments are likely made via EFT.
2 **Explain** the role of a petty cash system.
3 **Explain** why using a debit or credit card would be a preferable payment option rather than a petty cash system.

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6.4 Bank Statements

Bank Statement
a statement provided to customers by their banking institution that gives details of all cash transactions relevant to that particular account that have occurred over a specific period of time and the resulting balance at the end of that period

Bank Statements are statements provided by a business's bank that show all cash transactions in and out of a particular bank account for a specified period (usually a month). These days, with online banking being so prevalent, Bank Statements are made available electronically rather than being sent to you in the mail as a hardcopy (although it still does occur). They provide two useful functions:

1 Bank Statements provide a list of all transactions that can be used as a point of comparison to ensure all transactions are legitimate and to provide a balance of the account at the end of a specified period.
2 Bank Statements identify transactions that the business may have been unaware of such as direct debits (e.g. bank fees), direct credits (e.g. interest) or direct deposits from other entities.

Figure 6.11 provides an example of a Bank Statement.

Figure 6.11 Bank Statement

Bank of Euroa
Echuca Branch
A/c holder Jerry's Temp Agency
Punt Rd, Richmond, Victoria, 3121 a/c: 309867 543689

Date	Particulars	Debit	Credit	Balance
March 1	Balance b/fwd			1 250 CR
	DirDep – L. Lawyer		990	2 240 CR
2	W/draw online Offiz Werks	300		1 940 CR
4	BPAY Oriden Energy	375		1 565 CR
13	Deposit POS		1012	2 577 CR
17	EFTPOS W/draw Bunn 269	275		2 302 CR
18	DEPOSIT Cash		308	2 610 CR
18	W/Draw online D. Contractor	360		2 250 CR
20	Interest		25	2 275 CR
20	BPAY Tedstri Communications	165		2 110 CR
21	W/draw online water	180		1 930 CR
25	DirDep A. Accountant		2 000	3 930 CR
31	Bank charges	10		3 920 CR
	Closing Balance			**3 920 CR**

Review questions 6.4

1 **State** two purposes of a Bank Statement.
2 **Explain** why banks would encourage electronic statements.

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6.5 Credit transactions

With a cash transaction, the sale or purchase of a good or service occurs at the same time as the cash is exchanged. However, a credit transaction effectively separates a sale or purchase into two transactions: an exchange of goods or a service and an exchange of cash, which does not occur until a later date.

When goods or services are sold or purchased on credit, the source document will be an **invoice**, which will provide the evidence of the transaction and the details necessary to record it (even though no cash has changed hands). Because GST is recognised and reported at the time of purchase or sale, the invoice must also show all the information necessary for it to be classified as a tax invoice.

invoice
a source document used to verify credit transactions

The type of invoice depends on whether the business is issuing the invoice (sales invoice) or receiving the invoice (purchase invoice).

Sales invoice

The sales invoice in Figure 6.12 shows that Jerry's Temp Agency has provided a bookkeeper to its customer, A. N. Accountant, who now owes the agency **$1760**: $1600 for hiring the bookkeeper for 16 hours, plus $160 GST. The seller or supplier (Jerry's Temp Agency) is also the business that issues the invoice and so will have its name at the *top* of the invoice. Conversely, the purchaser or customer (A. N. Accountant) is named in the *middle* of the invoice. The original is sent to the customer with the copy being retained by the seller for its recording purposes. Note that even though this transaction is being carried out on a credit basis it still must display all the features required by the ATO of a tax invoice.

Figure 6.12 Sales invoice

Jerry's Temp Agency
Punt Rd, Richmond, Victoria, 3121
ABN: 11 708 656 213

TAX INVOICE
Date: 15/04/2030
Invoice: 52
Terms: 5/7, n/30

Customer: A.N. Accountant
Lakeside Dve, Sth Melb., Vic, 3205

Service	Hours	Hourly Rate	Total
BOOKKEEPER	16	100	1600
		GST	160
		TOTAL	**$1760**

Credit note

A **credit note** is a document that provides evidence of a reduction of what is owed to a particular supplier by one of its customers. A credit note relates to a previous credit transaction and can be issued for a variety of reasons:

credit note
a document that evidences that there is a reduction in the amount owed by a customer

- return of goods due to damage, spoilage or wrong specifications
- incorrect price or quantity on original sales invoice and overall amount was overstated
- a sales discount was not applied.

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Figure 6.13 Credit note

Jerry's Temp Agency
Punt Rd, Richmond, Victoria, 3121
ABN: 11 708 656 213

Tax invoice
Date: 28/4/2030
Credit Note: R23

Customer: A.N. Accountant
Lakeside Dve, Sth Melb., Vic, 3205

Description	Hours	Hourly Rate	Total
Credit for overcharge of work as discussed	2	100	200
		GST	20
		TOTAL	**$220**

The credit note in Figure 6.13 shows that Jerry's Temp Agency has provided a reduction in the amount owed by its customer, A. N. Accountant, for excess hours billed that were not received. This will lead to an overall reduction in debt for A.N. Accountant, who will now owe the agency **$1 540 ($1 760 – $220)**. Jerry's Temp Agency is the business that issues the credit note and so will have its name at the *top* of the document. Conversely, the customer (A. N. Accountant) is named in the *middle* of the document. The original is sent to the customer with the copy being retained by the seller for its recording purposes.

Purchase invoice

When Jerry's Temp Agency receives office supplies from its supplier, Offiz Werks, it is provided with a purchase invoice (Figure 6.14) outlining what has been purchased. Note that even though this transaction is being carried out on a credit basis it still must display all the features required by the ATO of a tax invoice.

The seller or supplier (Offiz Werks) is the business that issues the invoice, so will have its name at the *top* of the invoice. Jerry's Temp Agency is the customer in this case and is named in the *middle* of the invoice. The original is sent to Jerry's Temp Agency with the copy retained by the seller (Offiz Werks) for its recording purposes. Jerry's Temp Agency now owes Offiz Werks **$1 188**: $1 080 for various office supplies plus $108 GST.

Figure 6.14 Purchase invoice

Offiz Werks
Drop Kick Rd, Richmond, Victoria, 3121
ABN: 13 618 962 444

TAX INVOICE
Invoice: X782
Terms: 10/5, n/30
Date: 25/4/2030

Customer: Jerry's Temp Agency
Punt Rd, Richmond, Victoria, 3121

Goods	Quantity	Unit Cost	Total
Box of 2500 reams of A4	10	18	180
Printer cartridge refills	15	60	900
		GST	108
		TOTAL	**$1 188**

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Statement of Account

Statement of Account a statement provided to credit customers to give details of transactions that have occurred over a specific period of time and the resulting balance owing at the end of that period

A **Statement of Account** is provided to customers who purchase goods or services using credit. A business will issue a Statement of Account to each of its credit customers and receive one from each of their suppliers from whom they purchase goods or supplies on credit. It is a document that can be used to verify transactions that have occurred over a specified period of time and gives a balance owing at the end of that period. It includes all transactions with the customers including purchases, adjustments, returns and payments. An example is shown in Figure 6.15.

Figure 6.15 Statement of Account

Jerry's Temp Agency
Punt Rd, Richmond, Victoria, 3121
ABN: 11 708 656 213

STATEMENT OF ACCOUNT

Account of:	A.N. Accountant Lakeside Dve, Sth Melb., Vic, 3205		For period: April 2030	
Date	**Details**	**Sales**	**Payments**	**Balance**
April 1	Balance brought forward			1 200
15	Inv. 52	1 760		2 960
18	Payment received: (Direct debit)		1 200	1 760
28	Credit Note R23		220	1 540
29	Payment received: (Direct debit)		1 000	540
	Balance owing: 30 April 2030			**$540**

Once a business or customer receives their Statement of Account, they should match all transactions using source documents to ensure they concur with the statement and that there are no errors. It is also a handy way for the business issuing the statement to provide reminders to customers of amounts owing.

Review questions 6.5

1 **State** the source document used to verify a credit transaction.
2 **State** the source document that records a reduction in what is owed to the seller. **Provide** examples of what may cause this document to be issued.
3 **State** which entity receives the original and which entity retains the copy of each of the documents discussed in this section.
4 **State** the current asset created by a credit sale.
5 **State** the current liability created by a credit purchase.
6 **Explain** the purpose of a Statement of Account and **state** how often it should be issued.

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6.6 Other business transactions

Delivery docket

delivery docket
a document used to verify that the goods received are the goods ordered

When Jerry's Temp Agency receives office supplies from its supplier, Offiz Werks, it will also be provided a **delivery docket** (Figure 6.16), which is used to evidence the delivery of goods. The seller or supplier (Offiz Werks) is the business that issues the delivery docket, so it will have its name at the *top* of the document. Jerry's Temp Agency is the customer in this case and is named in the *middle* of the document. The original is sent to Jerry's Temp Agency with the copy being retained by the seller (Offiz Werks).

Figure 6.16 Delivery docket

Delivery docket (Original)

Offiz Werks
15 Drop Kick Rd,
Richmond, Victoria, 3121
ABN: 13 618 962 444

Delivery to:
Jerry's Temp Agency
Punt Rd, Richmond, Victoria, 3121

Docket Number	Customer Number	PO Reference	Date
DD567	JTA892345	PO 7364	25/4/2030

Code	Description	Quantity Ordered	Quantity Received
WP456 – white	Box of 2500 reams of A4	10	
RC x926	Printer cartridge refills	15	

Receipt Confirmation	
Docket Number DD567	Full Name (printed)
Pinnacle Management	Receipt signature
Purchase Order Reference PO 7364	Date Order Received
Comments:	

The delivery docket is not used for tax purposes so does not require information such as prices and tax information; however, it still contains all other necessary information that requires it to be a source document. It verifies that goods have been received and it provides a trail of evidence. It is important that an employee physically checks the delivery to ensure that what is on the purchase invoice and delivery docket is what was actually received and signed off accordingly. Missing items are highlighted by a number if the quantity received is less than the quantity ordered. If it is the incorrect product, a zero will appear in the quantity received column and a note will be made in the comments section. The wrong product will be taken away.

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Shipping and order confirmation

Shipping and order confirmations are common with online purchases and are commonly received as an email document, although paper versions do exist. Once an order and payment has been received by a supplier, they will package the purchase and then send through to a postal or delivery agency. The shipping and order confirmation provides evidence that the order has been dispatched (sent) and can be expected at some point in the future. The time for delivery is dependent on the country of origin and postal services. Some confirmations provide tracking numbers that allow the customer to track their delivery's progress. An example is shown in Figure 6.17.

shipping and order confirmation
a document that indicates that an order has been dispatched (sent) and can be expected at some point

Figure 6.17 Shipping and order confirmation

From: shipping_confirmation@posttrak.com
To: jerry.cartman@gmail.com
Cc:
Subject: Your package has been shipped

PostTrack©

SHIPPING CONFIRMATION

My PostTrack REWARDS

This email is to confirm that your items have been shipped.
Note that multiple items in an order may be shipped separately.

You can review the complete details of your order in your Account page.

Thank you for choosing PostTrack.

Order Confirmation Number: 7844327

Order date: 23/4/2030

Redemption Item	Quantity	Tracking Number
Paper, Print cartridge	1	3266890

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Internal transactions and memos

Some transactions will not be evidenced by any of the aforementioned documents, as they do not involve a sale or purchase, the receipt or payment of cash or the delivery of goods (like non-cash transactions with the owner and certain inventory transactions).

These transactions must still be verified by a document, but it will be a document issued from within the firm, called a memorandum or **memo**. Memos can be issued for any number of transactions that cannot be evidenced by standard source documents, and so their format is much more flexible than the other documents discussed so far. Put simply, they will describe a particular transaction and request that it is recorded.

memo
a source document used to verify internal transactions

Figure 6.18 shows a common layout for a memo:

Figure 6.18 Memo

Jerry's Temp Agency **memo 13**

Date: 24 May 2030
From: Jerry
To: Accounting Dep
Withdrew one business laptop for personal use.

Signature: *J. Cartman*

Review questions 6.6

1 **State** the document that verifies the delivery of goods and **explain** how it does this.
2 **State** the purpose of a shipping and order confirmation and its importance to online shopping.
3 **Explain** the purpose of a memo.

Where have we been?

- Source documents provide both the evidence that a transaction has occurred and the details of the transaction itself. They ensure the reports are reliable and free from bias.
- The Goods and Services Tax (GST) is a 10% tax levied by the federal government on most goods and services (excluding fresh food, health and medical care, educational supplies and childcare).
- GST on sales is owed to the government, but GST on purchases and payments reduces that liability.
- When cash is received, the source document will be a cash receipt.
- When cash is paid, the source document will be an EFT document, ATM document or Bank Statement.
- When a good or a service is purchased or sold on credit, the source document will be an invoice.
- A credit note is used to evidence the reduction of what is owed by a customer.
- A delivery docket is used to verify the receipt of goods from a supplier.
- A shipping and order confirmation is used to inform a customer that their purchase has been sent.
- A memo is used to verify an internal transaction.

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Exercises

Exercise 6.1
Cash transaction

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The following document was found in the office of Ripper Repair, which is owned by Harry Hardwood:

Ripper Repair — **TAX INVOICE**
294 Rowness Street
Vermont South Vic. 3133
ABN: 32 467 098 203

Receipt no.	253	**5 Oct. 2030**
Received from	Cash fees	
The sum of	Five hundred and fifty dollars	
Being for	Repairs	
Amount		**$500.00**
Plus GST		**50.00**
Total		**$550.00**
Signed:	*Harry Hardwood*	

Required

a. **Identify** the source document above and **describe** the transaction.
b. **Explain** why this transaction creates a GST liability for Ripper Repair.
c. Referring to two Qualitative characteristics, **explain** the role of source documents in the Accounting process.

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Exercise 6.2
Cash transaction

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The manager of Sally's Alteration Shop discovered the following source document:

Start Energy

Merchant	Start Energy
Description	WITHDRAWAL ONLINE 5250373 BPAY SE SALES SE
Account	WIZ BANK 555-000 123456
Scheduled payment date	22 Jan 2030
Amount	-$715
Transaction ID	add21267-ee2a-4704-8d5d-125eebe5b3f9
BPAY® receipt number	5250373
Type	BPAY®
From	WIZ BANK 555-000 123456
To	START ENERGY SALES P/L
Biller code	132475
Customer reference number	88455427972

Required

a. **Identify** the source document above and **describe** the transaction.
b. **Explain** the effect of this transaction on the GST liability of Sally's Alteration Shop.
c. **State** two reasons why payments should not be made using cash from the cash register.
d. **State** two reasons why this document would not satisfy the requirements of a tax invoice.

Exercise 6.3
Cash transaction

page 96

The following receipt was found by the owner of Clarke's Catering:

Barbeques Galore

Dodds Street South Melbourne

Date 31/5/2030

$850 plus $85 GST

Transaction ID: 200 5A44 937 09D2

Required

a. **Describe** the transaction evidenced by the document above.
b. **State** two benefits of paying by EFT.

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Exercise 6.4

Credit transaction

The accountant for Music Tuition Services came across the following source documents in a drawer:

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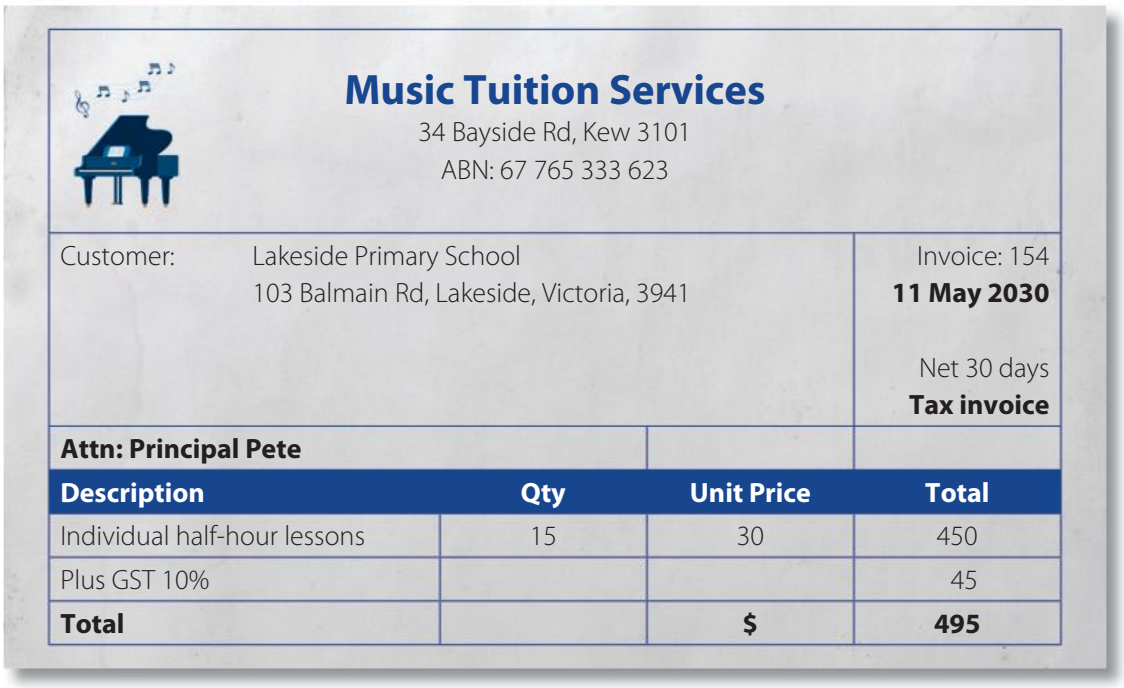
Document A

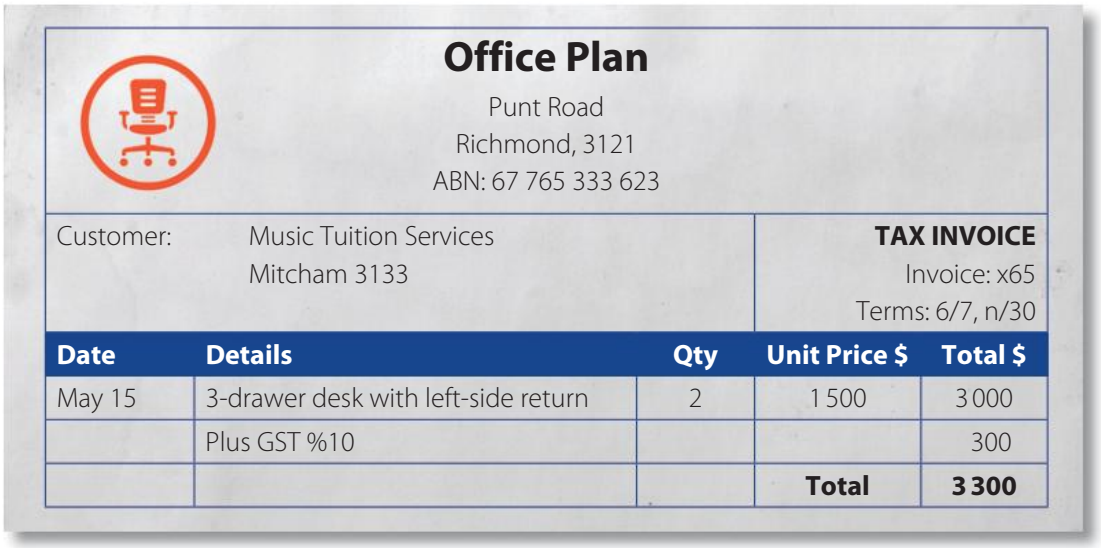


Music Tuition Services
34 Bayside Rd, Kew 3101
ABN: 67 765 333 623

Customer:	Lakeside Primary School 103 Balmain Rd, Lakeside, Victoria, 3941	Invoice: 154 **11 May 2030** Net 30 days **Tax invoice**
Attn: Principal Pete		

Description	Qty	Unit Price	Total
Individual half-hour lessons	15	30	450
Plus GST 10%			45
Total		**$**	**495**

Document B



Office Plan
Punt Road
Richmond, 3121
ABN: 67 765 333 623

Customer:	Music Tuition Services Mitcham 3133	**TAX INVOICE** Invoice: x65 Terms: 6/7, n/30

Date	Details	Qty	Unit Price $	Total $
May 15	3-drawer desk with left-side return	2	1 500	3 000
	Plus GST %10			300
			Total	**3 300**

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Required

a. **Identify** Documents A and B and **describe** each transaction.
b. **Explain** the effect of the transaction in Document A on the GST liability of Music Tuition Services.
c. **State** whether Music Tuition Services would have the original or copy of Document A. **Justify** your response.
d. **Explain** why Document B decreases the GST liability of Music Tuition Services.
e. **Explain** the effect of the transaction in Document B on the Accounting equation of Music Tuition Services.
f. **State** a supporting document Office Plan could send to Music Tuition Services at the end of the month. **Justify** your response.

Exercise 6.5
Credit note

page 99

The following source document was discovered by Peta's Party Hire:

Peta's Party Hire **TAX INVOICE: 41976**

Dandy Rd, Eltham, Victoria, 3095
ABN: 13 719 667 324
Credit Note: T923

Customer:	B. W. Lawyers Lakeside Dve, Albert Park Vic, 3206		Date: 15/6/2030
Description	**Hours**	**Daily Rate**	**Total $**
Credit for 2 outdoor heaters not working	2	175	350
		GST	35
		Total	**$385**

Required

a. **Identify** the source document above and **describe** the transaction.
b. **State** whether Peta's Party Hire would have the original or copy of the above document. **Justify** your response.
c. **Explain** the effect of the transaction on the amount owed by B. W. Lawyers to Peta's Party Hire.
d. **Explain** the effect of the transaction on the GST liability of Peta's Party Hire and B. W. Lawyers.

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Exercise 6.6

Delivery docket

page 100

The following source document was found by Julie's Modelling Agency:

Delivery Docket (Original)
Potty Plant Hire
67 Tigerland Rd,
Sunshine, Victoria, 3020
ABN: 14 707 851 538

Delivery to:
Julie's Modelling Agency
Punt Rd, Richmond,
Victoria, 3121

Docket Number	Customer Number	PO Reference	Date
DS 901	MA776		6/6/30

Code	Description	Quantity Ordered	Quantity Received
BLT 24	Large broad leaf tropical	15	
SFT 12	Small flowering tropical	30	
RB 8	Rose bushes	18	

Receipt Confirmation	
Docket Number DS 901	Full Name (printed)
Julie's Modelling Agency	Receipt signature
Purchase Order Reference	Date Order Received
Comments:	

Required

a. **Identify** the source document and **explain** its purpose.
b. **State** whether Julie's Modelling Agency would have the original or copy of the document. Justify your response.
c. **Explain** why there are no amounts listed on this source document.
d. **Explain** two courses of action that could occur if, when checked, it was discovered that only 25 small flowering tropical plants were delivered. (Assume the other quantities were correct.)

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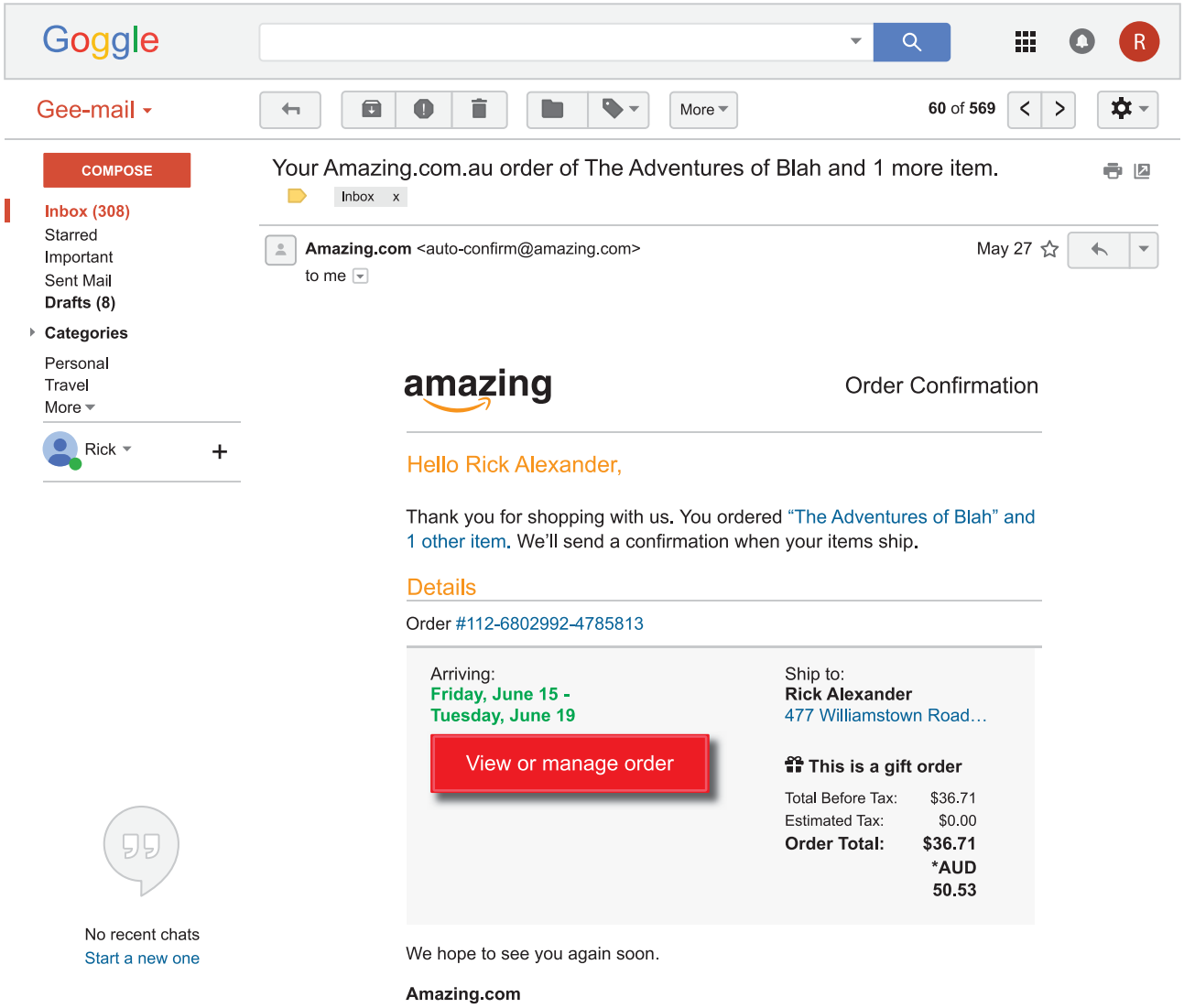
Exercise 6.7
Shipping and order confirmation

page 101



Required

a. **Identify** the source document above. **Explain** the purpose of the document.
b. **Identify** two real businesses or types of business that may provide a shipping and order confirmation.
c. **Explain** why this document tends to be electronic in nature.

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Exercise 6.8
Memorandums

page 102

The accountant of Larry's Couriers received the following source document in the internal mail from the manager:

Larry's Couriers **Memo 16**
Market St, Sunshine 3020 10/21/2030

To: the Accountant
Re: $300 worth of stationery has been taken for personal use.
Signed: *K. Ferris*

Required

a. **Identify** the source document above and **describe** the transaction.
b. Referring to one Accounting assumption, **explain** why this transaction must be reported in the Balance Sheet of Larry's Couriers.
c. **State** the effect (overstated/understated/no effect) on each element of the Accounting equation of Larry's Couriers if this transaction was **not** recorded.

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Chapter 7
Cash Accounting for service businesses

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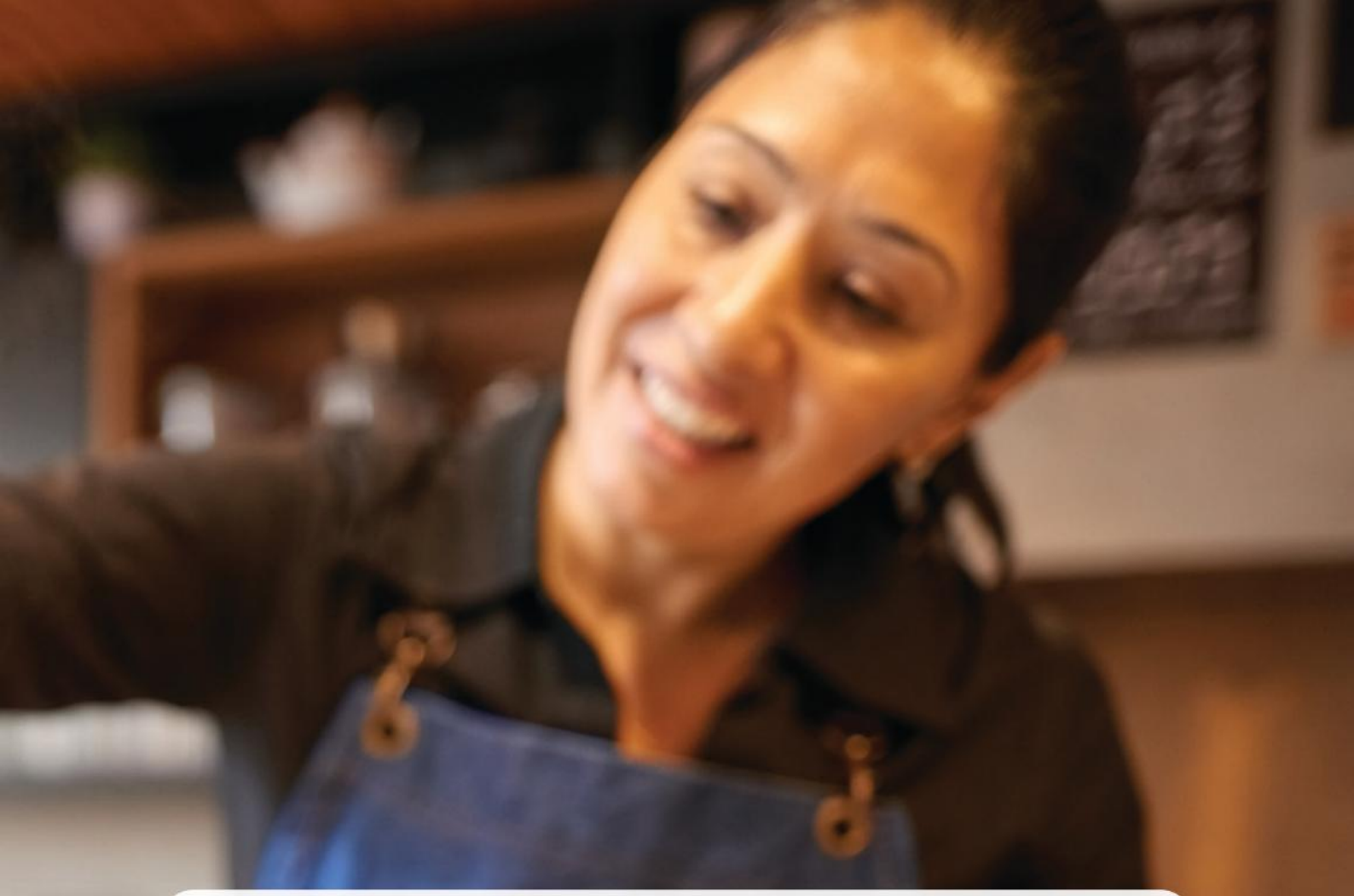

Learning intentions

After completing this chapter, you should be able to:

- **define** the term 'cash'
- **explain** the operation of a single-entry system to account for cash
- **list** the source documents used to verify cash transactions
- **record** transactions in cash journals, including GST
- **calculate** and **classify** a GST balance
- **prepare** a Cash Flow Statement
- **record** a GST settlement and a GST refund in the cash journals
- **calculate** Cash Flow Cover
- **analyse** liquidity using Cash Flow Cover.

Key terms

After completing this chapter, you should be familiar with the following terms:

- service business
- journal
- Statement of Receipts and Payments
- single-entry Accounting
- Cash Receipts Journal
- Cash Payments Journal
- cash surplus
- cash deficit
- Cash Flow Statement
- Operating activities
- Investing activities
- Financing activities
- GST payable
- GST settlement
- GST receivable
- GST refund
- Cash Flow Cover.

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7.1 Service businesses and cash

service business
a small business that operates by providing its time, labour, assets or expertise (or a combination of all four) in return for a fee or charge

In Chapter 3 we considered how a small business can be classified according to the nature of its operations as a service business, trading business or manufacturing business. In that chapter, a **service business** was defined as one that provides its time, labour, assets or expertise in return for some kind of fee. This would include small businesses run by plumbers, motor mechanics, editors, hire firms, hairdressers and architects, just to name a few.

Cash recording

The majority of the transactions of service businesses will be conducted using cash, so it is important that the Accounting system is able to generate information relating to the firm's cash position. Specifically, the information should cover the firm's:

- *cash receipts* – the amount of cash the business has received from other entities during a period and sources of the cash (i.e. where it has come from)
- *cash payments* – the amount of cash the business has paid to other entities during a period and the uses of the cash (i.e. what it was spent on)
- *bank balance* – the level of cash on hand at a particular point in time.

Cash receipts will increase a firm's bank balance, while cash payments will decrease that balance.

It is worth noting that when we speak of 'cash', we are not only talking about notes and coins in the cash register (i.e. cash on hand), but also about cash in the firm's bank account, and any credit card payments it may have received from customers. Although these items are not strictly dollars and cents, they are very easily changed into dollars and cents: cash can be withdrawn easily enough from a bank account, and credit card payments result in deposits into the firm's bank account.

Review questions 7.1

1 **Define** the term 'service business'.
2 **List** five typical service businesses.
3 **Explain** the relationship between a firm's cash receipts, cash payments and its bank balance.
4 **List** two items that are treated as 'cash' in an Accounting system.

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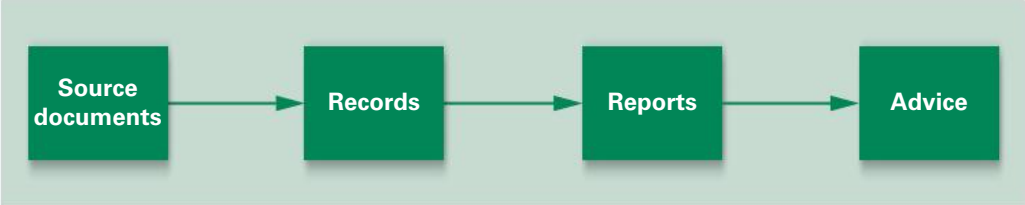
7.2 Single-entry Accounting

Accounting information is communicated to the owner via written reports, but these reports are themselves based on information generated by the recording system. Recall the Accounting process that was outlined in Chapters 1 and 6.

Figure 7.1 The Accounting process



Source documents

The first step in generating information about a firm's cash position is to collect the source documents relating to the cash it has received and paid during the reporting period. The main documents that are used to verify cash transactions are:

Cash received	Cash paid
Cash receipt Cash register roll Bank Statement Electronic Funds Transfer (EFT) receipt	Bank Statement Electronic Funds Transfer (EFT) receipt Credit Debit card receipt

Small businesses need to keep these source documents so that they can satisfy the Australian Taxation Office (ATO) and verify the information they record in their cash journals. (See Chapter 6 for a detailed discussion of source documents.)

Records: Cash Journals

Once the relevant documents have been collected and sorted, it is necessary to record the data they contain in journals. A **journal** is simply an Accounting record (in a manual system, like a ruled book) in which transactions are written down in an organised format. Cash transactions are recorded in one of two journals:

- *a Cash Receipts Journal*, which summarises all cash received by the business (from other entities) during a particular reporting period
- *a Cash Payments Journal*, which summarises all cash paid by the business (to other entities) during a particular reporting period.

journal
an Accounting record that classifies and summarises transactions during a particular reporting period

By recording the cash transactions in a Cash Receipts Journal and a Cash Payments Journal, the raw data contained on the source documents is classified and summarised so that it becomes information that can be presented in Accounting reports.

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Statement of Receipts and Payments
an Accounting report that lists cash receipts and payments during a reporting period, the change in the bank balance, and the opening and closing bank balance

single-entry Accounting
the process of recording transactions in journals and then using the summarised information to prepare reports

Reports: Statement of Receipts and Payments

The penultimate (second last) stage is the preparation of Accounting reports to communicate financial information to the owner.

As far as cash transactions are concerned, this means taking the information that has been generated in the Cash Receipts Journal and Cash Payments Journal and preparing a **Statement of Receipts and Payments**. This report shows the firm's cash receipts and payments and the consequent change in its bank balance over that period, which the owner can then use to make decisions about the firm's cash activities and position.

This process of recording transactions in journals and then using the summarised information to prepare reports is known as **single-entry Accounting**.

Study tip

In Accounting, 'recording' means writing down data in an organised format.

Review questions 7.2

1 **Draw** a flow chart to show the Accounting process as it relates to cash transactions.
2 **State** the source documents that provide evidence of:
   - cash receipts
   - cash payments.
3 **Explain** the function of the following elements of a single-entry Accounting system:
   - source documents
   - cash journals
   - Statement of Receipts and Payments.

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7.3 The Cash Receipts Journal

As we noted earlier, once the source documents are collected, they must be organised in some way so that they make sense (after all, a shoebox full of dockets hardly tells us how much cash the business has spent this week). Transactions must be classified and summarised so that the business has information rather than just data, and this is achieved by recording cash receipts in a **Cash Receipts Journal**.

Cash Receipts Journal an Accounting record that classifies and summarises all cash received from other entities during a particular reporting period

Example

Ryan Jones owns Goghs' Painting Service, a small business that specialises in interior and exterior painting. Ryan has provided the following list of cash receipts for March 2030:

March	1	EFT transfer of $1 600 plus $160 GST from E. Aplin for house painting (EFT 1052)
	8	Received via Credit card $1 100 (including $100 GST) from A. Stephens for fence painting (EFT 1053)
	19	Ryan contributed $700 cash to the business (Rec. 7)
	26	Received $1 650 (including $150 GST) from J. Tran via direct debit for house painting (Bank Statement)

In order to classify and summarise these cash receipts, they are recorded in a multi-column Cash Receipts Journal, as is shown in Figure 7.2:

Figure 7.2 Recording in the Cash Receipts Journal

Cash Receipts Journal

Date[1]	Details[1]	Source Document[1]	Bank[2]	Painting fees[3]	Sundries	GST
Mar. 1	Painting fees	EFT 1052	1 760	1 600		160
8	Painting fees	EFT 1053	1 100	1 000		100
19	Capital contribution	Rec. 7	700		700	
26	Painting fees	BS*	1 650	1 500		150
	TOTALS	**$**	**5 210**	**4 100**	**700**	**410**

* BS represents the Bank Statement. All direct deposit transactions such as EFTPOS, credit card and BPAY will have a transaction ID.

Notes for recording in the Cash Receipts Journal

1 Date/Details/Source Document

As with most Accounting records, transactions are recorded in the Cash Receipts Journal in date order, with a brief description of the transaction noted in the details column. In order to satisfy the demands of *Verifiability* and *Faithful representation*, the source document – which in this case is some type of receipt number – is recorded with the transaction. Because these receipts are issued by the firm itself (in this case, Goghs' Painting Service), the receipt numbers should run in sequence. (A missing document should be investigated immediately to identify any possible fraud.)

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Study tip

If a transaction states an amount plus GST, add them together to determine the amount to be recorded in the Bank column. If a transaction states that an amount includes GST, you already have the amount to be recorded in the Bank column.

Study tip

The Sundries column is like the junk drawer in your kitchen – anything that doesn't go anywhere else goes in here.

2 Bank

The amount of cash received is entered in the Bank column to allow calculation of the total cash received for the reporting period. This Cash Receipts Journal shows that Goghs' Painting Service received **$5 210** (cash) during March 2030.

3 Classification columns (Painting fees, GST)

In a multi-column Cash Receipts Journal, each cash receipt must be recorded twice: once in the Bank column to record the cash received and a second time in a classification column to record the source of that cash. These classification columns allow for *frequent* cash receipts to be summarised, so that only the *total* needs to be reported in the reports. In this case, most of the cash received by Goghs' Painting Service comes from Painting fees ($4 100 in total) and the GST on those fees ($410), so 'Painting fees' and 'GST' become column headings.

A business that just performs one function may only need one column; however, a small business owner would be able to gain more information if they could further classify their receipts. In this example, Ryan could split Painting fees into 'Interior painting fees' and 'Exterior painting fees' to determine which area was providing more cash.

4 Sundries

Any receipts that are infrequent should be recorded in the Sundries column, because it is not necessary (or possible!) to summarise transactions that occur only once. In this case, the $700 Capital contribution made by the owner is (hopefully) infrequent.

Double-checking mechanism

At the end of the period, each column in the Cash Receipts Journal should be totalled. As a double-checking mechanism, the total of the Bank column should equal the sum of the totals of the other (classification and Sundries) columns.

Using the data from Figure 7.2, Figure 7.3 shows this mechanism:

Figure 7.3 Double-checking mechanism: Cash Receipts Journal

Bank	**5 210**	=	Painting fees	4 100
		+	GST	410
		+	Sundries	700
Total	**$5 210**		**Total**	**$5 210**

If these amounts do not match, then an amount has not been recorded accurately in the Cash Receipts Journal, and the totals cannot be used in the preparation of reports until the error is corrected.

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GST on cash fees

As was noted in Chapter 6, the GST is a 10% tax on most goods and services sold in Australia, and it has to be collected by registered businesses. The transaction on 1 March 2030 shows that Ryan completed painting services worth $1 600, but to this amount he must also add 10% GST ($1 600 × 10% = $160 GST). Therefore, the total charge to the customer, and the total cash received by Goghs' Painting Service, was **$1 760**.

Because the business collects GST from its customers on behalf of the federal government (and must forward this GST to the ATO), GST received on cash fees becomes a liability for the business. The GST will be paid to the ATO after the business completes and lodges its next Business Activity Statement (BAS).

Notice that not all the transactions in the Cash Receipts Journal attract GST. The transaction involving the capital contribution has no GST attached, because it is not a transaction resulting in the sale of a good or the performance of a service.

Therefore, cash receipts that are not subject to GST include:

- interest revenue (on bank accounts, term deposits or other investments)
- capital contributions
- loans.

Review questions 7.3

1 **Explain** the function of the Cash Receipts Journal.
2 Referring to two Qualitative characteristics, **explain** why document numbers must be recorded in the Cash Receipts Journal.
3 **Explain** why transactions must be recorded in both the Bank column and a classification column.
4 **Explain** the function of the Sundries column in a Cash Receipts Journal.
5 **Explain** the mechanism used to check the totals of the Cash Receipts Journal.
6 **Explain** why GST on cash fees creates a GST liability.

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7.4 The Cash Payments Journal

Cash Payments Journal an Accounting record that classifies and summarises all cash paid to other entities during a particular reporting period

Just as cash receipts are recorded in a Cash Receipts Journal, cash payments are classified and summarised in a **Cash Payments Journal**.

Example

Goghs' Painting Service has provided the following list of payments for March 2030:

March	1	Paid wages of $450 (EFT 28355)
	5	Owner withdrew $500 cash (ATM Rec. 155)
	7	Purchased new equipment for $1 500 plus $150 GST (EFT 5168)
	12	Purchased paint costing $250 plus $25 GST (EFT 434)
	16	Paid $450 wages (EFT 28356)
	20	Purchased paint costing $400 plus $40 GST (EFT 485)
	22	Owner withdrew $400 cash (ATM Rec. 206)
	25	Purchased paint costing $150 plus $15 GST (EFT 535)
	28	Van was serviced for $200 plus $20 GST (EFT 824)
	30	Paid wages of $450 (EFT 28357)

In order to classify and summarise these cash payments, they are recorded in a multi-column Cash Payments Journal, as is shown in Figure 7.4:

Figure 7.4 Recording in the Cash Payments Journal

Cash Payments Journal

Date[1]	Details[1]	Source Document[1]	Bank[2]	Wages[3]	Drawings[3]	Paint[3]	Sundries[4]	GST
Mar. 1	Wages	EFT 28355	450	450				
5	Drawings	ATM 155	500		500			
7	Equipment	EFT 5168	1 650				1 500	150
12	Paint	EFT 434	275			250		25
16	Wages	EFT 28356	450	450				
20	Paint	EFT 485	440			400		40
22	Drawings	ATM 206	400		400			
25	Paint	EFT 535	165			150		15
28	Van service	EFT 824	220				200	20
30	Wages	EFT 28357	450	450				
	TOTALS	**$**	**5 000**	**1 350**	**900**	**800**	**1 700**	**250**

Video 7.1 Recording in the Cash Payments Journal

Notes for recording in the Cash Payments Journal

1 Date/Details/Doc.

Just like the Cash Receipts Journal, transactions are recorded in the Cash Payments Journal in date order, with a brief description in the details column. However, the source documents in this case are a mixture as all EFTs, withdrawals and ATM transactions will have a reference number.

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2 **Bank**
The amount of each cash payment must be recorded first in the Bank column, to allow calculation of the total cash payments for the reporting period. This Cash Payments Journal shows that Goghs' Painting Service made cash payments of **$5 000** during March 2030.

3 **Classification columns (Wages, Drawings, Paint, GST)**
Just like a Cash Receipts Journal, a Cash Payments Journal has classification columns for frequent cash payments. (The headings used for each of these classification columns will of course vary between businesses, as their transactions vary.) Note that the list of payments for Goghs' Painting Service is far more diverse than the list of receipts discussed earlier, including cash payments for paint, servicing of the van, wages, the purchase of equipment, cash drawings by the owner and GST. As a result, it is common for the Cash Payments Journal to have more classification columns than the Cash Receipts Journal.

4 **Sundries**
This column fulfils exactly the same function as it did in the Cash Receipts Journal, recording infrequent cash payments. The cash purchase of equipment and the servicing of the van are unlikely to occur more than once per month, and so do not warrant their own column.

Double-checking mechanism

Once the columns in the Cash Payments Journal are totalled, it has the same double-checking mechanism as the Cash Receipts Journal: the total of the Bank column should equal the sum of the totals of the other (classification and sundries) columns. Figure 7.5 shows this mechanism for the Cash Payments Journal:

Figure 7.5 Double-checking mechanism: Cash Payments Journal

Bank	**5 000**	**=**		Wages	1 350
			+	Drawings	900
			+	Paint	800
			+	GST	250
			+	Sundries	1 700
Total	**$5 000**			**Total**	**$5 000**

GST on cash payments

All sales of goods and services are subject to 10% GST, so if Goghs' Painting Service pays cash for a good or service, it will be charged GST by the supplier. The transaction on 12 March 2030 shows that Ryan purchased paint worth $250, but he was then charged a further 10% GST ($250 × 10% = $25 GST) Therefore, the total cash paid to the supplier by Goghs' Painting Service was **$275**.

Because the supplier will forward this $25 GST to the ATO (when it makes its own GST settlement), the GST paid to suppliers will reduce the GST liability of Goghs' Painting Service. (It is as if Ryan has already paid off some of the liability, even though it goes to the ATO via the supplier.) Thus, any GST that is paid to suppliers can be offset against the GST received to *reduce the GST liability* to the ATO.

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Study tip

It is consumers who end up 'paying' the GST, because they cannot claim GST credits.

Notice that there are two transactions in the Cash Payments Journal for March 2030 that do not require the payment of GST. The first of these is Wages, since the government already collects tax in the form of PAYG (Pay As You Go) income tax. The other is Drawings, which does not attract GST as it is not a transaction that involves the purchase of a good or service.

Other cash payments that are not subject to GST include:

- interest expense
- loan repayments
- commercial rates.

Review questions 7.4

1 **Explain** the function of the Cash Payments Journal.
2 **Explain** why a Cash Payments Journal usually has more classification columns than a Cash Receipts Journal.
3 **Explain** why GST paid to suppliers reduces the GST liability.
4 **Explain** why a credit card purchase would not appear initially in the cash payments journal.

7.5 The Statement of Receipts and Payments

The result of recording cash receipts and payments in cash journals will be *information* that is summarised, classified, and ready to be presented in the Accounting reports.

By recording the transactions in a Cash Receipts Journal (Figure 7.2) and a Cash Payments Journal (Figure 7.4), we know that in March 2030 Goghs' Painting Service:

- *received* **$5 210** in cash from other entities ($4 100 from Painting fees, $410 from GST and $700 from a Capital contribution by the owner)
- *paid* **$5 000** cash to other entities ($1 350 on Wages, $900 on Drawings, $800 on Paint, $250 on GST as well as $1 500 on new Equipment and $200 on a Van service).

Although this information is essential to Accounting for cash, the journals do not provide a complete assessment of the firm's cash situation because they do not show:

- the firm's bank balance at the *start* of the period
- the firm's bank balance at the *end* of the period
- the overall change (increase or decrease) in the firm's bank balance.

For this reason, we need to take the information contained within the cash journals and present it in an understandable manner. This is done by preparing a Statement of Receipts and Payments.

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Figure 7.6 shows the Statement of Receipts and Payments for Goghs' Painting Service for March 2030:

Figure 7.6 Statement of Receipts and Payments

GOGHS' PAINTING SERVICE
Statement of Receipts and Payments for March 2030

	$	$
Cash Receipts		
Painting fees	4 100	
GST Received	410	
Capital contribution	700	**5 210**
Less Cash Payments		
Wages	1350	
Drawings	900	
Paint	800	
GST Paid	250	
Equipment	1 500	
Van service	200	**5 000**
Cash Surplus (Deficit)		210
Add Bank Balance at start (1 March 2030)		420
Bank Balance at end (31 March 2030)		630

As with all Accounting reports, the title of this statement identifies *who* the report has been prepared for (Goghs' Painting Service), *what* type of report it is (Statement of Receipts and Payments) and *when* (the period) it applies (March 2030). Note that the period is for March 2030, as the transactions did not happen all on one day, but rather over a number of days – a whole month in fact. (The period can be as short, or as long, as the owner desires, as long as it does not exceed 12 months.)

The **totals** of the classification columns and the individual amounts listed in the Sundries columns are reported under the headings of cash receipts and cash payments, depending on the journal in which they were recorded. This includes the GST received on fees and paid to suppliers. The total cash receipts and cash payments reported in the Statement of Receipts and Payments should match exactly the total of each journal.

Study tip

There is little point in using a journal to summarise transactions unless the totals are reported.

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Surplus (Deficit)

The overall *change* in the firm's bank balance, known as a *surplus* or *deficit*, can be calculated by deducting total cash payments from total cash receipts.

cash surplus
an excess of cash receipts over cash payments, leading to an increase in a positive bank balance or a decrease in a bank overdraft

cash deficit
an excess of cash payments over cash receipts, leading to a decrease in a positive bank balance or an increase in a bank overdraft

Surplus (Deficit) = Cash Receipts – Cash Payments

A **cash surplus** occurs when cash received is greater than cash paid during the period, and it will lead to an increase in a positive bank balance or a decrease in a bank overdraft. A **cash deficit** occurs when cash received is less than cash paid, and it will lead to a decrease in a positive bank balance or an increase in a bank overdraft.

Opening bank balance

The opening bank balance represents how much cash was available in the firm's account at the start of the period. Because this balance is the same as the balance at the end of the previous period, it will be the closing bank balance on the previous Statement of Receipts and Payments and/or the amount shown as Bank in the previous Balance Sheet.

Closing bank balance

The closing bank balance represents how much cash should now be available in the firm's bank account, and it is the amount that will be reported as Bank in the next Balance Sheet. If the balance is positive, then Bank will be reported as a current asset; if the balance is negative, then Bank overdraft will be reported as a current liability.

Deficits and overdrafts

It is worth noting at this point the difference between a cash deficit and a bank overdraft. A deficit refers to a decrease in a firm's bank balance, the *change*, but it does not necessarily mean a negative balance. (It is quite possible for a firm to have payments greater than its receipts and suffer a cash deficit yet retain a positive bank balance due to a healthy opening balance.) An overdraft refers to a *negative* balance; it describes not a change but a level of cash.

The Statement of Receipts and Payments is more useful for decision-making than the cash journals because it summarises *all* the information relating to the firm's cash position. It can be used to help the owner make decisions about the firm's receipts, payments and level of cash on hand.

Review questions 7.5

1. **State** three pieces of information regarding a firm's cash position that are not shown in the cash journals.
2. **Explain** the function of a Statement of Receipts and Payments.
3. **Show** the formula to calculate a cash surplus or cash deficit.
4. **Explain** the effect on the firm's bank balance of a:
   - cash surplus
   - cash deficit.
5. **Distinguish** between a cash deficit and a bank overdraft.

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7.6 The Cash Flow Statement

The Statement of Receipts and Payments can assist the owner in managing cash; however, it is somewhat limited in its uses, because it only classifies the cash transactions as receipts or payments. Information about cash is more useful for decision-making if it classifies common sources and uses of cash, and separately identifies their effect on the bank balance. For this reason, the owner may wish to prepare a **Cash Flow Statement** to report on cash inflows (cash received) and cash outflows (cash paid), separately identifying cash flows relating to Operating activities, Investing activities and Financing activities.

Cash Flow Statement
an Accounting report that reports all cash flows during a period, classified as Operating, Investing and Financing activities

Operating activities

Operating activities refers to all cash flows related to day-to-day trading activities. Operating inflows will include cash sales, receipts from Accounts Receivable, GST received from customers (for cash fees this period), GST refund and any other cash revenue such as commission or interest received. Operating outflows will include all payments related to expenses (including interest), payments to Accounts Payable and GST paid (to suppliers and to the ATO for GST settlement).

Note: there are no credit transactions in a Cash Flow Statement; it deals only with items that involve a *cash flow*. Thus, instead of credit sales, receipts from Accounts Receivable are reported as an Operating cash inflow, and instead of credit purchases, payments to Accounts Payable are reported as an Operating cash outflow.

Operating activities
cash flows related to day-to-day trading activities

Investing activities

Investing activities are cash flows relating to the purchase or sale of non-current assets. In practice this will mean there are only two possible Investing items: cash received from the sale of a non-current asset (Investing inflow) and cash purchase of a non-current asset (Investing outflow).

Investing activities
cash flows related to the purchase and sale of non-current assets

Financing activities

Financing activities are cash flows that are the result of changes in a firm's financial structure. In essence, this will mean only cash transactions that change loans and owner's equity, such as receiving or repaying loan principal, or cash contributions or drawings by the owner.

Using the same information that was reported in the Statement of Receipts and Payments in Figure 7.6, the Cash Flow Statement for Goghs' Painting Service is shown in Figure 7.7.

Financing activities
cash flows related to changes in the financial structure of the firm

Net Cash Flows

The net increase in cash position (of **$210**) is calculated by adding together the Net Cash Flows from each activity: Net Cash Flows from Operating activities of $1 910 + Net Cash Flows from Investing activities of ($1 500) + Net Cash Flows from Financing activities of ($200). It can also be calculated by deducting total payments (as shown in the Cash Payments Journal) from total receipts (as shown in the Cash Receipts Journal). Either way, the answer should be the same and reflect the total or net change in the firm's bank balance from the start of the period to the end.

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Note that the final figure in this statement – Bank Balance at end – is exactly the same as that generated in the Statement of Receipts and Payments: **$630**. After all, both statements report the same items; the only difference is that the Cash Flow Statement classifies the cash flows as Operating, Investing and Financing activities.

A high bank balance might indicate the ability to make higher loan repayments, take greater drawings, purchase newer non-current assets or undertake other expansionary activities. A low bank balance might indicate the need for lower loan repayments, lower drawings, the use of credit for some purchases or perhaps even a capital contribution by the owner. A business that has not yet organised an overdraft facility may wish to do so to ensure that it has sufficient funds available to meet its payments.

Figure 7.7 Cash Flow Statement

GOGHS' PAINTING SERVICE
Cash Flow Statement for March 2030

	$	$
CASH FLOWS FROM OPERATING ACTIVITIES		
Painting fees	4 100	
GST Received	410	4 510
Wages	(1 350)	
GST Paid	(250)	
Paint	(800)	
Van service	(200)	(2 600)
Net Cash Flows from Operating Activities		1 910
CASH FLOWS FROM INVESTING ACTIVITIES		
Equipment		(1 500)
Net Cash Flows from Investing activities		(1 500)
CASH FLOWS FROM FINANCING ACTIVITIES		
Capital contribution		700
Drawings		(900)
Net Cash Flows from Financing activities		(200)
Net Increase (Decrease) in Cash Position		**210**
Add Bank Balance at start (1 March 2030)		**420**
Bank Balance at end (31 March 2030)		**630**

Uses of the Cash Flow Statement

Poor management of cash is one of the main reasons why small businesses fail. In this regard, the Cash Flow Statement is a vital tool for improving the owner's decision-making in relation to cash management. The specific benefits of preparing a Cash Flow Statement are:

- *to aid decision-making about the firm's cash activities* by detailing the sources and uses of cash in a particular period
- *to assess whether or not the business is meeting its cash targets* by comparing the Cash Flow Statement against budgeted (or expected) cash flows, which will highlight problems and allow for corrective action to be taken
- *to assist in planning for future cash activities* by providing a basis for the next budgeted Cash Flow Statement, which will set targets for the future
- *to identify whether or not the business is generating enough cash from its Operating activities* to fund its Investing and Financing activities.

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This last point is particularly important: a firm that has negative Net Operating Cash Flows will be unable to meet its other payments without contributions from the owner or external finance. This indicates that the business is unable to pay its way, as it cannot rely on capital contributions and loans every period. If a business is unable to generate sufficient cash flow from its Operating activities to meet its financial obligations, then its future as a Going concern is in serious doubt.

As can be shown graphically in Figures 7.8 and 7.9, the Cash Flow Statement can provide a lot more information due to its classification of cash flows:

Figure 7.8 Graph: Statement of Cash Receipts and Payments

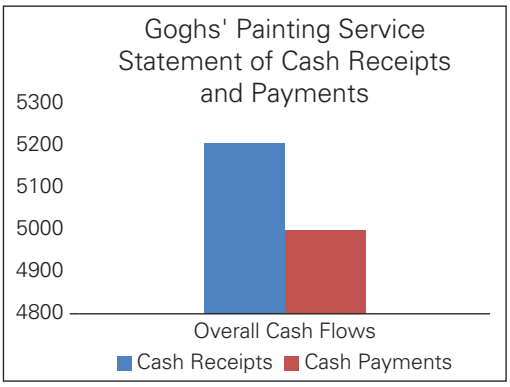
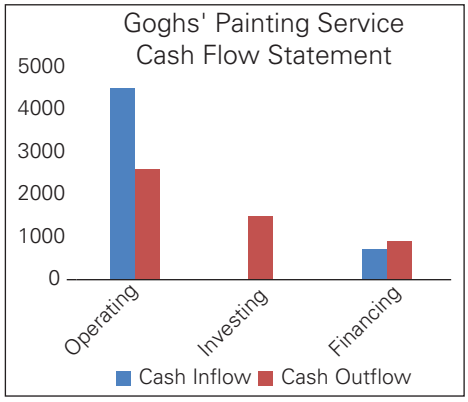


Figure 7.9 Graph: Cash Flow Statement



Using graphical representations like this can enhance the Understandability of the information, improving its ability to enhance decision-making.

Review questions 7.6

1 **Define** the following terms as they relate to the Cash Flow Statement, and **provide** one example of an inflow and one example of an outflow:
   - Operating activities
   - Investing activities
   - Financing activities.

2 **Explain** how the preparation of a Cash Flow Statement can assist in decision-making.

3 **Explain** how the preparation of a Cash Flow Statement can assist in planning for the future.

4 **Explain** why it may be more beneficial to prepare a Cash Flow Statement rather than just a Statement of Receipts and Payments.

5 Referring to one Qualitative characteristic, **explain** one reason for preparing a graphical representation of the Cash Flow Statement.

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7.7 GST payable and GST receivable

When a business receives GST on services, it does so on behalf of the government, so the business owes that GST to the ATO. However, if a business has paid GST to its suppliers, it is allowed to deduct this from the GST it owes. (Because the GST will be forwarded to the ATO by the supplier, it is treated as if the business had actually paid the GST straight to the government.) Therefore, at the end of the period, the business must calculate its overall GST balance.

During March 2030, Goghs' Painting Service received GST of $410 on fees it charged to its customers and paid GST of $250 to its suppliers.

The GST balance of Goghs' Painting Service would be calculated as is shown in Figure 7.10:

Figure 7.10 Calculation: GST balance

Opening GST balance	nil
Plus GST received on fees	$410
Less GST paid to suppliers	$250
GST payable	**$160**

In this example, Goghs' Painting Service has received more GST than it has paid, so it has a GST payable of **$160**.

GST payable
GST owed by the business to the ATO when the amount of GST the business has received on its fees is greater than the GST it has paid to its suppliers

GST settlement
a payment made to the ATO by a small business to settle GST payable (operating outflow)

GST payable

Because selling prices are usually higher than cost prices, GST received on fees will usually be greater than GST paid to suppliers. This will mean that under normal circumstances, a small business will accrue a liability in relation to GST called **GST payable**.

GST payable is a *current liability*, as the business has a present obligation which is expected to result in the transfer of an economic resource (when GST is paid to the ATO) sometime in the next 12 months. The GST will be paid to the ATO by means of a **GST settlement** after the business completes and lodges its next Business Activity Statement.

Example

On 1 April 2030, Goghs' Painting Service settled its GST payable from March by paying $160 to the ATO (EFT 11).

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Figure 7.11 shows how this GST settlement would be recorded in the Cash Payments Journal:

Figure 7.11 Recording a GST settlement

Cash Payments Journal

Date	Details	Source Document	Bank	Wages	Drawings	Paint	Sundries	GST
April 1	GST settlement	EFT 11	160				160	

Whereas GST paid to suppliers is recorded in the GST column, a GST settlement is paid to the ATO to settle a current liability from a prior period, so it must be recorded in the Sundries column. And because it is recorded in the Sundries column, a GST settlement must be reported separately from GST paid to suppliers on the Statement of Receipts and Payments and the Cash Flow Statement.

GST receivable

GST receivable
GST owed to the business by the ATO when the amount of GST the business has paid to its suppliers is greater than the GST it has received on its fees

The fact that GST is frequently a liability does not mean that this will always be the case. If the business makes bulk purchases of goods, which it has not yet sold, or purchases non-current assets, then it is possible that its GST paid to suppliers could be greater than its GST received. In this case, the business will have **GST receivable** from the ATO. GST receivable is a *current asset* because the business can look forward to a future economic benefit in the form of the cash that it will receive from the ATO within the next 12 months.

Example

On 1 July 2030, Goghs' Painting Service received a GST refund from the ATO of $320 (Rec. 19).

Figure 7.12 shows how this GST refund would be recorded in the Cash Receipts Journal:

Figure 7.12 Recording a GST refund

Cash Receipts Journal

Date	Details	Source Document	Bank	Painting fees	Sundries	GST
July 1	GST refund	Rec. 19	320		320	

GST refund
a cash receipt from the ATO to clear GST receivable (operating inflow)

Like a GST settlement, a **GST refund** would be reported as a separate item in the Statement of Receipts and Payments and the Cash Flow Statement, but as a cash receipt rather than a cash payment.

Review questions 7.7

1. **Define** the term 'GST payable'.
2. **Explain** why most small businesses will end up with GST payable.
3. **Explain** how GST payable is reported in the Balance Sheet.
4. **Explain** why a GST settlement must be recorded in the Sundries column of the Cash Payments Journal.
5. **Define** the term 'GST receivable'.
6. **State** two ways a small business could end up with GST receivable.
7. **Explain** how GST receivable is reported in the Balance Sheet.

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7.8 Financial indicators and the Cash Flow Statement

Cash Flow Cover
a liquidity indicator that assesses the ability of the firm's Operating Cash Flows to meet its short-term debts as they fall due

The Cash Flow Statement is a report that provides us with useful information in regards to the business's cash flows and cash position. Cash is the life blood of the business. Liquidity, the ability of the business to meet its debts as they fall due, is vital for the continuing success of the business. We have already looked at two indicators of liquidity (the Working Capital Ratio and the Quick Asset Ratio) in Chapter 2; however, these are static ratios based on balances and do not consider cash flows. Another useful indicator that uses cash flows is **Cash Flow Cover**:

Figure 7.13 Formula: Cash Flow Cover

$$\text{Cash Flow Cover} = \frac{\text{Net Cash Flows from Operating Activities}}{\text{Average Current Liabilities}}$$

This indicator assesses liquidity by calculating the number of times average Current Liabilities can be met using Net Cash Flows from Operations. This ratio is expressed as times per period.

If we use our Cash Flow Statement example from Figure 7.7, we also need to know what our current liabilities were for the period.

Example

Additional information: Current liabilities as at 1 March 2030 were $2 000 and as at 31 March 2030 were $1 600.

The Cash Flow Cover would be calculated as is shown in Figure 7.14:

Figure 7.14 Calculation: Cash Flow Cover

$$\begin{aligned}\text{Cash Flow Cover} &= \frac{\text{Net Cash Flows from Operating Activities}}{\text{Average Current Liabilities}} \\ &= \frac{\$1\,910}{\left(\left(\$2\,000 + \$1\,600\right)/2\right)} \\ &= \frac{\$1\,900}{\$1\,800} \\ &= 1.06 \text{ times}\end{aligned}$$

Study tip

Remember to express Cash Flow Cover as times per period – so take note of the time period being covered!

A Cash Flow Cover of 1.06 times per month means that the business can pay (cover) every dollar of current liabilities just over one time in a month. This indicates that the business is financially healthy and can meet its short-term financial obligations through the cash generated by its normal operating activities. However, this is very close to 1. The business would want a little more buffer on this figure to feel more secure.

Assessing the Cash Flow Cover

The more times a business's Net Operating Cash Flows can cover its current liabilities, the better off a business will be in terms of its liquidity and meeting its short-term financial obligations. With a high Cash Flow Cover due to a high Net Operating Cash Flow, the business can use excess cash to:

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- expand its current operations
- reduce its debt by paying down loans
- invest to increase cash revenue streams and have a back-up to provide support in case of economic downturns.

However, a Cash Flow Cover of less than 1 would indicate unsatisfactory liquidity, as the business has insufficient cash flow from its normal activities to cover its current liabilities, and therefore may not be able to meet its short-term debts as they fall due. If this is the case, the owner may be required to attempt to improve the Net Cash Flows from Operating activities by seeking to increase its forms of operating cash inflows and decrease its operating cash outflows or look to reduce current debt by perhaps refinancing a lot of short-term debt with long-term finance.

Review questions 7.8

1 **State** what is measured by the Cash Flow Cover.
2 **Show** the formula to calculate the Cash Flow Cover.
3 **Explain** why the Cash Flow Cover should be greater than 1.
4 **Explain** two courses of action if the Cash Flow Cover is high.
5 **State** two actions the owner may be required to take if the Cash Flow Cover is too low.

Where have we been?

- Service businesses operate by providing their time, labour, assets or expertise (or a combination of all four) in return for a fee or charge, and most of these transactions are for cash.
- 'Cash' includes notes and coins, credit card payments and the balance of the firm's bank account.
- Cash receipts are verified by receipts, cash register rolls and the Bank Statement; cash payments are verified by EFT receipts and the Bank Statement.
- Cash transactions are recorded in a Cash Receipts Journal or a Cash Payments Journal, so that they are classified and summarised.
- Frequent transactions are recorded in their own classification column; infrequent transactions are recorded in the Sundries column.
- Cash transactions are reported in the Statement of Receipts and Payments.
- Single-entry Accounting is the process of recording transactions in journals and then using the summarised information to prepare reports.
- The Cash Flow Statement reports cash inflows and cash outflows separately, identifying cash flows relating to Operating activities, Investing activities and Financing activities.
- The Cash Flow Statement is used to aid decision-making and planning.
- GST received on fees creates a GST liability; GST paid to suppliers reduces that liability.
- If GST received is greater than GST paid, the business will have a GST liability, and a GST settlement will be required.
- If GST paid is greater than GST received, the business will have a GST asset, and a GST refund will be received.
- As selling prices are generally higher than cost prices, most firms will end up with a GST liability.
- The Cash Flow Cover can be used to assess the firm's ability to meet its current liabilities using its Net Cash Flows from Operations.

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Exercises

Please note: asterisks indicate that an answer for that question is available in the Selected Answers section at the end of this book.

Exercise 7.1
Cash journals

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During the month of May 2030, Stan's Car Wash had the following transactions:

May	1	Received $600 for washing cars plus GST of $60 (Rec. 1–16)	$660
	2	Paid monthly mortgage: $400 principal, $700 interest (Dir. deb. Ref. 603)	1 100
	8	Received $770 for car detailing including $70 GST (Rec. 17–25)	770
	9	Received interest from SEC Bonds (Bank Statement (BS))	75
	12	Received $550 including $50 GST for car washes (Rec. 26–33)	550
	13	Paid for water recycling bill including $35 GST (BPAY Rec. 724)	385
		Paid for detergents and wax including $5 GST (EFT 013)	55
	14	Paid for insurance of $240 plus $24 GST (BPAY Rec. 813)	264
	15	Received $715 for car detailing including $65 GST (Rec. 34–46)	715
	16	Purchased new inventory for $500 plus $50 GST on credit (Inv. X 12)	550
	18	Paid for detergents and wax including $3 GST (EFT 027)	33
	20	Paid water recycling bill of $400 plus $40 GST (BPAY Rec. 293)	440
	22	Received $484 including $44 GST for car washes (Rec. 47–52)	484
	24	Paid for repairs to vacuum cleaner including $12 GST (EFT 312)	132
	26	Paid for detergents and wax including $4 GST (EFT 422)	44
	27	Paid for water recycling including $25 GST (EFT 132)	275
	29	Received $396 for car detailing including $36 GST (Rec. 53–58)	396
	30	Paid telephone bill of $170 plus $17 GST (BPAY Rec. 025)	187

As at 30 April 2030, the business had $750 in the bank.

Required

*a. **Record** the cash transactions for May 2030 in the cash journals of Stan's Car Wash. **Total** the journals.
*b. **Prepare** a Statement of Receipts and Payments for Stan's Car Wash for May 2030.
c. **Explain** the relationship between the cash journals and the Statement of Receipts and Payments.
d. **State** the effect on each element of the Accounting equation of the transaction on 16 May 2030.
e. **Prepare** a Cash Flow Statement for Stan's Car Wash for May 2030.

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Exercise 7.2
Cash journals

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Sadie La Voce has her own cleaning company, Vac and Sweep, and has provided the following list of transactions for August 2030:

Aug.	1	Received $220 (including $20 GST) for house cleaning (Rec. 42)
	2	Paid rent for the coming month: $4 000 plus $400 GST (EFT 221)
	5	Received $220 including $20 GST for house cleaning (Rec. 43)
	6	Paid wages of $1 500 (EFT 2222)
	7	Purchased cleaning supplies for $350 plus $35 GST (EFT 083)
	12	Received $231 (including $21 GST) for office cleaning (Rec. 44)
	13	Sadie withdrew $400 cash for personal use (ATM Rec. 765)
	15	Received $297 (including $27 GST) for home cleaning (Rec. 45)
	16	Paid for advertising of $360 plus $36 GST (EFT 2223)
	19	Received $495 (including $45 GST) for office cleaning (Rec. 46)
	26	Received $250 for home cleaning plus $25 GST (Rec. 47)
	28	Purchased cleaning supplies $280 plus $28 GST (EFT 145)
	29	Received $407 including $37 GST for home cleaning (Rec. 48)
	30	Paid $600 for advertising plus $60 GST (BPAY Rec. 2924)

At the start of August 2030, the business had $6 000 cash in its bank account.

Required

*a. **Record** the transactions for August 2030 in the cash journals of Vac and Sweep. **Total** the journals.
*b. **Prepare** a Cash Flow Statement for Vac and Sweep for August 2030.
c. Referring to one Qualitative characteristic, **explain** why sundries are itemised in the Cash Flow Statement.
d. **Calculate** the GST balance for Vac and Sweep as at 31 August 2030.
e. Referring to your answer to part **d**, **show** how the GST balance would be reported in the Balance Sheet for Vac and Sweep as at 31 August 2030.

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Exercise 7.3
Cash journals

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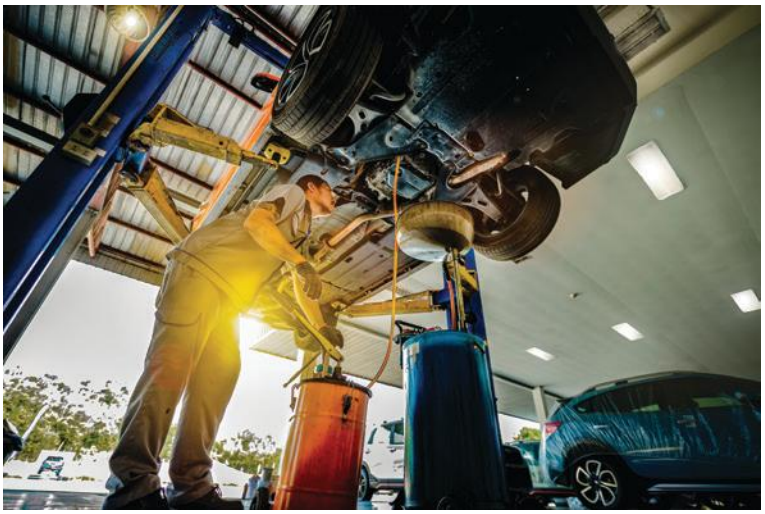
Minor Mechanics is an automotive repair shop owned and run by Patrick Minor. Patrick has provided the following list of transactions for July 2030:

July	1	Received $440 including $40 GST for repair work (Rec. 12)
	4	Received $550 including $50 GST for repair work (Rec. 13)
	5	Paid apprentice's wages of $550 (EFT 1302)
	7	Withdrew $600 cash for personal use (ATM 3103)
	9	Received $352 including $32 GST for tune up (Rec. 14)
	12	Purchased office furniture $1 500 plus $150 GST (EFT 724)
	14	Patrick contributed $800 to finance the new office furniture (Rec. 15)
	15	Paid monthly instalment of $700 on loan principal (BS)
		Paid $300 interest on loan (BS)
	18	Paid apprentice wages of $540 (EFT 1304)
	19	Received $610 plus $61 GST for repair work (Rec. 16)
	21	Withdrew $300 cash and $70 worth of parts for personal use (EFT 1305)
	22	Received $209 including $19 GST for tune up (Rec. 17)
	25	Received $253 including $23 GST for tune up (Rec. 18)
	28	Patrick paid $780 off his personal credit card using business funds (EFT 306)
	30	Received $660 including $60 GST for repair work (Rec. 19)

The previous Cash Flow Statement showed a closing bank position of $300.

Required

*a. **Record** the transactions for July 2030 in the cash journals of Minor Mechanics.
b. **Explain** how Patrick would have determined the headings of the classification columns in the Cash Payments Journal.
*c. **Prepare** a Cash Flow Statement for Minor Mechanics for July 2030.
d. **State** two actions that Patrick could have taken to avoid incurring an overdraft in July 2030.
e. **Calculate** the GST balance for Minor Mechanics as at 31 July 2030.
f. Referring to your answer to part **e**, **explain** how the GST balance would be reported in the Balance Sheet as at 31 July 2030.



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Exercise 7.4

Cash journals and source documents

page 113

Jeff Buckley is the owner and operator of Sweethearts Photography, a photography firm that specialises in wedding photography but also takes formal portraits for families and other groups. As at 1 April 2030, the business had $1 500 in its bank account and GST payable of $720. The following transactions occurred during April 2030:

April	1	Paid GST settlement to ATO (BPAY Rec. 025)	
	2	Paid for photography materials worth $850 plus $85 GST (EFT 844)	$935
	4	Received $462 including $42 GST for portraits (Rec. 201)	462
	6	Received $660 including $60 GST for wedding photos (Rec. 202)	660
	8	Cash drawings (ATM Rec. 078)	400
	9	Interest received on investment (BS)	110
	12	Received $880 including $80 GST for wedding shoot (Rec. 203)	880
	16	Paid wages (EFT 2646)	500
	18	Received $385 including $35 GST for portraits (Rec. 204)	385
	22	Paid for photography materials $750 plus $75 GST (EFT 867)	825
	23	Received $990 including $90 GST for wedding photos (Rec. 205)	990
	25	Received $550 including $50 GST for family portraits (Rec. 206)	550
	26	Purchased camera equipment $1 950 plus $195 GST (EFT 216)	2 145
	28	Received $220 including $20 GST for portrait (Rec. 207)	220
	29	Paid wages (EFT 2647)	500

Jeff has decided that the following transaction should be excluded from the cash journals:

Phil's Photo Shop
ABN: 55 554 989 617
Level 1 Highpoint Shopping Centre
Maribyrnong, Vic, 3032

Tax Invoice
Invoice: 91
29 April 2030

Sweethearts Photography	Qty	Cost	Total
C/o: J. Buckley			
Film – Kodak 400	25	8	200
Paper – A45	10	15	150
GST			35
Strictly 30 days		**Total**	**$385**

Required

a. **Explain** why Jeff is correct to exclude this transaction from the cash journals.
*b. **Complete** the cash journals of Sweethearts Photography for April 2030.
c. **Explain** the effect on the Balance Sheet of Sweethearts Photography of the GST settlement on 1 April 2030.
*d. **Prepare** a Cash Flow Statement for Sweethearts Photography for April 2030.
e. **Calculate** the GST balance for Sweethearts Photography as at 30 April 2030.
f. **Calculate** the Cash Flow Cover for Sweethearts Photography as at 30 April 2030 if average current liabilities were $1500.
g. Referring to your answer to part **f**, **explain** why the Cash Flow Cover is concerning.

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Exercise 7.5
Cash journals and source documents

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Jack Ryan is a political analyst who owns a consultancy firm called Polling Times. The firm's main source of revenue is from advising political parties about policies and the mood of the voters. As at 1 July 2030, the business had a bank overdraft of $1 000 and GST receivable of $720. The following transactions occurred during July 2030:

July	1	Received a GST refund from the ATO (Rec. 44)
	2	Paid travel expenses of $500 plus $50 GST (EFT 307)
	3	Jack withdrew $850 cash (ATM Rec. 004)
	5	Paid $1 500 wages (EFT 3107)
		Received $2 750 including $250 GST as research fees (Rec. 45)
	8	Paid electricity bill of $650 plus $65 GST (BPAY Rec. 213)
	10	Jack withdrew $900 cash for personal use (ATM Rec. 023)
		Received $4 000 plus $400 GST for consulting fees (Rec. 46)
	12	Owner contributed $4 000 cash (Rec. 47)
		Paid travel expenses $600 plus $60 GST (EFT 356)
	15	Received $3 960 including $360 GST for consultancy fees (Rec. 48)
	19	Paid $1 500 wages (EFT 3108)
	21	Paid travel expenses of $1 000 plus $100 GST (EFT 367)
	23	Received $1 540 including $140 GST in research fees (Rec. 49)
	24	Paid monthly rent $1 200 plus $120 GST (BS Dir. Deb.)

The following documents were found in the top drawer of Jack's desk and have not yet been recorded.

Document A

National Australia Bank

Date *26th July 2030*

To *Image Works*

For *Advertising*

Bal c/fwd $ *$300 plus $30 GST*

Deposits $

Amount *$330.00*

Balance $

EFT 114

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Document B

CPX Computers
35 High St
Preston Vic, 3072
ABN: 15 440 342 188
Tax Invoice

Date: 27/7/30
Invoice: 10
Duplicate:
Terms: 30 days

Charge to: Polling Times
491 Keilor Rd, Niddrie, 3042
ABN: 23 500 682 112

Attn: J. Ryan

Items	Qty	Unit cost	Total
Apple i-Book Laptop – Orange w/software	1	2500	2500
GST			250
Total		**$**	**$2750**

Document C

Transaction details

Merchant	Home Insurance Australia
Description	DIRECT TRANSFER ONLINE 5250373 BPAY HIA SALES
Account	National Australia Bank 555-000 123456
Scheduled payment date	28 July 2030
Amount	-$550
Transaction ID	add21267-ee2a-4704-8d5d-125eebe5b3f9
BPAY® receipt number	5250373
Type	BPAY®
From	NAB 555-000 123456
To	HIA SALES P/L
Biller code	132475
Customer reference number	88455427972

Document D

Polling Times
491 Keilor Rd
Niddrie, 3042
ABN: 23 500 682 112

Tax invoice

29 July 2030

Receipt no.	50
Received from	Victorian Conservative Party ABN: 40 103 665 782
The sum of	One thousand, five hundred dollars plus one hundred and fifty dollars GST
Being for	Cash fees
Amount	$1 650.00
Plus GST	
Signed	*Jack Ryan*

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Required

a. **Explain** why Polling Times had GST receivable as at 30 June 2030.
b. **Explain** the effect of the transaction in Document B on the Balance Sheet of Polling Times.
c. Referring to one Accounting assumption, **explain** why the transaction in Document C leads to a decrease in Jack's owner's equity.
***d.** **Record** the relevant transactions in the cash journals of Polling Times. **Total** the journals.
***e.** **Prepare** a Cash Flow Statement for Polling Times for July 2030.
f. **Calculate** the Cash Flow Cover for Polling Times for July 2030 if average current liabilities for the period was $3 500.
g. Referring to your answer to part **f**, **explain** why the Cash Flow Cover is pleasing.

Exercise 7.6
Cash journals and source documents

page 120

Nik Kershaw is the owner/operator of Wooden It Be Good, a carpentry firm that specialises in the restoration of antique furniture. As at 31 May 2030, the business had $3 500 in its bank account.
The following transactions occurred during June 2030:

June	1	Nik withdrew $400 cash (ATM Rec. 062)
	3	Cash fees received $781 including $71 GST (Rec. 51)
	6	Purchased restoration supplies costing $500 plus $50 GST (EFT 912)
	13	Cash fees received of $495 including $45 GST (Rec. 52)
	16	Nik withdrew $750 cash (ATM Rec. 078)
	17	Nik contributed $1 500 cash and $400 worth of tools (Rec. 53)
	19	Purchased equipment, paying $990 including $90 GST (EFT 043)
	24	Received cash fees of $880 including $80 GST (Rec. 54)
	25	Interest earned on bank account: $15 (BS page 34)
	27	Payment of loan principal: $200 (BS page 34)

The following documents have not yet been recorded:

Document A

Fletchers of Ballarat Country Rd, Ballarat 28 June 2030 11.04am	
Account:	SAV
Restoration supplies	165.00
Price includes GST of $15.00 EFT ref. 003	

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Document B

Wooden It Be Good **Receipt: 55**

Furniture Restoration
14 Menzies Ave
Sunbury, 3429
ABN: 33 405 662 310

Date	30 June 2030
Received from	Warren Walters
The sum of	Three hundred dollars plus thirty dollars GST
Being for	Fees – Repairs and French polishing
Amount	$330
Signed	*Nikolas J. Kershaw*

At 30 June 2030, the business had a GST payable of $71.

Required

*a. **Record** the transactions for June 2030 in the cash journals of Wooden It Be Good.
Total the journals.
b. **Explain** one benefit of recording transactions in cash journals.
*c. **Prepare** a Cash Flow Statement for Wooden It Be Good for June 2030.
d. **Explain** the difference between a cash deficit and an overdraft.
e. **Explain** how the GST payable should be reported in the Balance Sheet of Wooden It Be Good as at 30 June 2030.

Exercise 7.7

Cash journals and source documents

page 123

Fiona Darmanin is the owner of a small structural engineering consultancy firm called Daring Designs. Her main sources of revenue are from consultancy fees and design/drawing fees. Fiona has recorded the month's transactions up to 27 May 2030, and these are shown in the following cash journals:

Cash Receipts Journal

Date	Details	Source Document	Bank	Consulting fees	Design fees	Sundries	GST
May 2	Consulting fees	Rec. 904	583	530			53
7	Design fees	Rec. 905	462		420		42
12	Consulting fees	Rec. 906	374	340			34
16	Consulting fees	Rec. 907	550	500			50
19	Design fees	Rec. 908	319		290		29
24	Consulting fees	Rec. 909	715	650			65

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Cash Payments Journal

Date	Details	Source Document	Bank	Drawings	Wages	Advertising	Sundries	GST
May 1	Drawings	ATM Rec. 103	50	50				
5	TryUs Ads P/L	BPAY Rec. 902	451			410		41
9	Wages	20105	620		620			
11	Interest on loan	BS	55				55	
13	Drawings	ATM Rec.149	120	120				
17	Wages	20106	620		620			
20	Telephone	BPAY Rec. 082	176				160	16
27	Lease of vehicle	EFT 306	275				250	25

The following documents are yet to be recorded:

Document A

Daring Designs
54 Greenhills Road
Bundoora 3145
ABN: 33 405 662 310

Tax Invoice
Receipt: 910

Date	27 May 2030
Received from	Redwood Property Investors P/L
The sum of	Nine hundred dollars plus $90 GST
Being for	Design fees for Greenlakes Golf Retreat (Job no. 01–32)
Amount	$990
Signed	*F. Darmanin*

Document B

Transaction details

Merchant	F. Darmanin
Description	WITHDRAWAL ONLINE 5250373 BPAY AGL SALES AGL
Account	WIZ BANK 555-000 123456
Scheduled payment date	28 May 2030
Amount	-$1100 (including $100 GST)
Transaction ID	add21267-ee2a-4704-8d5d-125eebe5b3f9
EFT receipt number	5250373
Type	EFT
From	WIZ BANK 555-000 123456
To	F. Darmanin
Biller code	132475
Customer reference number	88455427972

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Document C

Daring Designs

54 Greenhills Road
Bundoora 3145
ABN: 33 405 662 310

Tax Invoice
Receipt: 911

Date	29 May 2030
Received from	Peter Trevite (employee)
The sum of	One hundred and thirty dollars plus $13 GST
Being for	Rent of office space for 21st birthday party
Amount	$143
Signed	*F. Darmanin*

Document C

Unidraw Supplies
ABN 9873 1324 543
Scribble St, Essendon
30 May 2030
3.08pm

Account:	SAV
Supplies	110.00

Price includes GST of $10.00
EFT ref. 714

Additional information:

- As at 1 May 2030, the business had GST payable of $380.
- On 31 May 2030, Fiona used her phone banking facilities to determine that the business had $1 400 in its bank account.

Required

a. Referring to two Qualitative characteristics, **explain** the importance of source documents in the Accounting process.
b. **Identify** the party who will keep the original of Document A.
c. **Suggest** one reason why two separate columns have been established for fees in the Cash Receipts Journal.
d. **State** the effect (overstated/understated/no effect) on each element of the Accounting equation if the transaction in Document B was not recorded.
e. **Identify** one weakness in the way Fiona records her cash payments.
*__f.__ **Record** the transactions for May 2030 in the appropriate cash journals. **Total** the journals.
*__g.__ **Prepare** a Cash Flow Statement for Daring Designs for May 2030.
h. **Calculate** the GST balance for Daring Designs as at 31 May 2030.

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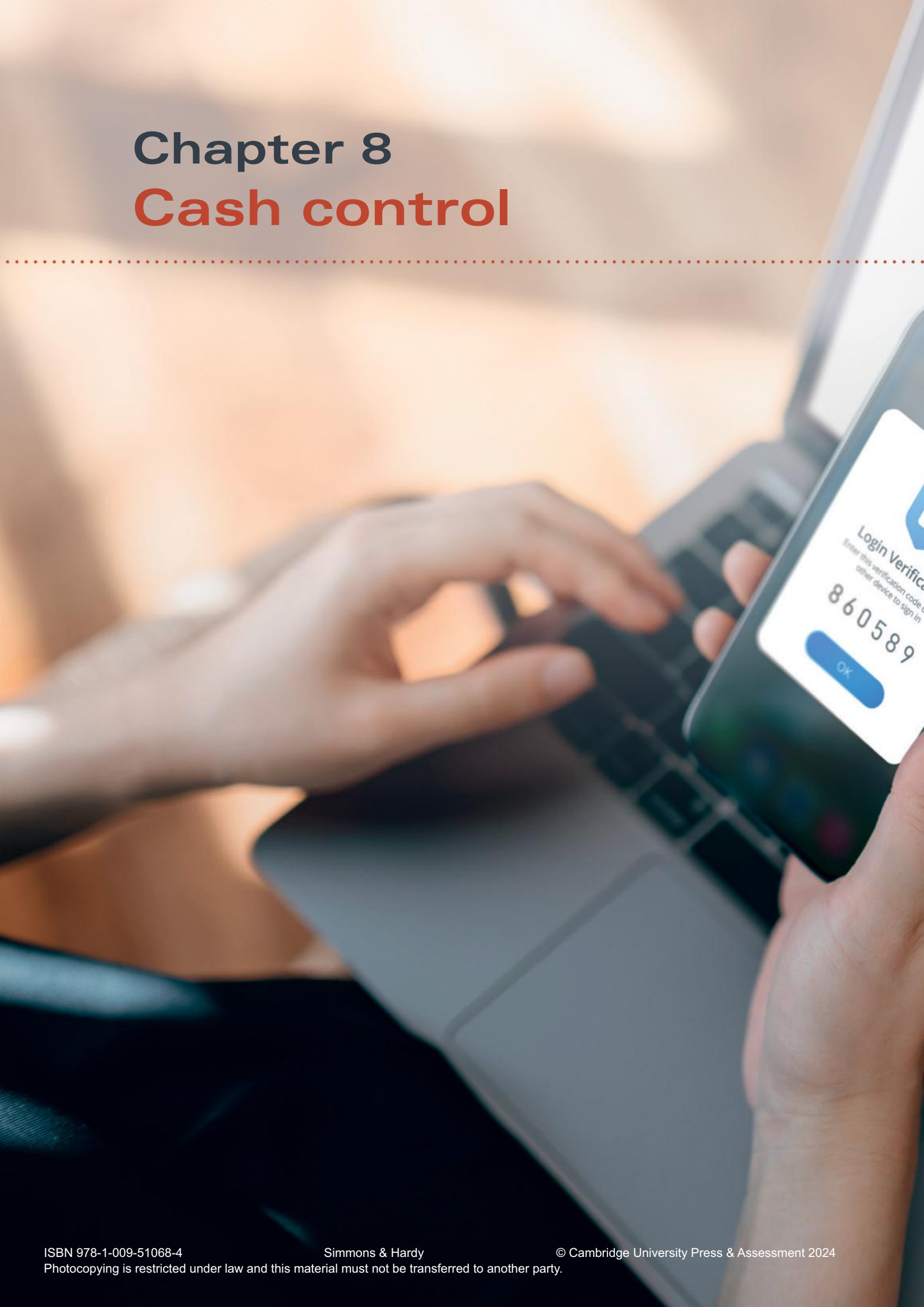
Chapter 8
Cash control



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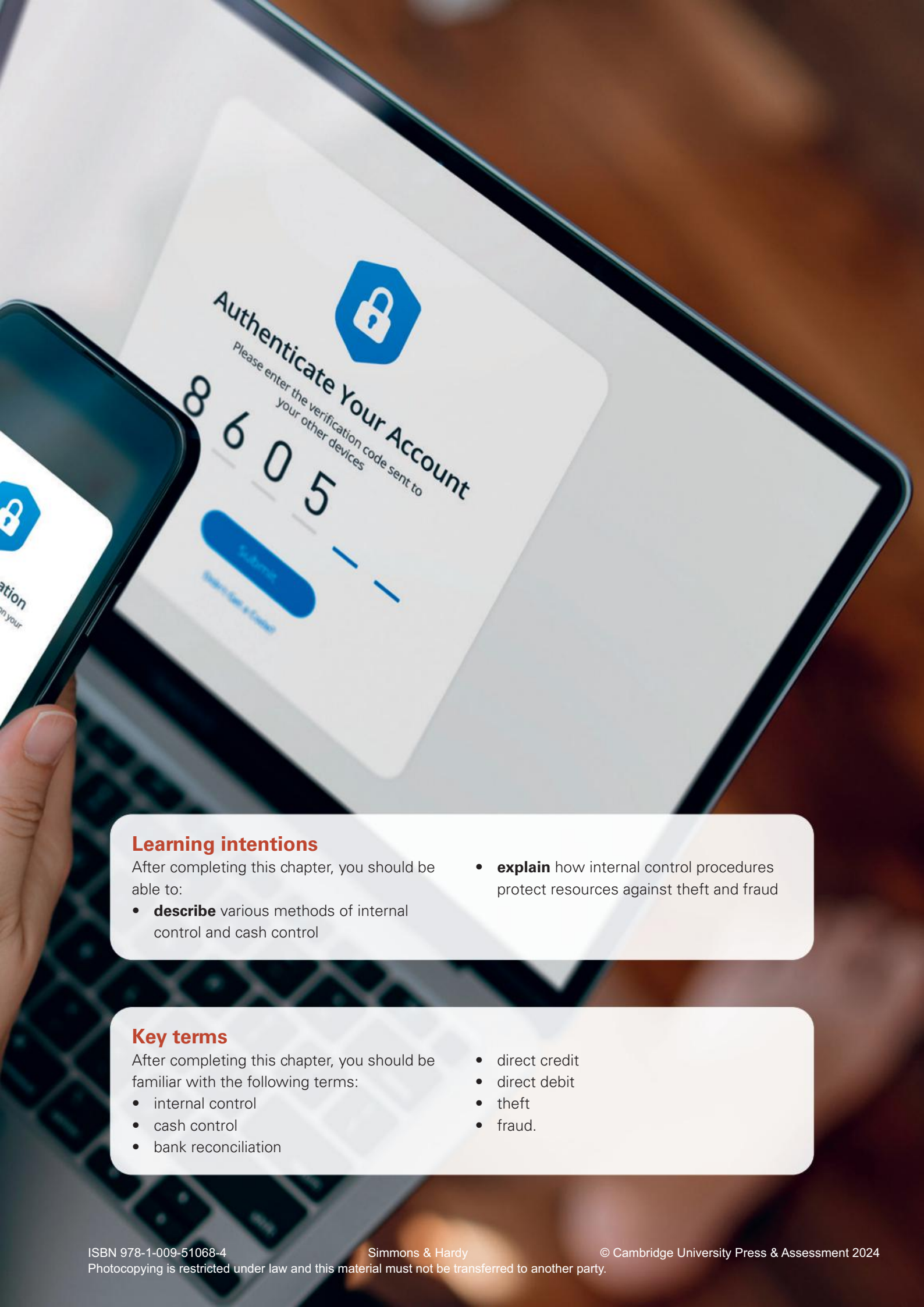

Learning intentions

After completing this chapter, you should be able to:

- **describe** various methods of internal control and cash control
- **explain** how internal control procedures protect resources against theft and fraud

Key terms

After completing this chapter, you should be familiar with the following terms:

- internal control
- cash control
- bank reconciliation
- direct credit
- direct debit
- theft
- fraud.

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8.1 Internal control

Like all small businesses, those in the service industry are highly reliant on their assets to carry out their operating activities. Whether it is the cash that pays for supplies, the tools that are used to perform the service, the vehicle that is used to travel between jobs or simply the phone on which work is organised, assets are vital to the firm's ability to earn revenue. Data security has become a greater issue of late. With increasing cases of cyber attacks and data theft, it is vital that businesses are able to protect their systems and confidential information.

The Australian Government defines fraud as 'dishonestly obtaining a benefit, or causing a loss, by deception or other means'. In this definition, 'benefit' refers both to tangible items, such as money or objects, and intangible benefits including power, status or information.

Despite fraud and theft having the same negative outcome, there is a clear difference between the two. Theft is physically taking another entity's property without their consent and intending to deprive them of it forever, whereas fraud uses manipulation, deception and/or misrepresentation to gain something of value dishonestly.

Fraud can occur within a business in a number of ways, including:

- the theft or misuse of a business' information – this could involve stealing and selling confidential data of the business to competitors or others
- accounting fraud – where an employee could be creating fake invoices or transactions to direct business funds for their own use
- misuse of corporate credit cards for personal benefit
- using equipment or supplies for personal use and benefit, e.g. using the company photocopier to print your sports club newsletter.

Therefore, it is essential that every small business has in place **internal control** mechanisms to protect its assets from fraud, theft, damage and misuse.

internal control
the procedures and strategies used to protect the firm's assets from fraud, theft, damage and misuse

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Internal control mechanisms

Some of the more common internal control mechanisms include:

- **Physical safeguards**
  These prevent unauthorised people from accessing a particular asset through barriers such as fences, padlocks or locked storerooms and server rooms, and for cash, in particular, through the use of safes, lock-boxes and lockable cash drawers. Data can be secured safely on and off-site. If people cannot touch the asset, they have less chance of misusing or misappropriating it.
- **Preventative safeguards**
  These involve dissuading misuse or theft of assets through the threat of apprehension. Systems such as alarms and security cameras (open, hidden and even dummy) work on the premise that people are less likely to attempt theft if they are concerned they will be caught.
- **Authentication Methods**
  These are a variety of systems that can limit access to physical assets or virtual assets including data. Authentication methods can use smart cards, security tokens, passwords or a multi-factor authentication (MFA) approach. Some can be quite sophisticated such as using biometric data like fingerprint or facial recognition. These safeguards ensure that only appropriate staff can access specific assets and data.
- **Separation of duties**
  This involves ensuring that no one employee (except the owner) has complete control over a particular type of asset, so their actions are open to scrutiny by another employee. The more people involved in the process, the less chance there is of collusion occurring.
- **Rotation of duties**
  This involves ensuring that tasks are not always performed by the same employee, so that their actions are open to scrutiny by the next employee who performs that task. (This has the added benefit of multi-skilling employees, who can then perform a number of tasks.)
- **Careful hiring practices**
  These involve effective screening and assessment of potential employees to ensure that only the most trustworthy and responsible candidates are employed. This should reduce the need to rely on other internal control mechanisms.
- **Effective employee training**
  This involves ensuring that staff are skilled in the use and management of the assets they are required to use or supervise, reducing the likelihood that assets are damaged through misuse. This is particularly the case for equipment and data, but also protects another of the firm's assets, its staff! A cyber security policy and a regular review of processes (e.g. password renewal) is necessary to ensure all employees are educated in relation to data security.

Review questions 8.1

1 **Distinguish** between theft and fraud. **Provide** an example of each.
2 **Define** the term 'internal control'.
3 Briefly **describe** five internal control mechanisms.

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8.2 Cash control

cash control
the procedures and strategies used to protect the firm's cash

Of all the assets under the control of a small business, the asset most at risk, and therefore most in need of protection, is cash. Cash is vital to the existence of a small business, but it is easy to remove, easily concealed and difficult to trace. For this reason, it is essential that every small business has effective **cash control** mechanisms.

Obviously, the internal control mechanisms mentioned previously can be applied to the protection of cash; however, there are other cash-specific procedures that can also be applied.

- *All cash transactions should be verified by a pre-numbered document* (such as a cash receipt or a EFT receipt).
- *All payments should be made by electronic transfer rather than cash* because they are more secure (allowing large payments to be made without the risk of carrying cash); debit or credit cards can be cancelled if lost or stolen, and the eventual recipient of the funds can be traced if necessary. Lost or stolen cards need to be reported immediately to the relevant bank or provider to limit liability for unauthorised transactions. In addition, the EFT receipt allows for the recording of the details of the transaction.
- *Payments should not be made directly from the till* because the owner cannot verify how much has been taken, or if it is being used for proper purposes.
- *Cash in registers should be verified against the cash register roll* to ensure that all cash received is accounted for.
- *A petty cash system should be used for small payments*, so that all payments are verified and authorised.
- *Cash should not be kept on the premises* in large quantities or overnight, as this not only increases the likelihood of theft, but also the potential loss if theft occurs.
- *EFTPOS facilities that allow the direct transfer of funds to the business bank account should be used* to reduce the amount of cash kept on the premises. All banks offer merchant facilities for businesses to make receiving cash easier.
- *Takings should be banked at least daily*, but not at the same time every day.
- *Cash procedures should be changed periodically* so that potential thieves are uncertain as to the level and location of any cash on hand.

- *Accurate and up-to-date cash records must be kept* so that discrepancies can be detected quickly and investigated. This would require the implementation of a system similar to the one described in Chapter 7.
- *A bank reconciliation should be conducted regularly* to ensure that the cash records of the business match those kept by the bank.

Review questions 8.2

1 **State** one way each of the following internal control mechanisms could be applied to the protection of cash:
   - physical safeguards
   - separation of duties
   - rotation of duties.

2 **State** three benefits of making payments by electronic transfer rather than cash.

3 **Explain** why small payments should be made using a petty cash system rather than straight from the cash register.

4 **List** five other cash control mechanisms.

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8.3 The Bank Statement

In Chapter 7 we considered how cash transactions are recorded and reported, beginning with the cash receipts and EFT receipts that provide the evidence and ending with the Cash Flow Statement, which reports the financial information to the owner. The whole point of starting with the source documents was to ensure that the information in the reports would be *Verifiable* and provide a *Faithful representation*, and provided the source documents themselves are accurate, so should be the information in the reports.

However, the information in the journals is sometimes incomplete, with not all transactions affecting the firm's bank balance being apparent. For instance, some businesses authorise payments (like those for a mortgage) to be made directly from their account (direct debits) without the need for a source document to be written. As a consequence, the owner needs a mechanism to verify that all the firm's cash transactions are accounted for, and that they have an accurate assessment of the firm's cash position.

Fortunately, this checking mechanism is provided in the form of the firm's Bank Statement. A Bank Statement is a record, kept and provided by the firm's bank, of all the transactions affecting the firm's bank account. When used in conjunction with the cash journals kept by the firm, it can be used to verify the firm's cash transactions to ensure that the owner has an accurate and complete assessment of the firm's cash position.

Figure 8.1 shows the Bank Statement for Willow's Window Wash for July 2030:

Figure 8.1 Bank Statement

Argus Bank of Australia AC No. 43 63 89

A/C holder: Willow's Window Wash
123 Tree Way
Gumsville 3243

Date	Particulars	Debit	Credit	Balance
2030		$	$	$
July 1	Balance forward			4830 CR
2	EFT 5011	1000		3830 CR
2	Deposit POS		1320	5150 CR
5	Service fee	15		5135 CR
11	EFT 5012	220		4915 CR
13	Deposit Cash		1100	6015 CR
15	EFT 5014	1450		4565 CR
20	EFT 5015	3960		605 CR
25	Deposit POS		850	1455 CR
28	EFT 5016	440		1015 CR
29	Transaction fee	10		1005 CR
30	Interest		2	1007 CR
	TOTALS THIS PAGE	$7095	$3272	
	Final Balance		**CREDIT**	**$1007**

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Study tip

An overdraft can also be indicated by the letters OD – overdraft/ overdrawn.

Unlike the Accounting records we have examined so far, the Bank Statement has a running balance – it is updated after every transaction – so that the user can see the firm's bank balance on any particular day. Cash receipts, or deposits, are recorded in the credit column and increase the balance, while payments, or withdrawals, are recorded in the debit column and decrease the balance. Consequently, a Credit (CR) balance indicates a positive balance, whereas a Debit (DR) balance indicates an overdraft. Figure 8.1 shows that Willow's Window Wash has a bank balance of $1 007 CR (cash in the bank) as at 31 July 2030.

Note that although each cash transaction for July 2030 is recorded here, the level of detail is much less than we are used to seeing in the Cash Receipts Journal or Cash Payments Journal. In fact, payments are identified simply by the transaction ID, and receipts by the abbreviation Deposit Cash for physical cash deposits at the bank or Deposit POS for a summary of EFT transactions, indicating the nature of what was deposited, but not its specific source.

Theoretically, the information on this Bank Statement should match the information recorded by the firm in its own cash journals, but only by comparing the two sets of records, the Bank Statement produced by the bank and the journals produced by the firm, will we be able to see if this holds true. This is performed by carrying out a bank reconciliation.

bank reconciliation the process of verifying that the entries in a firm's cash journals are the same as those recorded by the firm's bank on the Bank Statement

Bank reconciliation is the process of verifying the entries in the firm's cash journals by comparing them against the transactions recorded on the Bank Statement. Theoretically, both records should show the same transactions; however, the main reason why this will not always be the case is that there may be transactions the bank knows about, but the business does not.

Transactions the firm did not know about

As was discussed earlier, cash is sometimes deposited or withdrawn directly from the firm's account, and so might be recorded on the Bank Statement, but not in the cash journals.

direct credit a deposit of cash directly into a bank account

direct debit a withdrawal of cash directly from a bank account

1. **Direct credits** occur when cash is deposited directly into the firm's account for items such as interest earned. In addition, using internet banking, BPAY and other similar services, customers can pay amounts directly into the firm's bank account without having to come into the business.
2. **Direct debits** occur when cash is withdrawn directly from the firm's account for payments such as interest, bank fees or charges, merchant fees (for the use of EFTPOS facilities) or government taxes, or regular payments such as loan instalments.

These transactions that are not yet recorded in the firm's records must be added to the cash journals.

Many of the accounting software programs provide the option of an automated bank reconciliation function, where the software links to the business' online bank statement and updates the cash journals of the business for any transactions the business was unaware of. Any payments that the owner cannot justify (or remember) will need to be investigated to ensure no fraud has taken place.

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Review questions 8.3

1 **State** the function of a Bank Statement.
2 Referring to a Bank Statement, **identify** the type of transactions that are recorded in the:
   - credit column
   - debit column.
3 **Explain** how the Bank Statement can be used to verify the accuracy of the firm's own cash records.
4 **State** the main reason for differences between the Bank Statement and cash journals.
5 **Define** the following terms:
   - direct debit
   - direct credit.
6 **Explain** the process to account for direct debits and direct credits.

Where have we been?

- Theft is physically taking another entity's property without their consent and intending to deprive them of it forever, whereas fraud uses manipulation, deception and/or misrepresentation to gain something of value dishonestly.
- Internal control mechanisms protect assets from fraud, theft, damage and misuse; cash control mechanisms relate specifically to cash.

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Exercises

Exercise 8.1
Cash control

In a small hairdressing salon, the owner trusts a single employee with all cash handling responsibilities. Cash is taken directly from the cash register for small payments. There are no defined procedures for reconciling the cash register. The employee walks the day's cash down to the bank at 4 p.m. every day.

page 128

Required

a. **Identify** the weaknesses in the business's cash control processes.
b. **Recommend** specific controls that should be put in place to address the issues raised.

Exercise 8.2
Internal control

A small accounting firm, trying to improve efficiency, allows all of its employees unrestricted access to all files. Many employees use passwords that are stuck by sticky notes on their screens or share login credentials. There is no system for changing passwords at regular intervals.

page 129

Required

a. **Identify** the weaknesses in the business's internal control processes.
b. **Recommend** specific controls that should be put in place to address the issues raised.

Exercise 8.3
Internal control

A small restaurant purchases kitchen equipment and appliances and does not bother to keep the documentation. The owner also approves and pays invoices without verifying the supplies received. The staff generally help themselves to food when they are hungry. Additionally, the business does not conduct periodic inventory checks and there has been over-ordering and food spoilage.

page 130

Required

a. **Identify** the weaknesses in the business's internal control processes.
b. **Recommend** specific controls that should be put in place to address the issues raised.

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Exercise 8.4
Internal control

page 131

In a small marketing agency, employees are allowed to make business-related purchases without any approval process and are not required to provide receipts for any purchases. The business also has two vehicles and the keys are kept on a hook on the wall. It has been noted that the vehicles are not always present over the weekend.

Required

a. **Identify** the weaknesses in the business's internal control processes.
b. **Recommend** specific controls that should be put in place to address the issues raised.

Exercise 8.5
Internal control

page 132

A small graphic design studio has one desktop computer for its digital assets and project files. There are no regular backups or offsite storage of critical data. The owner has a portable, unencrypted hard drive where he keeps current files when storage on his desktop gets full. The owner has yet to renew his antivirus software and does not believe in passwords.

Required

a. **Identify** the weaknesses in the business's internal control processes.
b. **Recommend** specific controls that should be put in place to address the issues raised.

Exercise 8.6
Internal control

page 133

Shonky Fixes Pty Ltd is a small repair business specialising in fixing phones and iPads. The company operates without policies and procedures, relying on verbal instructions and institutional knowledge. All employees are responsible for orders and also handle inventory management and shipping. There has been concerns noted with inconsistent tracking, leading to shortages of some parts and overstocking of others as the business does not conduct regular physical counts of its supplies. Supplies are easily accessed in an open cupboard. Whoever is free at the time is in charge of finances. They pay invoices without reviewing the goods or services received and have been told to take cash from the unlocked register for purchases. There have been instances of frequent cash shortages. Shonky Fixes Pty Ltd heavily relies on digital systems for order processing and financial record-keeping and all staff can access the device with a common password.

Required

a. **Write** a report to the owner of Shonky Fixes Pty Ltd **identifying** concerns regarding internal control and **recommend** how these should be rectified.

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Chapter 9
Credit transactions

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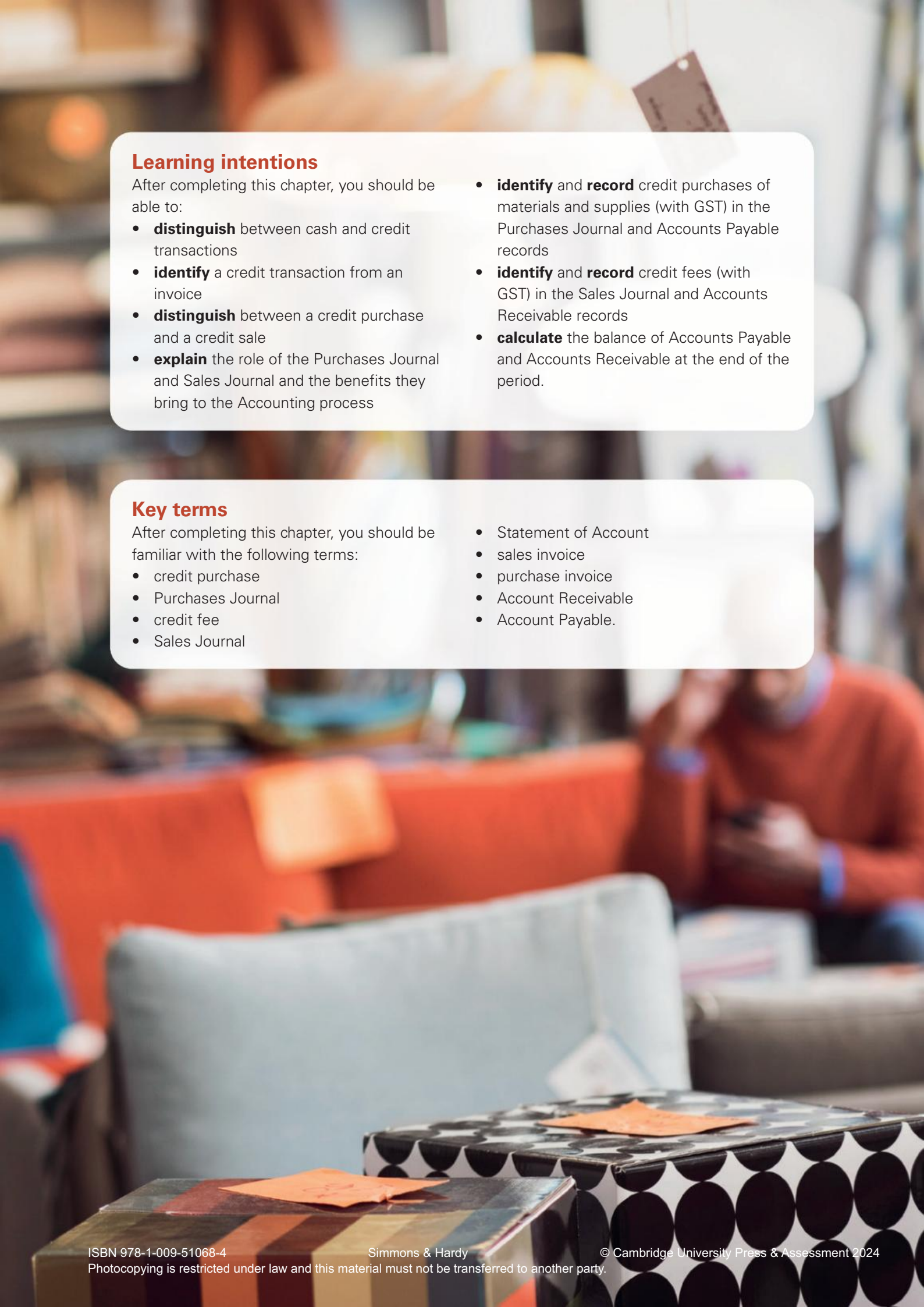

Learning intentions

After completing this chapter, you should be able to:

- **distinguish** between cash and credit transactions
- **identify** a credit transaction from an invoice
- **distinguish** between a credit purchase and a credit sale
- **explain** the role of the Purchases Journal and Sales Journal and the benefits they bring to the Accounting process
- **identify** and **record** credit purchases of materials and supplies (with GST) in the Purchases Journal and Accounts Payable records
- **identify** and **record** credit fees (with GST) in the Sales Journal and Accounts Receivable records
- **calculate** the balance of Accounts Payable and Accounts Receivable at the end of the period.

Key terms

After completing this chapter, you should be familiar with the following terms:

- credit purchase
- Purchases Journal
- credit fee
- Sales Journal
- Statement of Account
- sales invoice
- purchase invoice
- Account Receivable
- Account Payable.

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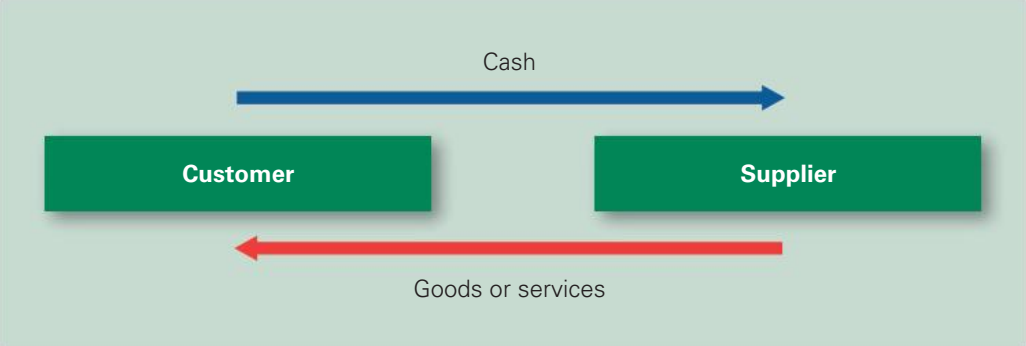
9.1 Credit transactions

As was noted at the very start of this text, a transaction is simply an exchange of goods or services for some other asset. In this instance, we will look at the provision of a service in return for cash from the customer. Another example is the business purchasing materials from its supplier. This 'exchange' is represented in Figure 9.1:

Figure 9.1 Performance of service or purchase of materials/supplies



credit transaction when a service is performed or goods are exchanged but the cash relating to the transaction is not exchanged until some later date, meaning the customer owes a debt to the provider/seller

So far, we have dealt only with cash transactions, which means that the **goods/services** and **cash** are exchanged at *the same time*. However, many small businesses will also conduct some of their trading activities using **credit transactions**, which effectively separates a service or purchase *into two* transactions: the exchange of the **goods/services** occurs first, with the exchange of **cash** occurring at a later date.

Example

On 3 April 2030, Funky Hair purchased 20 containers of shampoo on credit from Shine & Glo for $495 (including $45 GST).

Had this been a cash transaction, both the shampoo and the cash would have been exchanged on 3 April 2030. However, because it is a credit transaction, only the shampoo would be exchanged on 3 April: the cash related to the transaction would be exchanged at a later date. This means that on 3 April 2030, Funky Hair still owes $495 to Shine & Glo.

Note: when we speak of 'credit transactions' we are not referring to sales made to customers who pay with their credit card (even cards that are priceless or accepted everywhere). Transactions such as these are treated as a 'cash equivalent' because the customer does not owe the seller anything. (The credit relationship in this case is between the customer and the credit card provider.) Refer to Section 6.2 for further explanation.

Source document: Invoice

As has been noted previously, source documents are vital in ensuring the *Verifiability* of Accounting reports; by authenticating each transaction, source documents ensure that the reports provide a *Faithful representation* and are free from bias.

Whereas cash transactions are verified by a form of cash receipt or EFT document (for receipts and payments respectively), credit transactions are verified by an invoice such as the one shown in Figure 9.2.

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Figure 9.2 Invoice

Shine & Glo
53 Central St, Berwick, VIC 3806
ABN: 36 232 968 106
Sold to: Funky Hair
12 West Gate Court
Cranbourne, Victoria, 3977
ABN: 33 020 871 455

Date: 3/4/2030
Invoice: 29

TAX INVOICE

Terms: 30 days

Item	Qty	Unit Cost $	$
Shine & Glo Shampoo	20	22.50	450
GST (10%)			45
		$	**495**

The invoice will be issued by the seller/supplier (who is named at the top of the invoice) and delivered with the goods.

This invoice verifies that on 3 April 2030, Shine & Glo sold shampoo to Funky Hair. As a source document and tax invoice, it identifies:

- the name of the supplier (Shine & Glo)
- the name of the customer (Funky Hair)
- the terms of the sale/purchase (30 days)
- the type, number and value of items that have been supplied (20 containers of shampoo worth $22.50 each, for a total of $450)
- the GST on the sale ($45 i.e. 10% of the supplier's price)
- the total amount owing to the seller (**$495**).

Terms

By definition, a credit transaction means that the customer will not pay the cash on the day the sale is made. It is therefore important that the invoice given to the customer with the goods specifies exactly when that payment must be made, which is specified in the credit terms. In this example, the net amount must be paid in 30 days.

Credit sale or credit purchase?

Given that an invoice will provide evidence of both a credit purchase and a credit sale, how are the two to be distinguished? The answer depends on which entity for whom we are accounting. The name of the seller is always identified at the top of the invoice, and the name of the customer is identified in the middle (as 'Sold to' or 'Charged to'). Therefore, if the business for which we are accounting ('our business') is named at the top of the invoice, the document is a **sales invoice**, and the transaction is a credit sale. If, however, our business is named in the middle of the invoice, the document is a **purchase invoice** and the transaction is a credit purchase.

The invoice in Figure 9.2 would be treated as a credit sale in the records of Shine & Glo, as it is named at the top of the invoice as the seller. In the records of Funky Hair, however, it would be treated as a credit purchase, as Funky Hair is named in the middle as the purchaser.

sales invoice
a source document that verifies a credit sale of inventory

purchase invoice
a source document that verifies a credit purchase (usually of inventory)

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Accounts Receivable

A credit sale will mean that customers will owe the business for the goods/services provided to them, and these customers are known as Accounts Receivable. Accounts Receivable are reported as a current asset, because the amounts they owe (to 'us') represent a present economic resource controlled by the business (the business has a legal claim to the debt), which has the potential to provide a future economic benefit (when the cash is received) in the next 12 months.

Accounts Payable

Conversely, a credit purchase will mean that the business will owe suppliers for the materials or supplies it has purchased from them, and these suppliers are known as Accounts Payable. Because we have a present obligation to make a transfer of an economic resource to these Accounts Payable (by paying them the amount owing) sometime in the next 12 months, Accounts Payable are reported as a current liability.

GST on credit transactions

When a service is performed for cash, the customer must pay not only for the service, but also the GST (10% of the supplier's price). The supplier collects this GST on behalf of the Australian Taxation Office (ATO) and at some stage in the future must forward it to the ATO. When a service has been performed on *credit*, the customer must still pay for the service and the GST, but this will not occur until a later date. Therefore, the supplier must record the amount owing for the service, plus the GST.

When supplies are purchased on credit, the same principle applies. The customer must still pay GST on the purchase, but because the transaction is on credit, the customer will owe the GST to the supplier. This means the customer will owe to the supplier an amount for the supplies, plus the GST amount. In our example on the previous page, Funky Hair will owe Shine & Glo **$495**: **$450** for the shampoo that has been purchased and the $45 GST.

Review questions 9.1

1. **Distinguish** between a cash transaction and a credit transaction.
2. Referring to two Qualitative characteristics, **explain** the importance of source documents in the Accounting process.
3. **Explain** why credit terms should be noted on an invoice.
4. **Explain** how a business can distinguish between a sales invoice and a purchase invoice.
5. Define the following terms:
   - Accounts Receivable
   - Accounts Payable.
6. **Explain** how Accounts Receivable and Accounts Payable are reported in the Balance Sheet.
7. **Explain** how GST affects the amount owed to an Account Payable for the purchase of materials or supplies on credit.

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9.2 Recording credit purchases

In literal terms, a **credit purchase** occurs when a business buys materials or supplies from a supplier but is not required to pay until a later date. Although a service firm could purchase any type of asset on credit, the term 'purchases' on its own usually relates to the purchase *of materials or supplies*. Therefore, we will use the term 'credit purchases' to refer to purchases *of materials or supplies* that need not be paid until a later date.

Every credit purchase should be verified by a purchase invoice. However, a collection of invoices does not represent usable Accounting information – the data must be sorted, classified and summarised in some way before it can be used to assist decision-making. Chapter 7 introduced the use of the Cash Receipts Journal and Cash Payments Journal to summarise cash transactions, and a similar approach can be applied here by using a **Purchases Journal** to summarise all purchases of materials or supplies on credit during a particular period.

Figure 9.3 shows the Purchases Journal for Funky Hair for April 2030:

credit purchase a transaction that involves the acquisition of materials or supplies (or other goods) from a supplier who does not require payment until a later date

Purchases Journal an Accounting record that summarises all transactions involving the purchase of materials or supplies on credit

Figure 9.3 Purchases Journal

Date[1]	Account Payable[2]	Inv. No.[3]	Inventory of materials[4]	GST[5]	Accounts Payable[6]
Apr. 3	Shine & Glo	29	450	45	495
8	Gel 'n' Slick	X401	260	26	286
15	Shine & Glo	35	700	70	770
20	Spray & Hold	AV12	280	28	308
23	Gel 'n' Slick	X432	240	24	264
29	Shine & Glo	39	600	60	660
	TOTALS	**$**	**2530**	**253**	**2783**

Notes for recording in the Purchases Journal

1 **Date**
Transactions are recorded in the journal on the date they occur. (This date will be very important for the individual Accounts Payable records, which will be discussed later.)

2 **Account Payable**
The journal must show the name of each individual Account Payable. (A separate record will be maintained elsewhere for each individual Account Payable – see Chapter 13).

3 **Invoice number (Inv. No.)**
In order to ensure *Verifiability* and a *Faithful representation*, the source document (purchase invoice) must be recorded. If ever a query arises as to the details of the transaction, it can be traced easily back to the source document for clarification and verification.
The purchase invoices listed in the Purchases Journal will not run in order, because they are issued not by Funky Hair, but by their suppliers such as Shine & Glo, Gel 'n' Slick and Spray & Hold. Between purchases by Funky Hair, these suppliers will issue invoices to all of their other customers.

4 **Inventory of materials**
This is the value of the materials that have been purchased (their cost price), excluding GST.

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5 **GST**
This is the GST incurred on credit purchases, calculated as 10% of the price of the purchase (as recorded in the Inventory of materials column).

6 **Total Accounts Payable**
This is the total amount owed to Accounts Payable, calculated by adding together the value of the materials purchased and the GST. That is, we owe the Account Payable for the materials that have been purchased and the GST incurred.

By recording all the credit purchases in a Purchases Journal, we have a summary of how much inventory of materials has been purchased on credit during the period. In this case, Funky Hair has purchased **$2530** worth of materials during April 2030. As a result, it has been charged GST of **$253**, meaning that the amount it owes to its Accounts Payable has increased by a total of **$2783**.

GST on credit purchases

Although the GST incurred on credit purchases will increase the debt owed to the Account Payable, it will not affect the valuation of the inventory of materials, because it is in fact a reduction in the GST liability to the ATO. Just as the *GST paid to suppliers* (discussed in Chapter 7) will be forwarded to the ATO by the supplier, so too will the *GST on credit purchases*. As a result, any GST the business is charged on its own purchases can be deducted from its GST liability. Therefore, inventory of materials is valued at the supplier's price, and the GST on credit purchases reduces the GST payable.

Effect on the Accounting equation

The overall effect of total credit purchases on the Accounting equation of Funky Hair for April 2030 would be:

	Increase/Decrease/No effect	Amount $
Assets	Increase (Inventory)	2530
Liabilities	Increase (increase Accounts Payable $2783, decrease GST $253)	**2530**
Owner's equity	No effect	

Review questions 9.2

1 **Explain** the role of the Purchases Journal.
2 **State** which type of source document is used to verify all transactions recorded in the Purchases Journal.
3 **Explain** the effect of 'GST on credit purchases' on the valuation of inventory.
4 Referring to the Purchases Journal, **state** one reason why the amount recorded in the Total Accounts Payable column is greater than the value of inventory of materials purchased.
5 **Explain** the effect of 'GST on credit purchases' on GST payable.
6 **State** the effect of a credit purchase of inventory on each element of the Accounting equation.

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9.3 Payments to Accounts Payable

Credit purchases are recorded in the Purchases Journal on the day the inventory is purchased, but like all cash payments, the other half of the transaction – when the cash is paid to the Account Payable – is verified by a EFT receipt or other source document and recorded in the Cash Payments Journal. Figure 9.4 shows the EFT receipt to provide evidence of a payment to an Account Payable:

Figure 9.4 Payment to an Account Payable: EFT receipt

Zag Bank

Funky Hair 12 Apr 2030 11:49:48

INTERNAL PAY NOW

Reference Number	AT3OUPA14002CCZ9
Transfer to	Shine & Glo
Account Type	Internal
Account Number	XXXXXXXXXXXX0024
Account Name	Shine & Glo
Transfer From	XXXXXXXXXXXX0026
Amount	AUD 495.00
Transfer When	12 Apr 2030
Purpose	Transaction is a general cash management instruction.
Note	

This is a computer generated receipt no signature required.
Electronic Receipt owns no official legal effect,
you may go to branch to get the paper receipt.

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This EFT payment receipt indicates that the cash has been paid to the Account Payable (Shine & Glo) to settle the amount outstanding. Note that there is **no** GST on a payment to an Account Payable, because the GST is recognised and reported only at the time the purchase is made.

This would be recorded in the Cash Payments Journal as is shown in Figure 9.5:

Figure 9.5 Payment to an Account Payable: Cash Payments Journal

Cash Payments Journal

Date	Details	Source Document	Bank	Accounts Payable	Drawings	Wages	Sundries	GST
April 2	Gel 'n' Slick	EFT 6347	**220**	220				
6	Wages	EFT 348	**1500**			1500		
7	Drawings	ATM 105	**1000**		1000			
12	Shine & Glo	EFT 3492	**495**	495				
15	Electricity	BPAY 635	**275**				250	25
16	Spray 'n' Hold	EFT 1350	**385**	385				
20	Wages	EFT 351	**1500**			1500		
21	Drawings	ATM 603	**600**		600			
23	Shine & Glo	EFT 3542	**990**	990				
28	Rent	EFT 3253	**1320**				1200	120
	TOTALS	**$**	**8285**	**2090**	**1600**	**3000**	**1450**	**145**

Payments to Accounts Payable will be frequent, and so are recorded in their own classification column just like (in this example) Drawings, Wages and GST. Total cash paid to Accounts Payable by Funky Hair in April 2030 is thus **$2090**.

Effect on the Accounting equation

The overall effect of payments to Accounts Payable on the Accounting equation of Funky Hair for April 2030 would be:

	Increase/Decrease/No effect	Amount $
Assets	Decrease (Bank)	2090
Liabilities	Decrease (Accounts Payable)	2090
Owner's equity	No effect	

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Calculating the Accounts Payable balance

With total credit purchases recorded in the Purchases Journal, and total payments to Accounts Payable recorded in the Cash Payments Journal, we can calculate the total balance owed to Accounts Payable at the end of the reporting period. Assuming Funky Hair owed $850 to its Accounts Payable as at 1 April 2030, its Accounts Payable balance as at 30 April 2030 would be calculated using the formula shown in Figure 9.6:

Figure 9.6 Accounts Payable formula

Accounts Payable balance at start	850	From the *previous* Balance Sheet
+ Credit purchases incl. GST	2 783	From the Purchases Journal
	3 633	
– Payments to Accounts Payable	2 090	From the Cash Payments Journal
Accounts Payable balance at end	$1 543	Goes into the *next* Balance Sheet as a current liability

This new balance of the total owed to Accounts Payable ($1 543) can now be reported as a current liability in the Balance Sheet for Funky Hair as at 30 April 2030.

Review questions 9.3

1. **State** a source document that can be used to verify cash paid to an Account Payable.
2. **Explain** why there is no GST to account for when cash is paid to an Account Payable.
3. **State** one reason why payments to Accounts Payable are recorded in their own classification column in the Cash Payments Journal.
4. **State** the effect of a payment to an Account Payable on each element of the Accounting equation.
5. **Show** the formula to calculate the balance of Accounts Payable at the end of the reporting period, identifying the sources of the information it uses.

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9.4 Recording credit fees

Previously in this chapter, we have used the term 'credit sales'. However, when a service is performed the revenue generated is referred to as fees rather than sales and this is the term we will use for the remainder of this chapter, but it will still be recorded in the Sales Journal.

credit fee
a transaction that involves the provision of a service to a customer who is not required to pay until a later date

One of the great benefits of selling services on credit terms is that it may actually generate more revenue, and thus profit, than would be possible through cash fees alone. As with a cash fee, a **credit fee** increases revenue because it increases assets and increases owner's equity. The only difference is that for a cash fee, the increase in assets is in the form of cash (so Bank increases), whereas for a credit fee for services, the asset that increases is Accounts Receivable.

Example

On 6 April 2030, Funky Hair performed six washes, cuts and blow waves for a wedding (Inv. 514).

The sales invoice for this credit sale is shown in Figure 9.7:

Figure 9.7 Sales invoice

Funky Hair
12 West Gate Court
Cranbourne, Victoria, 3977
ABN: 53 020 871 465

Tax invoice

Customer: W. Nuptials,
15 Aisle St
Dandenong

6 April 2030
Invoice 514
Terms: n/30

Service	Qty	Unit Price	Total
Wash, cut and blow wave	**6**	**120**	720
GST (10%)			72
		Total	**$792**

Video 9.1
Interpreting an invoice

Sales Journal
an Accounting record that summarises all transactions involving the sale/performing of services on credit during a period

The GST is recognised and reported at the time of the sale, so the sales invoice must show all the information necessary for it to be classified as a tax invoice, including the selling price of the service, the amount of the GST and the total invoice price. Recording all credit fees in a **Sales Journal** allows us to classify and summarise the transactions, so that total credit fees can be reported with ease in the Income Statement.

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Figure 9.8 shows the Sales Journal for Funky Hair for April 2030:

Figure 9.8 Sales Journal

Date[1]	Account Receivable[2]	Inv. No.[3]	Fees[4]	GST[5]	Accounts Receivable[6]
April 6	W. Nuptials	514	720	72	**792**
9	Perfect Weddings	515	1800	180	**1980**
16	Models Inc	516	1 050	105	**1155**
20	Perfect Weddings	517	1200	120	**1320**
23	Models Inc	518	860	86	**946**
	TOTALS	**$**	**5 630**	**563**	**6 193**

Notes for recording in the Sales Journal

1 **Date**
As with the Purchases Journal, transactions are recorded in the Sales Journal on the date they occur, as this is the date on which they will be recorded in the Accounts Receivable records.

2 **Account Receivable**
Whereas credit purchases will increase Accounts Payable, credit fees will increase Accounts Receivable, so the Sales Journal must show the name of each individual Account Receivable (the individual transactions will be recorded in the Accounts Receivable records).

3 **Invoice number (Inv. No.)**
Although the invoices will not run in sequence in the Purchases Journal, they will in the Sales Journal because they are all issued by the business keeping the journal.

4 **Fees**
This is the fees revenue earned from the service, recorded at its selling price, excluding any GST.

5 **GST**
This is the GST charged on credit fees, calculated as 10% of the price of the fee (as recorded in the Fee column). The GST charged does not affect fees earned, but it does increase the debt owed by each Account Receivable, and it increases the GST payable to the ATO by the seller.

6 **Total Accounts Receivable**
This is the total amount owed by Accounts Receivable for each sale, calculated by adding together the selling price of the services performed and the GST charged. That is, each Account Receivable owes us for the service performed and the GST.

By recording all the credit fees in a Sales Journal, we have a summary of how much revenue has been earned from credit fees during the reporting period. In this case, Funky Hair has earned **$5 630** worth of fees during April 2030. In the process it has charged its Accounts Receivable GST of **$563**, meaning that the amount it is owed by its Accounts Receivable has increased by a total of **$6 193**.

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GST on credit fees

GST on credit fees has no effect whatsoever on profit because it does not affect the fees revenue earned. However, it will increase the debt owed by the Account Receivable.

Further, like GST on *cash fees* (recorded in Chapter 7), GST on *credit fees* is levied on behalf of the ATO and so must be forwarded to the ATO at some time in the next 12 months. As a result, any GST charged on credit fees is therefore owed back to the ATO, increasing the GST payable.

Effect on the Accounting equation

The overall effect of total credit fees on the Accounting equation of Funky Hair for April 2030 would be:

	Increase/Decrease/No effect	Amount $
Assets	Increase (increase **Accounts Receivable $6 193**)	6 193
Liabilities	Increase (GST)	563
Owner's equity	Increase (Fees $5 630 = Revenue)	5 630

Review questions 9.4

1. **Explain** why credit fees are classified as revenue.
2. **State** which type of source document is used to verify all transactions recorded in the Sales Journal.
3. **Explain** the role of the Sales Journal.
4. **Explain** why the source documents in the Sales Journal run in sequence.
5. **Explain** the effect of 'GST on credit fees' on revenue and profit.
6. **Explain** the effect of 'GST on credit fees' on GST payable to the ATO.
7. **State** the effect of credit fees on each element of the Accounting equation.

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9.5 Receipts from Accounts Receivable

Credit fees are recorded in the Sales Journal on the day the service is performed, but the receipt from the **Account Receivable** is recorded in the Cash Receipts Journal on the day the cash is received. Figure 9.9 shows the receipt to provide evidence of cash received from an Account Receivable:

Account Receivable
a customer who owes a debt to the business for goods or services sold to them on credit

Figure 9.9 Receipt from an Account Receivable

Funky Hair
12 West Gate Court
Cranbourne, Victoria, 3977
ABN: 53 020 871 465

REC: 315

Date	13 April 2030
Received from	Perfect Weddings
For	Progress payment on account
Amount	$2 000

As with a payment to an Account Payable, there is no GST to account for when cash is received from an Account Receivable, because the GST is recognised and reported only at the time sales are made. This receipt would be recorded in the Cash Receipts Journal as is shown in Figure 9.10:

Figure 9.10 Receipt from an Account Receivable: Cash Receipts Journal

Cash Receipts Journal

Date	Details	Source Document	Bank	Accounts Receivable	Hairdressing fees	Sundries	GST
April 2	Cash fees	Rec. 312	**132**		120		12
5	Models Inc	Rec. 313	**1 650**	1 650			
8	Cash fees	Rec. 314	**462**		420		42
13	Perfect Weddings	Rec. 315	**2 000**	2 000			
18	W. Nuptials	Rec. 316	**792**	792			
22	Cash fees	Rec. 317	**319**		290		29
26	Capital contribution	Rec. 318	**2 000**			2 000	
28	Perfect Weddings	Rec. 319	**1 300**	1 300			
	TOTALS	**$**	**8 655**	**5 742**	**830**	**2 000**	**83**

Receipts from Accounts Receivable will be frequent, and so they are recorded in their own classification column just like cash fees and GST. The total cash received from Accounts Receivable by Funky Hair in April 2030 is thus **$5 742**.

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Effect on the Accounting equation

The most common error in recording cash received from an Account Receivable is to treat it as additional revenue, rather than as simply swapping one asset (Accounts Receivable) for another (Bank). The fact that *assets do not increase overall* means that a receipt from an Account Receivable cannot be recorded as revenue – it does not fit the definition. In addition, recording a receipt from an Account Receivable as revenue would be double counting; the revenue was already recorded – as a credit fee – at the point of sale, when the goods were provided to the customer.

The overall effect of receipts from Accounts Receivable on the Accounting equation of Funky Hair for April 2030 would be:

	Increase/Decrease/No effect	Amount $
Assets	No effect (increase Bank $5 742, decrease Accounts Receivable $5 742)	
Liabilities	No effect	
Owner's equity	No effect	

Calculating the Accounts Receivable balance

Using the summaries from the Sales Journal and Cash Receipts Journal, we can calculate the total balance owed by Accounts Receivable at the end of the period. Assuming an opening Accounts Receivable balance of $2 200 as at 1 April 2030, the Accounts Receivable balance of Funky Hair as at 30 April 2030 would be calculated using the formula shown in Figure 9.11:

Figure 9.11 Accounts Receivable formula

Accounts Receivable balance at start	2 200	From the *previous* Balance Sheet
+ Credit sales incl. GST	6 193	From the Sales Journal
	8 393	
– Receipts from Accounts Receivable	5 742	From the Cash Receipts Journal
Accounts Receivable balance at end	$2 651	Goes into the *next* Balance Sheet as a current asset

This new balance of the total owed by Accounts Receivable ($2 651) can now be reported as a current asset in the Balance Sheet for Funky Hair as at 30 April 2030.

Review questions 9.5

1. **State** two source documents that can be used to verify cash received from an Account Receivable.
2. **State** one reason why receipts from Accounts Receivable are recorded in their own classification column in the Cash Receipts Journal.
3. **State** the effect of a receipt from an Account Receivable on each element of the Accounting equation.
4. **Explain** why a receipt from an Account Receivable is not recognised as revenue.
5. **Show** the formula to calculate the balance of Accounts Receivable at the end of the reporting period. **Identify** the sources of the information it uses.

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9.6 Statement of Account

The first and most important thing to note about a Statement of Account is that it is not evidence of a single transaction with an Account Payable or Account Receivable, but rather a summary of a number of transactions involving that Account Receivable or Account Payable over a certain period. Because it is a list of transactions that have already occurred – and have already been recorded – the Statement of Account does not need to be recorded again. Figure 9.12 shows the Statement of Account from an Account Payable – Shine & Glo – for April 2030:

Figure 9.12 Statement of Account

Shine & Glo

ABN: 36 232 968 106
53 Central St, Berwick, VIC 3806
STATEMENT OF ACCOUNT

Account of: Funky Hair
12 West Gate Court
Cranbourne, Victoria, 3977
ABN: 53 020 871 465

For period: April 2030

Date	Details	Sales	Payments	Balance
April 1	Balance carried forward			220
3	Inv. 29	495		715
12	Payment received: (EFT 3492)		495	220
15	Inv. 35	770		990
23	Payment received: (EFT 3542)		990	–
29	Inv. 39	660		**660**
	Balance owing: 30 April 2030			**$660**

This Statement of Account summarises the various credit purchases made by Funky Hair during April 2030, as well as the payments it made. Each transaction should be checked against the source document that was issued at the time to check its accuracy, and it may be a reminder to pay the Account Payable the balance owing, but no further recording is required when this statement is received.

Review questions 9.6

1 **State** the purpose of a Statement of Account.
2 **Explain** why a Statement of Account does not need to be recorded.

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Where have we been?

- A credit transaction occurs when the service is completed or goods are exchanged, but the cash is not exchanged until a later date and is verified by an invoice.
- A credit purchase will be verified by a purchase invoice, and recorded in the Purchases Journal, which summarises all credit purchases of inventory, materials or supplies in a reporting period.
- A credit fee will be verified by a sales invoice, and recorded in the Sales Journal, which summarises all credit fees in a reporting period.
- The balance of Accounts Payable/Accounts Receivable at the end of the reporting period can be calculated using a formula.
- GST is recognised and reported only at the time the purchase or sale is made, rather than when cash is paid to an Account Payable or received from an Account Receivable.

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Exercises

Please note: asterisks indicate that an answer for that question is available in the Selected Answers section at the end of this book.

Exercise 9.1
Source documents

page 135

The following document was provided by the manager of Stitch in Time, a repair shop in Malvern East:

Common Thread
ABN: 22 118 743 573
Chadstone

Invoice: 112

Charge to: Stitch in Time (ABN: 26 123 033 527)
Malvern Rd, Malvern East, 3145

Terms: 15 days
Tax invoice

Date	Details	Qty	Unit price	Total $
3 Aug 2030	Packet of five spools of thread	10	38	380
	GST (10%)			38
			Total	**$418**

Required

a. **Identify** the source document, and **describe** the transaction it verifies.
b. **Explain** what is meant by 'terms'.
c. **Record** this transaction in the appropriate journal of Stitch in Time.
d. **Explain** why the GST incurred on credit purchases does not affect the valuation of materials.
e. **State** the effect of this transaction on each element of the Accounting equation of Stitch in Time.

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Exercise 9.2
Purchases Journal

page 136

Sparky Electricians has provided the following list of transactions for July 2030 :

July	2	Credit purchase of materials from Volt Industries for $4 200 plus $420 GST (Inv. V53)
	7	Bought components on credit from Wattage Supplies for $2 750 including $250 GST (Inv. 346)
	16	Purchased parts from Ampage Ltd for $1 980 inclusive of GST (Inv. A52)
	23	Purchased wire from Wattage Supplies for $1 540 including $140 GST (Inv. 387)
	28	Received delivery of materials from Volt Industries, at a cost of $3 600 plus $360 GST (Inv. V65)

Required

a. **Explain** the role of the Purchases Journal.

* **b.** **Record** the transactions for July 2030 in the Purchases Journal of Sparky Electricians.

c. **Explain** why the source documents in the Purchases Journal do not run in sequence.

d. **Explain** the effect of GST on credit purchases on the GST payable to the ATO.

Exercise 9.3
Purchases Journal and Cash Payments Journal

page 137

Heel 'n' Toe purchases all its supplies on credit. As at 31 August 2030, its Account Payable records showed the following balances:

Sole Man	770
Lillies Laces	120
Leather Emporium	1 980
Total Accounts Payable	**$2 870**

During September 2030, the following transactions occurred:

Sept.	1	Paid Lillies Laces $120 (EFT 1065)
	3	Purchased leather on credit from Leather Emporium for $360 plus $36 GST (Inv. L56)
	7	Paid wages – $950 (WDWL online 9560)
	8	Purchased inventory from Sole Man for $825 including $75 GST (Inv. 201)
	11	Paid $2 200 (GST included) for new office equipment (EFT 1606)
	14	Owner withdrew $500 cash (ATM 653)
	16	Purchased supplies from Lillies Laces for $240 plus GST (Inv. LL314)
	19	Paid Sole Man $770 (EFT 0167)
	21	Paid wages – $950 (WDWL online 9875)
	24	Credit purchase of inventory from Sole Man for $400 plus $40 GST (Inv. 246)
	27	Cash drawings – $500 (ATM 741)
	30	Paid Leather Emporium $1 000 (EFT 1658)

Required

* **a.** **Record** the transactions for September 2030 in the journals of Heel 'n' Toe.

b. **Explain** the effect of the transaction on 30 September 2030 on the Balance Sheet of Heel 'n' Toe.

* **c.** **Calculate** the total owed to Accounts Payable as at 30 September 2030.

d. **Explain** why there is no GST to account for when cash is paid to an Account Payable.

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Exercise 9.4
Journals and Accounts Payable

page 139

Mow and Mulch repairs mowers and other gardening equipment. All materials are purchased on credit, and as at 1 April 2030, its Account Payable records showed the following balances:

Parts and Pieces	14 000
ReeObi	9 900
Victor Mowers	10 500
Total Accounts Payable	**$34 400**

During April 2030, the following transactions occurred:

April	2	Paid ReeObi $6 000 (EFT 215)
	5	Owner withdrew $800 cash (ATM 902)
	7	Purchased 10 mower blades from Victor Mowers for $180 (plus $18 GST) each (Inv. 385)
	8	Paid $1 200 wages (WDWL online 6095)
	10	Paid Victor Mowers $8 500 (EFT 216)
	12	Bought 10 replacement chains for chainsaws from ReeObi at $210 plus $21 GST each (Inv. R47)
	13	Paid electricity bill $310 plus $31 GST (BPAY 612)
	18	Purchased engine components from Victor Mowers for $6 985 including $635 GST (Inv. 413)
	19	Paid ReeObi $2 000 (EFT 217)
	21	Owner withdrew $600 cash (WDWL online 6679)
	22	Paid $1 200 wages (WDWL online 6438)
	23	Purchased mower parts from Parts and Pieces for $5 500 GST included (Inv. P2501)
	24	Paid Victor Mowers $3 500 (EFT 218)
	27	Paid $253 for water bill including $23 GST (BPAY 946)
	28	Bought chainsaw parts from ReeObi for $4 500 plus $450 GST (Inv. R65)
	29	Paid Parts and Pieces $12 000 (EFT 219)

Required

* **a.** **Record** the transactions for April 2030 in the journals of Mow and Mulch.
* **b.** **Calculate** the balance of Accounts Payable as at 30 April 2030.
c. Referring to one Qualitative characteristic, **explain** why Mow and Mulch should retain its source documents even after the transactions have been recorded in the journals.

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Exercise 9.5
Source documents

page 141

Good as New repairs leather lounge suites from a shop in Keilor East and has provided the following source document:

GOOD AS NEW
ABN: 21 888 276 832
PEGS St, Keilor East VIC 3033

Invoice: 112
Terms: Net 30 days
TAX INVOICE
5 October 2030

Charge to: Ouch Dental
Molar St, Essendon VIC 3040

Item	Description	Qty	Unit Cost	$
Repair	Chesterfield – 3 seater	3	1500	4500
	GST			450
	Total		**$**	**4950**

Required

a. **Identify** the source document above, and **describe** the transaction it verifies.
b. **State** the latest date by which the cash related to this transaction must be received.
c. **Explain** why this transaction is classified as revenue.
d. **Record** this transaction in the appropriate journal of Good as New.
e. **State** the effect of this transaction on each element of the Accounting equation of Good as New.

Exercise 9.6
Sales Journal

page 142

Cut and Groom provides gardening services and has provided the following list of its transactions for February 2030:

Feb	4	Maintained gardens for Plus Accounting for $270 plus $27 GST (Inv. 102)
	9	Maintained gardens for Shone Lawyers for $520 plus GST (Inv. 103)
	15	Maintained grounds for French Apartments for a total of $935 including $85 GST (Inv. 104)
	22	Rented plants to Shone Lawyers for $430 plus $43 GST each (Inv. 105)
	27	Rented plants to Plus Accounting for $330 inclusive of GST (Inv. 106)

Required

a. **State** the number that will be used on the next sales invoice issued by Cut and Groom.
* b. **Record** the transactions for February 2030 in the Sales Journal of Cut and Groom.
c. Referring to your answer to part **b**, **state** two reasons why the total of the Sales Journal is unlikely to be the balance owed by Accounts Receivable as at 28 February 2030.
d. **Explain** the effect of GST on credit fees on the GST payable to the ATO.

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Exercise 9.7

Sales Journal and Cash Receipts Journal

page 143

Unbreakable Gear hires plates, glass and cutlery for events and functions. As at 1 May 2030, its Accounts Receivable records showed the following balances:

Fab Events	3550
Party Dayz	4450
Total Accounts Receivable	**$8000**

During May 2030, the following transactions occurred:

May	1	Received $1850 cash from Fab Events (Rec. 56)
	3	Hired gear on credit to Fab Events for $1420 plus $142 GST (Inv. 271)
	4	Hire fees – $280 plus GST (Rec. 57)
	6	Received loan from Fincorp – $8000 to purchase new office equipment (BS)
	9	Provided party gear to Party Dayz on credit for $1595 inclusive of GST (Inv. 272)
	10	Fab Events paid $1800 cash (Rec. 58)
	13	Provided plates and glasses to Lando's Café for $900 plus $90 GST (Inv. 273)
	16	Hired glasses for social event to Wow ART for $792 including $72 GST (Inv. 274)
	18	Party Dayz settled previous month's account in full (Rec. 59)
	22	Received full balance owing from Lando's Café (Rec. 60)
	25	Hire fees of $120 plus $12 GST (Rec. 61)
	27	Hire of plates and cutlery to Party Dayz worth $3200 plus GST (Inv. 275)
	31	Received $500 cash from Wow ART (Rec. 62)

Credit terms are strictly 30 days.

Required

a. **Explain** why the transaction on 1 May 2030 is **not** classified as revenue.
b. **Explain** why there is no GST to account for as a result of the transaction on 10 May 2030.
* c. **Record** the transactions for May 2030 in the journals of Unbreakable Gear.
* d. **Calculate** the balance owed by Accounts Receivable as at 31 May 2030.
e. **Explain** whether all Accounts Receivable have met the credit terms during May 2030.

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Exercise 9.8
Credit transactions

page 145

Adeline Skywalker operates Musical Beat, which provides music tuition services and hires instruments. At 30 June 2030, the firm's records showed the following balances:

Accounts Receivable	
Sunshine Secondary College	2 800
Beaconsfield Primary	1 050
Blackburn Secondary College	1 430
Total Accounts Receivable	**$5 280**
Accounts Payable	
Strung Instruments	1 900
Buff and Shine	1 250
Total Accounts Payable	**$3 150**

The following transactions occurred during July 2030:

July
1 Paid monthly rent of $1 200 plus $120 GST (EFT 1205)
2 Hired instruments to Sunshine Secondary College for $3 400 plus GST (Inv. 109)
3 Received $500 cash from Beaconsfield Primary (Rec. 57)
4 Paid Buff and Shine $800 (EFT 2063)
5 Charged Blackburn Secondary College for tuition lessons for $1 683 including $153 GST (Inv. 110)
7 Received invoice for maintenance from Buff and Shine for $3 100 plus $310 GST (Inv. 16X)
8 Paid wages of $1 100 (WDWL online 3864)
9 Put instruments in for repair for $1 958 including GST from Strung Instruments (Inv. 403)
11 Owner withdrew $1 500 cash (ATM 6309)
12 Credit fees to Beaconsfield Primary for lessons of $400 plus $40 GST (Inv. 111)
14 Cash fees of $220 plus $22 GST (Rec. 58)
16 Paid Strung Instruments balance owing from June (EFT 2507)
17 Sunshine Secondary College paid cash to settle June account (Rec. 59)
20 Put instruments in for repair to Buff and Shine for $2 420 including $220 GST (Inv. B71)
22 Paid wages of $600 (WDWL online 3892)
23 Provided tuition to Sunshine Secondary College – total invoice price $1 100 including GST (Inv. 112)
24 Put instruments in for maintenance to Strung Instruments for $850 plus GST (Inv. 431)
25 Cash fees of $230 plus $23 GST (Rec. 60)
27 Paid advertising worth $490 plus $49 GST (BPAY 495)
28 Blackburn Secondary College paid full amount owing (Rec. 61)
29 Paid Buff and Shine $1 000 (EFT 7208)
30 Provided tuition to Beaconsfield Primary for $561 including $51 GST (Inv. 113)
31 Received $8 interest on bank account (BS)

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Required

* **a.** **Record** the transactions for July 2030 in the journals of Musical Beat.
* **b.** Using the appropriate formula, **calculate** the balances of Accounts Receivable and Accounts Payable as at 31 July 2030.
  c. Referring to your answers to part **b**, **explain** how Musical Beat could verify these balances.

Exercise 9.9
Statement of Account

The owner of No Drips Painting has received the following source document in the mail:

page 147

PAINT WORLD
ABN: 68 803 200 163
Penny Lane
St Kilda Victoria 3182

5 Nov 2030
Acc: 5003

STATEMENT OF ACCOUNT

Statement for: No Drips Painting (ABN: 82 623 093 267)
Flinders Lane
Melbourne 3000

Date	Particulars	Debit	Credit	Balance
October 1	Balance b/fwd			1 620
15	Inv. 1772	880		2 500
23	Thank you – payment		1 500	1 000
30	Inv. 1786	583		1 583

Required

a. **Explain** the function of a Statement of Account.
b. **Explain** how Paint World would be reported in the Balance Sheet of No Drips Painting as at 31 October 2030.
c. **Explain** how No Drips Painting would be reported in the Balance Sheet of Paint World as at 31 October 2030.

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Chapter 10
Reporting for a service business

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Learning intentions

After completing this chapter, you should be able to:

- **prepare** a Cash Flow Statement
- **identify** and **define** revenue and expenses
- **calculate** Cost of materials used
- **calculate** Net Profit or Loss
- **prepare** an Income Statement
- **report** a Net Profit or Loss in the Balance Sheet
- **distinguish** between cash and profit
- **explain** the uses of an Income Statement.

Key terms

After completing this chapter, you should be familiar with the following terms:

- revenue
- expense
- Income Statement
- vertical analysis of the Income Statement
- profitability
- Net Profit Margin (NPM).

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10.1 Calculating profit

The most basic function of any small business is to earn a profit for the owner, so from time to time the owner must calculate whether a *profit* or *loss* has been generated.

Basically, profit is the net increase in the owner's equity as a result of the firm's operations. It is calculated by measuring the firm's revenue (what it has earned from its customers for performing a service) and deducting from this its expenses (what it has cost the business to provide those services). Thus the calculation of profit is simple enough – profit is what is left over after expenses are deducted from revenue. That is:

Profit = Revenue – Expenses

Applying the *Accrual basis assumption* determines profit for an Accounting period by subtracting *expenses incurred* for a period from *revenue earned* in that same period. However, not all the cash the business receives is as a result of its trading activities, and therefore not all of it is revenue. The same applies to cash payments: not all cash payments are expenses. In fact, the definitions of revenue and expenses are quite specific.

Revenue

revenue
an increase in assets (or decrease in liabilities) that leads to an increase in owner's equity (except for a capital contribution)

Revenue is an increase in assets or decrease in liabilities that leads to an increase in owner's equity (except for a capital contribution). Revenue occurs from the ordinary activities of the business and includes items such as sales, fees, interest, dividends, royalties and rent. Under the *Accrual basis assumption*, revenue is recognised as earned in the period in which the expected inflow of economic benefits can be measured in a faithful and verifiable manner. In the case of a service-based business, revenue is said to be earned when the service has been provided.

Let's break this definition into its components as we did for the definitions of assets and liabilities. A revenue must be:

- **An increase in assets (or decrease in liabilities)**
  If a service is performed for cash, then the asset that increases will be Bank, but there could be other assets received from earning revenue, like Accounts Receivable when a service is performed on credit. If, when paying Accounts Payable, a business takes advantage of credit terms and can takes advantage of a discount (discount revenue), then the business has decreased its liabilities; that is, what it owes.
- **An increase in owner's equity (except for capital contributions)**
  Revenue must increase what the business owes to the owner, but it cannot be as a result of a capital contribution, as this is not a result of the firm's operations.

Revenue then represents the increase in owner's equity that occurs through business activities, and in most cases will be what the business has earned from the services that it has provided to its customers. The key here is that revenue must increase owner's equity, but not as a consequence of the owner making a contribution to the business.

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Expenses

An **expense** is a decrease in assets or increase in liabilities that leads to a decrease in owner's equity (except for Drawings). Expenses encompass losses such as loss on sale of disposal of a non-current asset or inventory loss as well as expenses that arise from the ordinary activities of the business such as cost of materials used, wages, depreciation and advertising.

expense
a decrease in assets (or increase in liabilities) that reduces owner's equity (except for drawings)

An expense refers to benefits that have been *consumed* (or used up) and are thus gone. For instance, there is no lasting benefit from paying wages – if the owner wants the employee to work again next week, another payment will be required. However, expenses need not involve a cash payment; any time the business consumes an economic benefit, an expense has been incurred.

Therefore, an expense must be:

- **A decrease in assets (or increase in liabilities)**
  If the expense is paid in cash, then the asset that decreases will be Bank, but an expense could also involve the consumption of materials or supplies. If an expense like Wages is incurred (used) but not paid, it will lead to an increase in liabilities as it will create a present obligation in the form of wages owing (accrued wages).
- **A decrease in owner's equity (except for Drawings)**
  Expenses decrease profit, and profit goes to the owner; therefore, expenses decrease owner's equity. However, expenses refer to what the *business has consumed* to earn revenue, not what the *owner has withdrawn* for personal purposes, so Drawings is excluded as an expense.

Study tip

Compare the definitions of 'revenue' and 'expenses'– opposites definitely apply here.

Expenses then represent decreases in owner's equity that occur through business activities or what a business has consumed to earn its revenue. The key here is that an expense must decrease owner's equity, but not as a consequence of the owner making a withdrawal from the business.

The reporting period and Relevance

The question of when to calculate profit depends on the needs of the owner. Remember, the *Going concern assumption* assumes that the life of the business is continuous or never-ending, so to follow this assumption alone means that profit could never be determined! As a result, the owner would not have information about the performance of their firm until it was too late to do anything about it. This is why the *Period assumption* is so important: it allows us to divide the life of the business into arbitrary periods in order to determine profit.

Note that the length of these reporting periods is subjective – it is up to owners to decide how often they want profit to be determined. Some owners will want profit calculated every month; others will be satisfied with seasonal or quarterly profit reports. In fact, the length of the reporting period can be as short or as long as the owner desires (although taxation requirements mean that the reporting period must be no longer than one year), and the length of the reporting period will determine how frequently profit is calculated.

Once the length of the reporting period is determined, it is important that the calculation of profit includes *only* revenue and expenses. This ensures *Relevance* in the reports by including only information that is useful for decision-making about profit. If we were to include items other than revenue and expenses (like drawings or loan repayments), our reports would contain information that would not be useful for decision-making, but would actually distort decision-making (and probably lead to negative consequences for the business and its owner).

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Review questions 10.1

1 **Define** the following terms:
- profit
- revenue
- expense
- cost of materials used.

2 **State** one reason why a capital contribution is excluded by the definition of revenue.
3 **State** one reason why drawings are excluded by the definition of an expense.
4 **Explain** how the Period assumption assists in the calculation of profit.
5 **Explain** how the Period assumption leads to Relevance in Accounting reports.

10.2 The Income Statement

Income Statement
an Accounting report that details the revenue earned and expenses incurred during the reporting period

The information about profit or loss must be reported to the owner in a formal Accounting report known as an **Income Statement**. For a business that deals in cash and credit transactions, the cash journals (or the Cash Flow Statement that reports the information summarised in the cash journals) and the credit journals (sales and purchases) contain all the information necessary to prepare an Income Statement.

Example

Nomi's Naturopathy has provided the following information relating to its trading activities for May 2030:

NOMI'S NATUROPATHY
Balance Sheet as at 30 April 2030

Assets	$	$	Equities	$	$
Current Assets			**Current Liabilities**		
Bank	4 000		GST Payable	400	
Accounts Receivable	2 200		Accounts Payable	1 100	
Inventory of materials	500	6 700	Mortgage	6 000	7 500
			Non-Current Liabilities		
Non-Current Assets			Mortgage		60 000
Equipment	12 000				
Premises	80 000	92 000	**Owner's equity**		
			Capital – Nomi		31 200
Total Assets		**98 700**	**Total Equities**		**98 700**

Sales Journal

Date	Accounts Receivable	Inv. No.	Fees	GST	Total Accounts Receivable
May	**TOTALS**	**$**	3 800	380	4 180

Purchases Journal

Date	Accounts Payable	Inv. No.	Materials	GST	Total Accounts Payable
May	**TOTALS**	**$**	1 500	150	1 650

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NOMI'S NATUROPATHY Cash Flow Statement for May 2030		
	$	$
CASH FLOWS FROM OPERATING ACTIVITIES		
Cash fees	6000	
Receipts from Accounts Receivable	3300	
GST received	600	
Interest on Bank Account	20	9920
GST paid	(440)	
Payments to Accounts Payable	(880)	
Wages	(1800)	
Electricity	(400)	
Interest on mortgage	(200)	
GST settlement	(400)	
Materials	(1400)	(5520)
Net Cash Flows from Operating Activities		**4400**
CASH FLOWS FROM INVESTING ACTIVITIES		
Office furniture		(3000)
Net Cash Flows from Investing activities		**(3000)**
CASH FLOWS FROM FINANCING ACTIVITIES		
Capital contribution	1000	
Loan – INS Finance	2000	3000
Drawings	(2000)	
Mortgage repayment	(500)	(2500)
Net Cash Flows from Financing activities		**500**
Net Increase (Decrease) in cash position		**1900**
Add Bank Balance at start (1 May 2030)		**4000**
Bank Balance at end (31 May 2030)		**5900**

Additional information:

- Inventory of materials was $300 as at 31 May 2030.
- The Loan – INS Finance is an interest-only loan payable 1 May 2032.

Video 10.1
Identifying revenues and expenses

Identifying revenue

The Sales Journal indicates revenue earned as the service has been performed and an invoice issued. It causes an increase in assets (Accounts Receivable) and results in an increase in owner's equity.

Some cash receipts are also revenue, as the cash received represents an inflow of economic benefits that has led to an increase in assets in the form of an increase in Bank:

- Cash fees is revenue received from providing a service.
- Interest on Bank Account is a by-product of the business operating a bank account. Both items meet the definition of revenue as inflows of economic benefits (cash received) in the form of an increase in assets (Bank), which increase owner's equity.

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However, even though they are all inflows of economic benefits, some cash receipts are not revenue:

- Receipts from Accounts Receivable is not revenue because it does not increase owner's equity; it increases assets (Bank), but also decreases assets (Accounts Receivable). The revenue was already recognised as credit fees at the point of sale.
- Capital contribution is expressly excluded by the definition of revenue, as it is not earned by the business, but rather simply contributed *by the owner*.
- Loan – INS Finance is not revenue because it does not increase owner's equity; it increases assets (Bank), but also increases liabilities (Loan – INS Finance).
- GST received is not revenue because it does not increase owner's equity; it increases assets (Bank), but also increases liabilities (GST payable).

With the exception of Capital contribution, these cash receipts that are not revenue affect an element of the Accounting equation *other than owner's equity*, and this effect must be reported separately on the Balance Sheet.

Identifying expenses

Some cash payments are expenses, as the cash paid represents an outflow of economic benefits in the form of a decrease in Bank:

- Wages are consumed in the process of providing naturopathy services.
- Electricity is consumed by using the business premises.
- Interest on mortgage is incurred as a result of using a mortgage to purchase the business premises.

Each of these items meets the definition of an expense as they are decreases in assets (Bank) and they result in a decrease in owner's equity.

However, even though they are all outflows of economic benefits, some cash payments are not expenses:

- Materials is the purchase of materials; however, it is not the amount of materials used during the reporting period. It is not an expense because it does not decrease owner's equity; it decreases assets (Bank), but also increases an asset (Inventory of materials). They offset each other (transfer of assets) with no overall effect. However, there is an expense related to Materials (see the following section on Materials).
- Payment to Accounts Payable is not an expense because it does not decrease owner's equity; it decreases assets (Bank), but also decreases a liability (Accounts Payable).
- Mortgage repayment is not an expense because it does not decrease owner's equity; it decreases assets (Bank), but also decreases a liability (Mortgage).
- GST settlement is not an expense because it does not decrease owner's equity; it decreases assets (Bank), but also decreases a liability (GST payable).
- Office equipment is not an expense because it does not decrease owner's equity, and it does not actually decrease assets either; it decreases a current asset (Bank) but increases a non-current asset (Office equipment). The office equipment is a *future* economic benefit rather than an *outflow* of an economic benefit.
- GST paid is not an expense because it does not decrease owner's equity; it decreases assets (Bank), but also decreases a liability (GST payable).
- Drawings is excluded by the definition of an expense, as it is not consumed by the business to earn revenue but is withdrawn by the owner for personal use.

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With the exception of Drawings, these cash payments that are not expenses affect an element of the Accounting equation *other than owner's equity*, and this effect must be reported separately on the Balance Sheet.

Materials

While service firms do not sell goods as the primary basis of their operation, they do require materials to carry out their service. For example, Nomi might keep on hand materials like herbal essences and massage oils to support her naturopathy services. (A mechanic might have some spare parts on hand and a hairdresser might have shampoos, conditioners and colours.)

Inventory of materials

When these materials were purchased, they would be recorded as a current asset (Inventory of materials) as they represent a present economic resource controlled by the business that has the potential to produce future economic benefits (by assisting the business to earn revenue), and they are reasonably expected to be consumed within 12 months.

Cost of materials used

When preparing the Income Statement, the business needs to calculate how much of its materials were actually consumed or 'used up' within the time period. Under the *Accrual basis assumption*, this amount incurred will be reported as an expense to support the correct matching of revenue earned and expenses incurred.

Figure 10.1 shows how Cost of materials used for Nomi's Naturopathy would be calculated for May 2030:

Figure 10.1 Calculating Cost of materials used

Inventory of materials at start	500	From the *previous* Balance Sheet (as at 30 April 2030)
+ Credit purchases	1 500	From the Purchases Journal
+ Cash purchases	1 400	From the Cash Flow Statement
Cost of materials available for use	**3 400**	
Inventory of materials at end	300	From physical count (as at 31 May 2030)
Cost of materials used (E)	**$3 100**	**Reported as an expense in the Income Statement**

Of the **$3 400** worth of materials available for use, $300 remains on hand as at 31 May 2030, meaning $3 100 worth of materials has been consumed, so this amount is reported as the expense incurred: Cost of materials used. (The $300 still on hand will be reported in the Balance Sheet as at 31 May 2030 as a current asset: Inventory of materials.)

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The Income Statement for Nomi's Naturopathy for May 2030 is shown in Figure 10.2:

Figure 10.2 Income Statement

NOMI'S NATUROPATHY
Income Statement for May 2030

	$	$
Revenue		
Cash fees	6000	
Credit fees	3800	
Interest on Bank Account	20	9820
Less Expenses		
Cost of materials used	3100	
Wages	1800	
Electricity	400	
Interest on mortgage	200	5500
Net Profit		**4320**

Study tip

Note that the 'bottom line' is profit – the final result – hence the saying!

Like all Accounting reports, the title of the Income Statement states *who* the report is prepared for (Nomi's Naturopathy), *what* type of report it is (Income Statement), and *when* – the period to which it applies (May 2030). Like the Cash Flow Statement, the Income Statement reports transactions that have occurred not just on the one day, but over a period of time, so the report specifies for May 2030.

This report tells the owner that as a result of operating the naturopathy business, there was an increase in the owner's equity caused by a Net Profit of **$4320**, which itself was the result of earning $9820 in revenue and consuming $5500 worth of expenses in the process.

Review questions 10.2

1 **Explain** why the following items are excluded from an Income Statement:
- capital contribution
- receipts from Accounts Receivable
- purchase of a non-current asset
- loan repayment
- drawings
- materials (purchased)
- payments to Accounts Payable.

2 **Explain** why an Income Statement is titled for a particular period rather than as at a particular date.

3 **Identify** which item appeared in the Income Statement but not the Cash Flow Statement. **Explain** why.

4 **Show** the formula to calculate Cost of materials used.

5 Referring to the *Accrual basis assumption*, **explain** why Materials on hand at the end of the time period is **not** reported as an expense.

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10.3 Cash versus profit

The fact that not all cash receipts are revenue, and not all cash payments are expenses, and vice versa, means that it is possible for a business to earn a profit (with an associated increase in owner's equity) and yet suffer a cash deficit (leading to a decrease in Bank). The opposite can also be true, with a firm that incurs a loss (leading to a decrease in owner's equity) capable of generating a net increase in cash position (leading to an increase in Bank). This can be a confusing concept, but we must remember that a net increase in cash position (or net decrease) and profit (or loss) do not measure the same thing.

- A *net increase (or net decrease) in cash position* measures the difference between cash inflows and cash outflows.
- A *Net Profit (or Loss)* measures the difference between revenue and expenses.

Earning a Net Profit but suffering a net decrease in cash position

Many business owners assume that earning a profit means that the business will have more cash on hand. However, this is not always the case. It is possible for a business to earn a Net Profit but still suffer a net decrease in cash position due to:

- cash drawings
- a loan repayment
- a cash purchase of a non-current asset
- a GST settlement.

These items will have no effect on Net Profit as they are not expenses. However, each is a cash payment, and as a consequence will decrease Bank. Therefore, a business that earns a Net Profit could still find itself with less cash in the bank at the end of the period.

Study tip

The reason(s) for a difference between cash and profit will depend on the business itself; examine the firm's reports to identify which of these reasons applies.

Generating a net increase in cash position despite incurring a Net Loss

It is also possible for a business to incur a loss, and yet still see its bank balance increase, if it receives:

- a loan
- a capital contribution from the owner
- a GST refund.

These items will have no effect on Net Profit as they are not revenue. However, all are cash receipts and will increase Bank.

Materials purchased versus Cost of materials used

The purchase of materials and the calculation of Cost of materials used will have different impacts on the Income Statement and Cash Flow Statement. If, for example, Materials purchased and Payments to Accounts Payable were *greater* than Cost of materials used for a particular reporting period, this could support the business earning a Net Profit but lead to a decrease in Operating flows and a net decrease in cash position. Conversely, if Cost of materials used was *greater* than Materials purchased and Payments to Accounts Payable or if there was a Cost of materials used expense and no materials were purchased or no Payments to Accounts Payable during that reporting period, this would support why the business has more cash than profit.

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Credit fees versus Receipts from Accounts Receivable

Credit fees greater than Receipts from Accounts Receivable for a particular reporting period could support why the business has more profit than cash. Alternatively, if Receipts from Accounts Receivable is more than Credit fees for a particular reporting period, then this could explain why the business has more cash than profit.

GST

Aside from a GST settlement or GST refund, the GST a business receives from its customers and pays to its suppliers will also affect its cash position, but not its profit.

- *If GST received from customers is greater than GST paid to suppliers*, Bank will increase, and this may be one of the reasons why the business has more cash than profit.
- *If GST paid to suppliers is greater than GST received from customers*, Bank will decrease, and this may be one of the reasons why the business has less cash than profit.

Review questions 10.3

1 Citing four examples, **explain** how a business can earn a Net Profit and yet suffer a net decrease in cash position.
2 Citing three examples, **explain** how a business can incur a Net Loss and yet generate a net increase in cash position.
3 **Explain** how materials purchased and Cost of materials used can lead to:
   - more cash than profit
   - less cash than profit.
4 **Explain** how Credit fees and Receipts from Accounts Receivable can lead to:
   - more cash than profit
   - less cash than profit.
5 **Explain** how GST received from customers and paid to suppliers can lead to:
   - more cash than profit
   - less cash than profit.

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10.4 Reporting a Net Profit or Loss in the Balance Sheet

As was noted earlier, the profit or loss the business earns affects owner's equity: a Net Profit represents a net increase in owner's equity, whereas a Net Loss represents a net decrease in owner's equity, both as a result of business operations. This must then be reported in the owner's equity section of the Balance Sheet. In fact, the Balance Sheet must show the initial Capital balance, as well as any Capital contribution, Net Profit or Loss and Drawings to show how the capital at end was determined.

The Balance Sheet for Nomi's Naturopathy as at 31 May 2030 is shown in Figure 10.3:

Figure 10.3 Reporting Net Profit in the Balance Sheet

NOMI'S NATUROPATHY
Balance Sheet as at 31 May 2030

Assets	$	$	Equities	$	$
Current Assets			**Current Liabilities**		
Bank[1]	5900		GST payable[6]	390	
Accounts Receivable[2]	3080		Accounts Payable[7]	1870	
Inventory of materials[3]	300	9280	Loan – INS Finance[8]	2000	
			Mortgage[9]	6000	10260
Non-Current Assets			**Non-Current Liabilities**		
Office furniture[4]	3000		Mortgage[9]		59500
Equipment[5]	12000		**Owner's equity**		
Premises[5]	80000	95000	Capital – Nomi[10]	32200	
			Plus Net Profit[11]	4320	
			Less Drawings[12]	2000	34520
Total Assets		**104280**	**Total Equities**		**104280**

Notes to the Balance Sheet

1 Bank $5900
This is the closing bank balance from the Cash Flow Statement for May 2030.

2 Accounts Receivable
This is calculated by:

Accounts Receivable at start	$2200
Plus Credit fees including GST	$4180
	$6380
Less Receipts from Accounts Receivable	$3300
Equals Accounts Receivable at end	$3080

3 Inventory of materials $300
This is the balance of Inventory of materials at the end of the reporting period, which is determined by a physical count.

4 Office furniture $3000
This was reported as an Investing cash outflow in the Cash Flow Statement for May 2030.

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5 Other assets
There were no transactions affecting Equipment or Premises, so these items remain unchanged.

6 GST payable

Opening	GST payable	$400
Less	GST settlement	$400
Plus	GST on fees	$980 (600 + 380)
Less	GST to suppliers	$590 (440 + 150)
	GST payable	$390

7 Accounts Payable
This is calculated by:

Accounts Payable at start	$1 100
Plus Credit purchases of materials plus GST	$1 650
	$2 750
Less Payments to Accounts Payable	$ 880
Equals Accounts Payable at end	$1 870

8 Loan – INS Finance $2 000
This was reported as a Financing cash inflow in the Cash Flow Statement for May 2030.

9 Mortgage $6 000/$59 500
There was $500 reported as a Financing cash outflow in the Cash Flow Statement for May 2030. Note that the $500 payment was taken from the non-current part of the mortgage; the current section must always show how much is due in the 12 months from the date of the statement (12 months × $500 per month = $6 000).

10 Capital $32 200
This is the Capital of $31 200 from the previous Balance Sheet (as at 30 April 2030), plus the $1 000 Capital contribution reported as a Financing cash inflow in the Cash Flow Statement for May 2030.

11 Plus Net Profit $4 320
This is the Net Profit determined in the Income Statement for May 2030.

12 Less Drawings $2 000
This was reported as a Financing cash outflow in the Cash Flow Statement for May 2030.

Study tip

Using the Accounting equation will calculate owner's equity at the end, but the Balance Sheet must show how that figure was calculated by reporting Net Profit (Loss) and Drawings.

Reporting a Net Loss

Assume that the business had a downturn in the next month and reported a Net Loss for the month of June. The owner's equity section of the Balance Sheet would thus appear as is shown in Figure 10.4:

Figure 10.4 Reporting a Net Loss in the Balance Sheet

NOMI'S NATUROPATHY
Balance Sheet extract as at 30 June 2030

Owner's equity		
Capital – Nomi	34 520	
Less Net Loss	600	
	33 920	
Less Drawings	1 800	32 120

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Review questions 10.4

1 **Explain** the relationship between the Cash Flow Statement, Income Statement and the Balance Sheet.
2 **State** the effect on owner's equity of:
- Net Profit
- Net Loss
- drawings
- capital contributions.

10.5 Uses of the Income Statement

An Income Statement must be prepared in order to provide information for the business owner. By highlighting the revenue and expense items and identifying whether the business achieved a Net Profit or Loss, the report is useful as a decision-making tool.

The specific benefits of preparing an Income Statement are to:

1 *aid decision-making about the firm's operations* by measuring the firm's performance. Detailing revenue and expenses (and ultimately profit) allows the owner to identify where changes may be necessary.
2 *assess whether the business is meeting its revenue and expense targets* by comparing the Income Statement against budgeted (or expected) performance.
3 *assist in planning for future service activities* by providing a basis for the next budgeted Income Statement, which will set targets for the future. This may include setting targets to achieve a certain level of fees, staffing requirements or advertising expenditure.
4 *assess the performance of management* in operating the business, primarily relating to generating sales and controlling expenses.

With the information provided by the Income Statement, the owner can now make informed decisions on how to improve profit and profitability.

To increase profit a business needs to increase revenue, decrease expenses or a combination of both.

Strategies to increase revenue

To generate more revenue, the owner may:

- **Decrease prices**
  Decreasing prices can make the business's service appear more competitive, leading to a higher volume of sales.
- **Employ effective marketing**
  Advertising could be engaged more effectively by ensuring it targets the prospective customer base specifically desired. The best method of conveying a business's service needs to be determined; for example, print, radio, internet (including social media) or a mix that will provide the most reach. Marketing material must accurately represent the qualities of the service offered to maintain a business's ethics and reputation.
- **Improve their service**
  Improving the service already offered with additional services as part of the standard package and being more customer-friendly can improve customer satisfaction and word of mouth.

Ethical considerations

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Strategies to decrease expenses

In order to control expenses, a business might:

- **Change supplier**
  Finding an alternative supplier who can provide cheaper materials could result in a reduction in Cost of materials used. Also looking at different providers of electricity, mobile and internet services can expose cost savings via different plans.
- **Buy in bulk**
  Purchasing in large quantities can allow a business to achieve a reduced cost price per unit of materials thus decreasing cost of materials used. Also, it could potentially cut delivery costs if a business reduced the number of purchases and deliveries per month by making one large purchase rather than many small ones.

Ethical considerations

However, despite wanting to take advantage of cost savings, ethical considerations must still be given appropriate attention. A business owner may for ethical reasons decide to choose electricity generated through 'green power', a more expensive option, because it is more socially and environmentally responsible.

Financial information is only one aspect; non-financial information is also vital to see the whole picture. For example, the following can all have an influence on what decisions are made:

- the number of competitors in the area
- the number of customer complaints
- the amount of repeat business
- the number of calls received per hour
- the predicted weather for the next month (especially if you provide an outdoor service).

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Review questions 10.5

1 **Explain** how an Income Statement can be used by a business to assess its performance.
2 **Explain** how an Income Statement can be used by a business to plan for future activities.
3 **List** three strategies that might be used to generate more revenue.
4 **List** two strategies that might be used to improve expense control.
5 **Explain** the importance of non-financial information in decision-making to improve profit.
6 **Explain** why ethical considerations must be considered by business owners when choosing strategies to improve profitability.

Ethical considerations

10.6 Graphical representations

The information presented in the Income Statement can be of greater use if its *Understandability* is improved by presenting the information in graphical form. A type of graph that can be utilised is a pie chart.

Pie charts

By inputting the Income Statement from Figure 10.2 into a spreadsheet, we can create a **vertical analysis of the Income Statement's** data, where we express each item in the Income Statement as a percentage of a total to view its importance. Using the Total Revenue figure as our base would indicate the relative importance of each revenue stream to Total Revenue. This is also the case for Expenses, as it indicates how much revenue is absorbed by each expense area. Thus showing what percentage of revenue makes it through to Net Profit.

vertical analysis of the Income Statement
a representation of individual expenses as a percentage of revenue to allow for an assessment of their relative importance

Example

Pie chart: Spreadsheet

	A	B	C	Formula in cell
1	**Item**	**$**	**%**	
2	Cash fees	6000	61.1	=B2/$B$5
3	Credit fees	3800	38.6	=B3/$B$5
4	Interest on Bank Account	20	0.2	=B5/$B$5
5	**Total Revenue**	9820	100.0	=B5/$B$5
6	**Less Expenses**			
7	Cost of materials used	3100	31.6	=B7/$B$5
8	Wages	1800	18.3	=B8/$B$5
9	Electricity	400	4.1	=B9/$B$5
10	Interest on mortgage	200	2.0	=B10/$B$5
11	**Net Profit**	**4320**	44	=B11/$B$5

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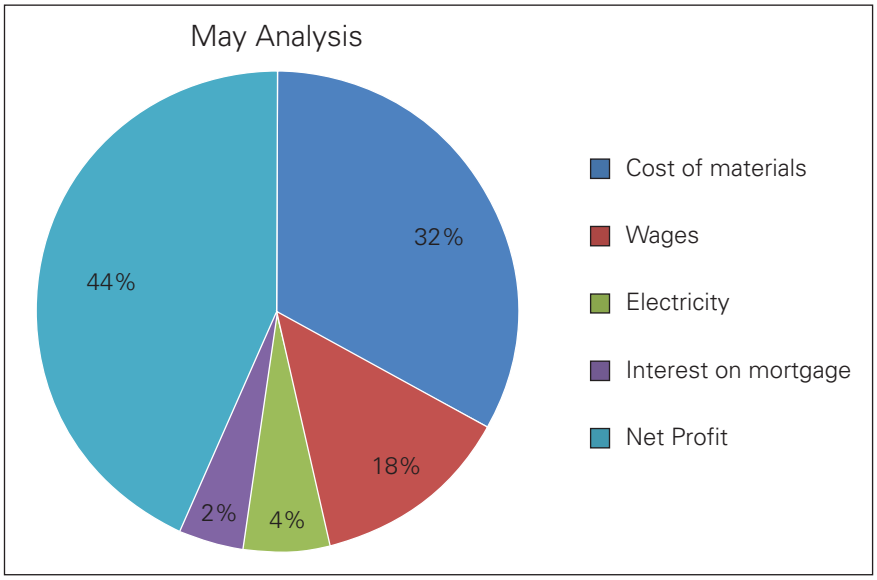
The formulas shown in the additional column use a *relative cell* reference (meaning it changes from B2 to B3 etc.) for each item but an *absolute cell* reference (meaning it always refers to the figure in cell B5) for the Total Revenue. Absolute cells are designated by the use of a '$' prior to the row and/or column, which will not change. In this way, every percentage shown in column C is calculated by dividing the item by the Total Revenue of $9820.

Figure 10.5 shows how a pie chart can be used to represent the relative size of each Expense and Net Profit in relation to Total Revenue:

Figure 10.5 Pie chart



From this graph it is clear that Wages and Cost of materials are the biggest expenses, consuming nearly 50% of Total Revenue and therefore each deserving of the most attention. Efforts to improve smaller expenses, like Electricity and Interest on mortgage, may improve profit, but by only a small amount.

profitability
the ability of a business to earn profit as expressed in relative terms by comparing profit against a base like sales, assets or owner's equity

Net Profit Margin (NPM)
a profitability indicator that assesses expense control by calculating the percentage of Sales revenue that is retained as Net Profit

It is a common saying that to make money you need to spend money. Although expenses are a necessary part of doing business, every dollar of Sales revenue that is consumed by Expenses means one dollar less as profit for the owner. Effective expense control is a fundamental characteristic of a profitable small business and should be part of any assessment of **profitability**. We are able to assess the effectiveness of a firm's expense control if we measure the percentage of revenue that is retained as Net Profit. The calculations used to create the pie chart in Figure 10.5 used vertical analysis to show how much revenue each expense consumed and what percentage remained as Net Profit. This remaining percentage is a useful indicator of profitability known as the **Net Profit Margin (NPM)**.

Whether the Net Profit Margin of 34% would be seen as satisfactory or not would depend on a comparison against **previous periods, budgeted performance** and **competitors' performance** (industry averages).

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Line graphs

When an owner or manager wishes to view data longitudinally, looking at changes in a particular item over time, line graphs can be a useful way of presenting information.

Example

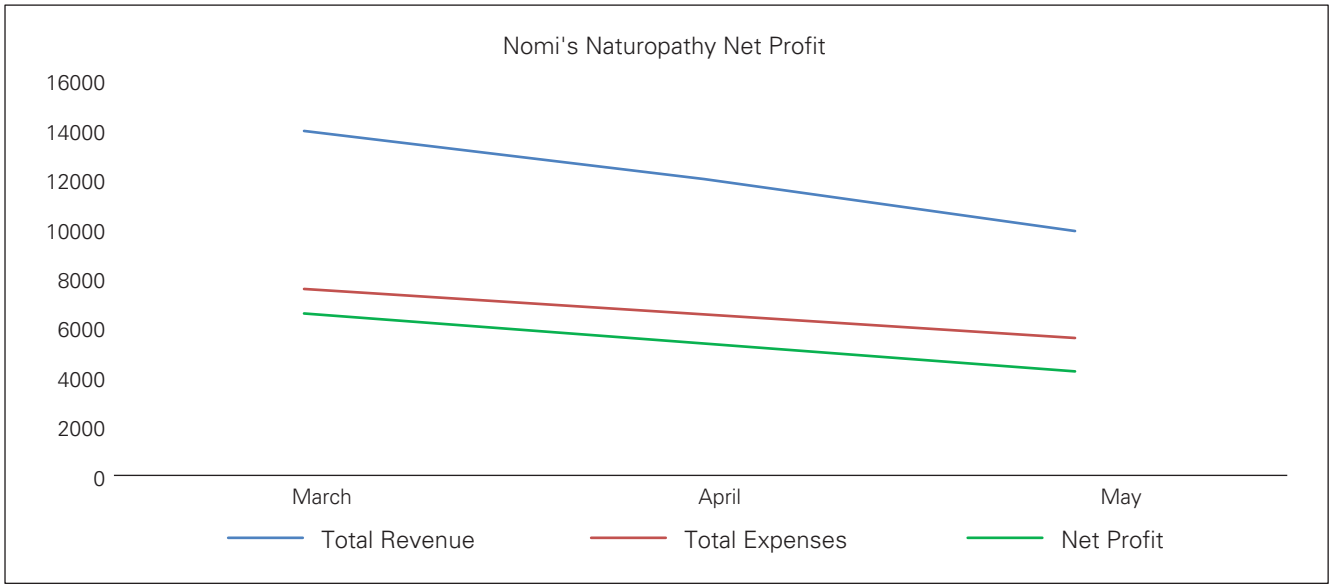
Nomi's Naturopathy has presented the following data relating to its activities for the past three months:

	March	April	May
Total Revenue	13950	12040	9820
Total Expenses	7425	6600	5500
Net Profit	6525	5440	4320

Trends and relationships can be seen and established as benchmarks (points of comparison) to determine whether a trend is positive or negative.

Figure 10.6 uses a line graph to represent the information for Nomi's Naturopathy:

Figure 10.6 Line graph



The graph provides a visual representation of the decrease in Total Revenue over the past three months; despite the decline in Total Expenses as well, it was not sufficient to maintain the profit margin achieved in March, so Net Profit fell in April.

Notwithstanding a larger percentage fall in Total Expenses from April to May than the proportional decline in Total Revenue, it was still insufficient enough to halt the decline in Net Profit again.

The trend is quite easy to see, and Nomi should investigate. Further trend analysis of the same period last year or trends over an extended period, such as a year or two, may highlight that this may be a regular event (seasonal factor) and that the current trend will reverse. However, if further investigation indicates that this is out of character, then Nomi should be considerably worried and determine why this is occurring quickly, for example it may be due to a new competitor in the area.

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To create the graph in Figure 10.6, the data had to be rearranged in the spreadsheet as shown in Figure 10.7:

Figure 10.7 Line graph: Spreadsheet

	A	B	C	D
1		Total Revenue	Total Expenses	Net Profit
2	**March**	13950	7425	6525
3	**April**	12040	6600	5440
4	**May**	9820	5500	4320

Review questions 10.6

1. Referring to one Qualitative characteristic, **explain** the purpose of using graphical representations to communicate Accounting information.
2. **Explain** the purpose of preparing a pie chart.
3. **Explain** the difference between Net Profit and profitability.
4. **State** the formula to calculate the Net Profit Margin.
5. **Explain** what the Net Profit Margin shows.
6. **State** three benchmarks that can be used to assess the Net Profit Margin.
7. **Explain** the purpose of preparing a line graph.

Where have we been?

- Revenue are increases in assets (or decreases in liabilities) that increase owner's equity (except for capital contributions by the owner).
- Expenses are decreases in assets (or increases in liabilities) that decrease owner's equity (except for drawings by the owner).
- Net Profit or Loss is calculated by comparing revenue earned less expenses incurred in a reporting period.
- GST is not included as a revenue or expense item as it is collected/paid on the government's behalf and will result in either a GST asset or GST liability.
- Cash is not the same as profit because not all receipts are revenue and not all payments are expenses.
- Cost of materials used must be calculated to determine the expense incurred in the current period.
- The Income Statement is useful as a tool for planning and decision-making.
- Graphical representations of the Income Statement improve *Understandability*.
- Net Profit Margin is a profitability indicator that highlights a firm's ability to control its expenses.

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Exercises

Please note: asterisks indicate that an answer for that question is available in the Selected Answers section at the end of this book.

Exercise 10.1

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For each of the following transactions, **state** the effect on the:

- Cash Flow Statement
- Income Statement
- Balance Sheet.

a. Paid wages
b. Cash fees
c. Cash drawings
d. Cash purchase of equipment
e. Receipt of a loan
f. Paid rent
g. Capital contribution
h. Credit purchase of materials.

Exercise 10.2

Income Statement

page 151

Christi's Car Clean Emporium has provided the following cash flows for January 2030:

	$
Cash receipts	
Cash fees	7430
Receipts from Accounts Receivable	1000
GST received	743
Capital contribution	10000
Cash payments	
Wages	2250
Cleaning supplies	3000
Drawings	700
GST paid	1430
Equipment	9000
Advertising	300
Rent	2000
Loan repayment	5000

Additional information:

- Credit fees were $1800 plus GST.
- Bank balance at 1 January 2030 was $6500.
- Inventory of cleaning supplies as at 1 January 2030 was $450.
- Inventory of cleaning supplies as at 31 January 2030 was $600.
- Owner's equity as at 1 January 2030 was $23000.

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Required

* **a.** **Prepare** a Cash Flow Statement for Christi's Car Clean Emporium for January 2030.
* **b.** **Calculate** the cost of cleaning supplies used for January 2030.
* **c.** **Prepare** an Income Statement for Christi's Car Clean Emporium for January 2030.
  d. Referring to your answer to part **c**, **explain** your treatment of:
  - capital contribution
  - cost of cleaning supplies used.
  e. **Explain** three reasons why Christi's Car Clean Emporium suffered a net decrease in cash position in January 2030 despite earning a profit.
* **f.** **Show** the owner's equity section of the Balance Sheet of Christi's Car Clean Emporium as at 31 January 2030.
  g. **Calculate** the Net Profit Margin for Christi's Car Clean Emporium.

Exercise 10.3
Income Statement

page 154

Batman and Bowler is a specialist cricket coaching clinic, and as at 1 October 2030, the Balance Sheet showed Bank of $500 and Owner's equity of $39400. The owner has provided the firm's Cash Flows for October 2030:

	$
Cash receipts	
Cash fees	4000
Receipts from Accounts Receivable	2000
GST received	400
Interest on investments	150
GST refund	2300
Loan – ANZ	2000
Cash payments	
Wages	4200
Drawings	1000
GST paid	345
Electricity	400
Insurance	250
Rent	2000
Accounting fees	800
Interest on loan	100

Additional information:

- Credit fees were $3300 inclusive of GST.

Required

* **a.** **Prepare** a Cash Flow Statement for Batman and Bowler for October 2030.
* **b.** **Prepare** an Income Statement for Batman and Bowler for October 2030.
  c. Referring to your answer to part **a**, **explain** your treatment of:
  - interest on investments
  - drawings.
  d. **Explain** two reasons why Batman and Bowler suffered a loss despite generating a net increase in cash position for October 2030.

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e. **Show** the breakdown of Expenses and Net Profit in a pie graph.
* f. **Show** the owner's equity section of the Balance Sheet of Batman and Bowler as at 31 October 2030.

Exercise 10.4
Income Statement and Balance Sheet

page 157

Jackson Pollock is the owner/operator of Blue Pools, a swimming pool maintenance service. Jackson employs two pool cleaners and is personally responsible for customer management and bookkeeping. On 28 February 2030, the unclassified Balance Sheet of Blue Pools showed the following:

Assets	$	Equities	$
Bank	14 500	Accounts Payable	1 100
Accounts Receivable	4 400	Loan – Wizard	24 000
Inventory of cleaning materials	1 500	GST payable	360
Tools and equipment	25 500	Capital – J. Pollock	35 440
Van	15 000		
Total Assets	**60 900**	**Total Equities**	**60 900**

The cash flows for Blue Pools for March 2030 showed the following information:

	$
Cash receipts	
Cash fees	8 520
Receipts from Accounts Receivable	5 280
GST received	852
Capital contribution	1 000
Small business prize	500
Cash payments	
Payments from Accounts Payable	660
Wages	9 500
Drawings	3 000
GST paid	575
Interest on loan	250
Loan repayment	500
Cleaning materials	1 600
Van expenses	150
GST settlement	360
Tools and equipment	4 000

Additional information:

- Credit purchases of materials was $440 inclusive of GST.
- Inventory of cleaning materials was $300 as at 31 March 2030.
- The small business prize was awarded by Stonnington Council in recognition of Blue Pool's outstanding customer satisfaction rating.
- The Loan – Wizard is repayable in monthly instalments of $500.
- Credit fees of $5 500 plus GST were earned for the month.

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Required

* **a.** **Prepare** a Cash Flow Statement for Blue Pools for March 2030.
* **b.** **Prepare** an Income Statement for Blue Pools for March 2030.
c. Referring to your answer to part **b**, **explain** your treatment of the small business prize.
d. **Suggest** two actions Jackson could take to reduce cash payments without directly affecting Net Profit for April 2030.
* **e.** **Prepare** an appropriately classified Balance Sheet for Blue Pools as at 31 March 2030.
f. **Provide** two recommendations to Jackson for improving his revenue earnings.

Exercise 10.5
Accounting reports

page 161

On 1 January 2030 Bella Bancroft left her job as a computer technician, keen to start her own clothing alterations and mending service called Sew Well. On 31 May 2030, the unclassified Balance Sheet of Sew Well showed the following information:

Assets	$	Equities	$
Bank	5500	Accounts Payable	2500
Accounts Receivable	7000	Loan – Aussie	30000
Inventory of materials	2000	GST payable	1000
Tools and equipment	76000	Capital – Bancroft	84000
Van	27000		
Total Assets	**117 500**	**Total Equities**	**117500**

The cash journals for Sew Well for June 2030 showed the following:

Cash Receipts Journal (extract)

Date	Details	Source Document	Bank	Cash fees	Accounts Receivable	Sundries	GST
June	Capital contribution		4000			4000	
	TOTALS	**$**	**21590**	**13900**	**2300**	**4000**	**1390**

Cash Payments Journal (extract)

Date	Details	Source Document	Bank	Wages	Materials	Accounts Payable	Drawings	Sundries	GST
June	Van expenses							800	
	Loan repayment							400	
	GST settlement							1000	
	Sewing machines							4500	
	Interest on loan							150	
	TOTALS	**$**	**27220**	**10200**	**3400**	**3100**	**2800**	**6850**	**870**

Sales Journal (extract)

Date	Accounts Receivable	Inv. No.	Fees	GST	Accounts Receivable
	Total	**$**	4500	450	4950

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Purchases Journal (extract)

Date	Accounts Payable	Inv. No.	Inventory of materials	GST	Accounts Payable
	Total	**$**	1 900	190	2 090

Additional information:

- Inventory of materials as at 30 June 2030 was $3 000.
- The Loan – Aussie is repayable at $4 800 p.a.

Required

* **a.** **Prepare** a Cash Flow Statement for Sew Well for June 2030.
* **b.** **Calculate** the cost of materials used for Sew Well for June 2030.
* **c.** **Prepare** an Income Statement for Sew Well for June 2030.
d. **Explain** two reasons why Sew Well was able to earn a profit despite suffering a net decrease in cash position for June 2030.
* **e.** **Prepare** an appropriately classified Balance Sheet for Sew Well as at 30 June 2030.
f. **Explain** why the Balance Sheet is titled 'as at', yet the Income Statement is titled 'for' the period.

Exercise 10.6
Accounting reports

page 165

Mark Lindsberg runs a dry cleaning business in Frankston called Clean as a Whistle. Most customers are small businesses whose employees wear uniforms, but as an expert in the field, Mark is also consulted by clothing firms who seek his advice regarding the care instructions for new garments. Garments are picked up and delivered using a company van. On 31 August 2030, the assets and equities of Clean as a Whistle were as follows:

Assets	$	Equities	$
Bank	2 500	Loan – ANZ	42 000
Computer	3 200	Capital – Lindsberg	40 000
Office furniture	7 600	GST payable	2 700
Cleaning equipment	59 000		
Delivery van	12 400		
Total Assets	**84 700**	**Total Equities**	**84 700**

Lindsberg's capital as at 1 August 2030 was $35 300. In August 2030 he withdrew $1 200 in cash for his own use.

Required

a. **Calculate** the Net Profit or Loss of Clean as a Whistle for August 2030.

The cash journals of Clean as a Whistle for September 2030 showed the following:

Cash Receipts Journal (extract)

Date	Details	Source Document	Bank	Cleaning fees	Consultancy fees	Sundries	GST
Sept. 2030	Loan – ANZ	312				4 000	
	TOTALS	**$**	**17 950**	**9 500**	**3 500**	**4 000**	**950**

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Cash Payments Journal (extract)

Date	Details	Source Document	Bank	Supplies	Drawings	Wages	Sundries	GST
Sept. 2030	Electricity						600	
	Interest on loan						150	
	Cleaning equipment						800	
	Rent						1 500	
	Advertising						1 000	
	TOTALS	**$**	**16 590**	**6 500**	**1 400**	**3 600**	**4 050**	**1 040**

Additional information:

- The Loan – ANZ was extended in September 2030 in readiness for the purchase of a new computer in mid-October 2030 and is repaid in quarterly instalments of $2 100.
- All supplies were consumed during the reporting period.

* **b.** **Prepare** a Cash Flow Statement for Clean as a Whistle for September 2030.
* **c.** **Prepare** an Income Statement for Clean as a Whistle for September 2030.
d. **Explain** a reason why Clean as a Whistle suffered a Net Loss despite generating a net increase in cash position for September 2030.
* **e.** **Prepare** an appropriately classified Balance Sheet for Clean as a Whistle as at 30 September 2030.
f. **State** two ethical considerations Mark needs to keep in mind in regards to his line of work.

Ethical considerations

Exercise 10.7
Income Statement and Balance Sheet

W B page 169

Alex Chilton runs a painting business in Sydenham called Big Star Decorating. Most of her work is done for cash for individuals who are renovating their homes, but she also does some credit jobs for small businesses. Paint is purchased only as necessary for each job, so Alex never keeps any paint on hand. On 1 January 2030, the assets and equities of Big Star Decorating were as follows:

Assets	$	Equities	$
Bank	1 000	Loan – nab	16 000
Computer	5 500	GST payable	2 000
Office furniture	8 600	Capital – Chilton	36 000
Painting equipment	26 500		
Van	12 400		
Total Assets	**54 000**	**Total Equities**	**54 000**

Additional information:

- The loan principal is repaid in equal instalments of $1 000 per quarter.
- During December 2029, Big Star Decorating earned a profit of $5 400, and Alex withdrew $3 500.

Required

a. **Calculate** Alex's capital as at 1 December 2029.
b. **Calculate** the Working Capital Ratio of Big Star Decorating as at 1 January 2030.
c. Referring to the Working Capital Ratio, **comment** on the liquidity of Big Star Decorating as at 1 January 2030.

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The cash flows for Big Star Decorating for January 2030 showed the following:

	$
Cash receipts	
Cash fees	8000
GST received	800
Cash payments	
Wages	500
Paint	4000
Drawings	3000
GST paid	490
Insurance	200
Loan principal	1000
Interest on loan	100
GST settlement	2000
Van expenses	700

Alex is concerned that because the business has suffered a net decrease in cash position, it must not be making a profit.

* **d.** **Prepare** a Cash Flow Statement for Big Star Decorating for January 2030.
* **e.** **Prepare** an Income Statement for Big Star Decorating for January 2030.
f. **Explain** two reasons, apart from drawings, why Big Star Decorating was able to earn a profit despite suffering a net decrease in cash position for January 2030.
* **g.** **Prepare** an appropriately classified Balance Sheet for Big Star Decorating as at 31 January 2030.

Alex discovers that her employee is disposing of unused paint down the drains of clients' homes. The employee stated it was cheaper to dispose of this way.

Ethical considerations

h. **Advise** Alex on a course of action to follow. **Justify** your response.

Exercise 10.8
Income Statement and Balance Sheet

W B page 173

At the start of 2030, Michael Owen left his job as a courier with Speedy Deliveries to start up his own courier business called Faster than the Rest. Michael had been earning $45000 p.a. but was eager to take up the challenge of owning and operating his own small business. As at 30 June 2030, the unclassified Balance Sheet of Faster than the Rest showed the following:

Assets	$	Equities	$
Accounts Receivable	6000	Bank	500
Inventory of fuel	800	Accounts Payable	1000
GST receivable	1000	Loan – nab	24000
Office equipment	11500	Capital – Owen	29000
Courier vans	35200		
Total Assets	**54500**	**Total Equities**	**54500**

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Additional information:

- The Loan – nab was taken out on a fixed term at the start of January 2030. The principal is repaid on the first of every month in equal instalments of $500.
- At 1 June 2030, Michael's equity in Faster than the Rest amounted to $31 000. During June 2030, the firm earned a profit of $1500.

Required

a. **Calculate** the date at which the loan will be repaid in full.
b. **Calculate** Michael's Return on Owner's Investment (ROI) for June 2030.
c. **Calculate** Michael's drawings for June 2030.
d. **Suggest** one reason why Michael should decrease his drawings and one reason why Michael should **not** decrease his drawings.

The Cash Flow Statement for Faster Than the Rest for July 2030 showed the following:

FASTER THAN THE REST
Cash Flow Statement for July 2030

	$	$
CASH FLOWS FROM OPERATING ACTIVITIES		
Cash fees	12 000	
GST received	1200	
Receipts from Accounts Receivable	5400	
GST refund	1 000	19600
Payments to Accounts Payable	(900)	
GST paid	(590)	
Wages – driver	(6700)	
Van expenses	(4000)	
Insurance	(1200)	
Interest on loan	(300)	(13690)
Net Cash Flows from Operating Activities		**5910**
CASH FLOWS FROM INVESTING ACTIVITIES		
Office equipment		(700)
Net Cash Flows from Investing activities		**(700)**
CASH FLOWS FROM FINANCING ACTIVITIES		
Capital contribution	4000	4000
Drawings	(1900)	
Loan principal	(500)	(2400)
Net Cash Flows from Financing activities		**1600**
Net increase (decrease) in cash position		**6810**
Add Bank Balance at start (1 July 2030)		**(500)**
Bank Balance at end (31 July 2030)		**6310**

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Sales Journal

Date	Accounts Receivable	Invoice No.	Fees	GST	Accounts Receivable
	Total		1 500	150	1 650

Purchases Journal

Date	Accounts Payable	Invoice No.	Inventory of Fuel	GST	Accounts Payable
	Total	**$**	1 300	130	1 430

Additional Information:

- Inventory of fuel as at 31 July was $500.
- Michael is confident that because the bank balance has increased, the firm must be trading profitably.

* **e.** **Prepare** an Income Statement for Faster Than the Rest for July 2030.

f. Referring to your answer for part **e**, **explain** your treatment of office equipment.

g. **Explain** two reasons why Faster Than the Rest was able to generate a net increase in cash position despite incurring a loss.

* **h.** **Prepare** an appropriately classified Balance Sheet for Faster Than the Rest as at 31 July 2030.

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Unit 2

Accounting and decision-making for a trading business

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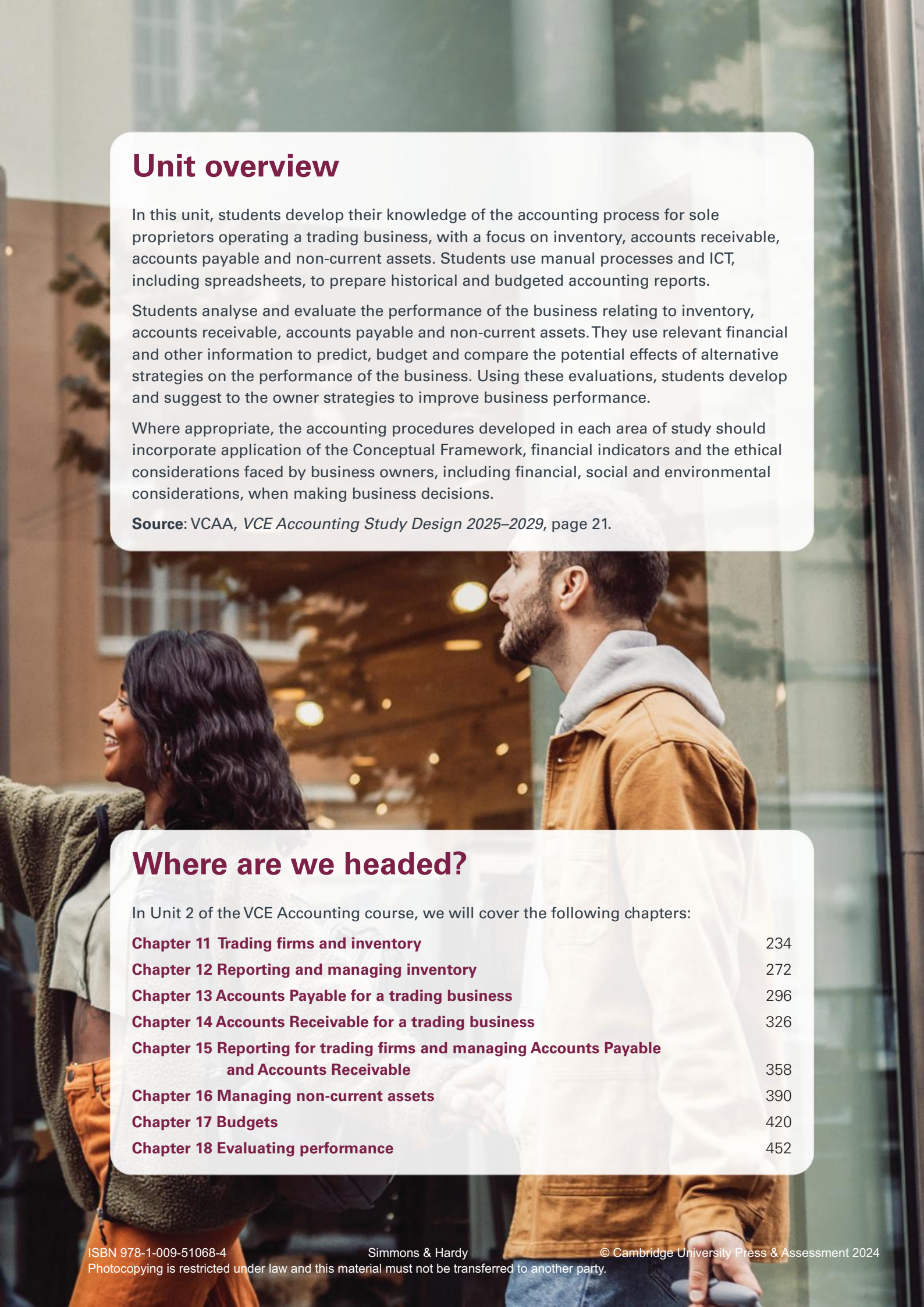

Unit overview

In this unit, students develop their knowledge of the accounting process for sole proprietors operating a trading business, with a focus on inventory, accounts receivable, accounts payable and non-current assets. Students use manual processes and ICT, including spreadsheets, to prepare historical and budgeted accounting reports.

Students analyse and evaluate the performance of the business relating to inventory, accounts receivable, accounts payable and non-current assets. They use relevant financial and other information to predict, budget and compare the potential effects of alternative strategies on the performance of the business. Using these evaluations, students develop and suggest to the owner strategies to improve business performance.

Where appropriate, the accounting procedures developed in each area of study should incorporate application of the Conceptual Framework, financial indicators and the ethical considerations faced by business owners, including financial, social and environmental considerations, when making business decisions.

Source: VCAA, *VCE Accounting Study Design 2025–2029*, page 21.

Where are we headed?

In Unit 2 of the VCE Accounting course, we will cover the following chapters:

Chapter 11 Trading firms and inventory 234
Chapter 12 Reporting and managing inventory 272
Chapter 13 Accounts Payable for a trading business 296
Chapter 14 Accounts Receivable for a trading business 326
Chapter 15 Reporting for trading firms and managing Accounts Payable and Accounts Receivable 358
Chapter 16 Managing non-current assets 390
Chapter 17 Budgets 420
Chapter 18 Evaluating performance 452

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Chapter 11
Trading firms and inventory

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Learning intentions

After completing this chapter, you should be able to:

- **explain** the operations of a trading business
- **explain** the importance of inventory to a trading business
- **define** and **classify** inventory
- **explain** the perpetual inventory system
- **record** transactions in inventory cards using the First In, First Out method of inventory recording as well as the Identified Cost method
- **explain** the role of a physical count
- **identify** and **record** inventory losses and gains.

Key terms

After completing this chapter, you should be familiar with the following terms:

- trading firms
- inventory
- Gross Profit
- perpetual inventory system
- inventory card
- sales – cash and credit
- purchases – cash and credit
- Cost of Sales
- Identified Cost
- First In, First Out (FIFO)
- physical count
- inventory loss
- inventory gain.

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11.1 Trading firms and inventory

trading firm
a business that aims to generate profit by purchasing goods and then selling them at a higher price

inventory
goods purchased by a trading firm for the purpose of resale at a profit

Trading firms purchase goods from suppliers/wholesalers and then sell them to customers at a higher price, with the difference between the cost price and the selling price earning them profit. These goods that are sold are, from the trading business's point of view, referred to as **inventory**.

The importance of inventory

Inventory is crucial to the success of a trading business for two main reasons:

1. Sale of inventory is the main source of revenue for a trading firm, and thus the key to its ability to earn profit.
2. Inventory is likely to be one of the most significant assets in the Balance Sheet of a trading business.

In light of its importance, it is imperative that the owner has useful information relating to inventory. But when we refer to inventory, what do we mean? Inventory is the generic term applied to the goods held by a trading firm for the purposes of resale. Items such as office furniture, shelving and vehicles are **not** inventory for most businesses, as they are intended for use rather than sale. (Although the business may ultimately sell these items, it is not their intended purpose when they are purchased.) The term 'inventory' therefore is only used to describe goods that are purchased expressly for the purpose of resale.

Study tip

Inventory can also be called stock, product or merchandise, but this course uses the term 'inventory'.

As it is intended for sale – hopefully within the next 12 months – inventory is classified as a *current asset* in the Balance Sheet. That is, it is a present economic resource controlled by the business that has the potential to provide a future economic benefit (when it is sold) within the next 12 months. This definition also distinguishes inventory from other goods – such as office furniture, shelving and vehicles – as these items would normally be kept for more than 12 months, and so are classified as *non-current assets*.

The intention of the business at the time of purchase also means that what is inventory for one business may well be a non-current asset for another. For example, a clothing shop would not classify a delivery van as inventory, but rather as a non-current asset. However, in a car yard, delivery vans could very well be considered inventory and therefore classified as a current asset. The clothing shop intends to use the van for more than 12 months, whereas the car yard intends to sell the van within 12 months.

Such an important asset as inventory needs to be protected, and as previously raised in Chapter 8, there is a variety of strategies that a business can employ to ensure its inventory is safe from theft, fraud and damage. The business can ensure that the following strategies set in place:

- **Physical safeguards**
  These are to prevent unauthorised people from accessing inventory through barriers such as locked display cases or locked storerooms. If people cannot touch the inventory, they have less chance of misusing or misappropriating it.
- **Preventative safeguards**
  These involve dissuading misuse or theft of assets through the threat of apprehension. Systems such as electronic tags and alarms, plain-clothed security guards and security cameras (open, hidden and even dummy) work on the premise that people are less likely to attempt theft if they are concerned they will be caught. Tags on clothing that if not removed by the correct method will tear and ruin the item are another form of deterrent.

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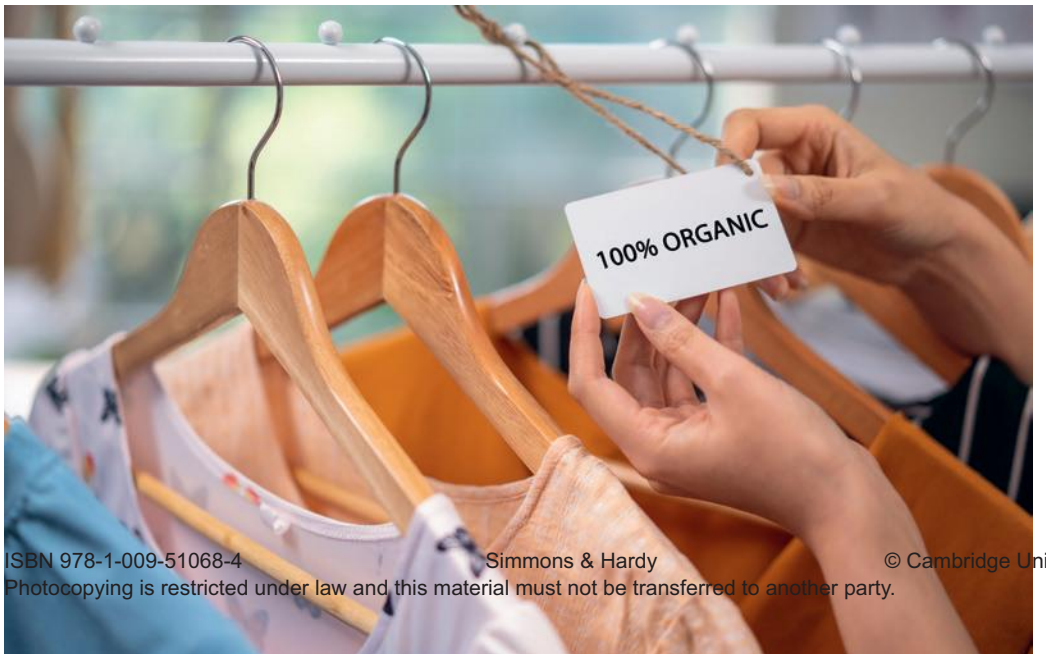
- **Separation of duties**
  This involves ensuring that no one employee (except the owner) has complete control over inventory, so their actions are open to scrutiny by another employee. The more people involved in the process, the less chance there is of collusion occurring. For example, the person ordering the inventory should be different to the one receiving and recording delivery, so that the person ordering is unable to divert arriving goods for their own purposes.
- **Careful hiring practices**
  These involve effective screening and assessment of potential employees to ensure that only the most trustworthy and responsible candidates are employed. This should reduce the need to rely on other inventory control mechanisms.
- **Effective tracking**
  This involves maintaining a proper paper trail to ensure accurate records are kept so that all inventory can be accounted for.
- **Spot checks**
  These are like mini physical counts that occur at random to identify any concerns early and ensure staff are aware that this is occurring to dissuade potential dishonest employees.
- **Effective employee training**
  This involves ensuring that staff are skilled in the use and management of inventory, reducing the likelihood that it is damaged through misuse.

Ethical considerations regarding inventory

Business owners need to consider ethical considerations when deciding what inventory to sell. For example, in regards to products sold, businesses can ensure that they purchase:

Ethical considerations

- from local suppliers and support the local community or economy
- products that are of a particular quality and do what has been advertised
- products that are sourced from suppliers that provide safe working conditions and fair wages; for example, not sweat shops or those engaging child labour
- products that meet minimum required safety standards, including performance, composition, components, packaging, flammability and labelling. Mandatory standards exist to ensure information and safety features exist for consumers.



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For businesses that deal with food or perishable items, proper handling and storage needs to take place. Other issues could include:

- is it actually organic?
- has it been sustainably sourced; for example, tuna fishing?
- has it been genetically modified?
- was it grown in Australia?

Business owners should also honour all warranties offered in regards to the inventory item, so that the consumer can feel safe that any defects will be repaired or the product replaced or compensation received in the form of a refund.

Business owners should engage a proper method of recording and valuing inventory to ensure that:

- profit or loss figures and associated tax payable are accurate
- misleading financial information is not provided to decision-makers.

Finally, business owners should ensure that pricing of inventory is fair and reasonable and does not extort customers in relation to high-demand products in short supply.

The decisions the business owner takes in regards to the types of inventory they sell will have non-financial and financial ramifications. Non-financial consequences are the leading indicators. For example, if a business made the decision to sell products that were sourced cheaply in order to maximise profits, but these products proved to be of low quality and unreliable, an increasing number of customers may make complaints and return those products. This would then cause a decline in customer satisfaction, an increase in negative feedback (most likely via social media) and a swift reduction in demand for those products. These impacts would adversely affect the reputation of the business, which would have to work very hard to undo the damage, if it can. All of the above is unable to be shown in a financial report; however, it will eventually appear as a major deterioration in the Income Statement, in the form of a decline in sales and profits. However, if the business owner makes the right choice to sell quality products, the reverse may occur.

Ethical considerations

Review questions 11.1

1. **Explain** the operations of a trading firm.
2. **State** two reasons why inventory is important to a trading firm.
3. **Define** the term 'inventory'.
4. **Explain** how inventory is classified in the Balance Sheet.
5. **State** three methods of protecting inventory and **explain** how each of the methods work.
6. **State** and **explain** three ethical considerations a business owner needs to contemplate in regards to inventory.
7. **Explain** how inventory choice can have non-financial and financial implications.

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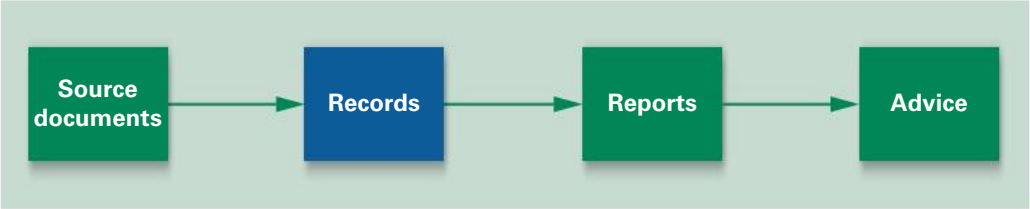
11.2 Accounting for inventory



Because of the need to account for inventory, the Accounting system we have used so far must be developed so that it can be used for trading businesses. At the recording stage, this will be done by introducing the **perpetual inventory system**. This system of Accounting for inventory involves the continuous recording of all inventory movements in subsidiary Accounting records called **inventory cards**, with a separate inventory card maintained for each individual line of inventory.

After all the inventory transactions have been recorded in inventory cards, the business will then conduct a physical count to verify that the inventory cards are accurate, and in the process detect any inventory losses or gains.

In the reporting stage, the need to account for inventory will necessitate a change to the way the Income Statement is presented so that it shows both **Gross Profit** and Net Profit. (This will be explained in detail in Chapter 12.)

perpetual inventory system
system of Accounting for inventory that involves the continuous recording of inventory movements in inventory cards

inventory card
a subsidiary Accounting record that records each individual transaction involving the movement in and out of the business of a particular line of inventory

Gross Profit
the profit earned purely from the purchase and sale of inventory, measured by deducting Cost of Sales from Sales revenue

sales
the revenue earned by a trading firm from the sale of inventory

purchases
the inventory bought by a trading firm for the purposes of resale

Purchases and sales

The fact that trading firms sell inventory rather than provide a service also means a small change in Accounting terminology. Service businesses refer to their revenue as 'fees' or 'takings', but a trading business will refer to its main source of revenue as **sales**. After all, this is what a trading business does – it makes sales. The other change in Accounting terminology concerns the term **purchases**, which for a trading firm refers exclusively to purchases of **inventory**.

Cash and credit purchases

As we have already noted, inventory is classified as a current asset because it represents a potential future economic benefit controlled by the business and is expected to be sold within 12 months. This means that when a business makes a cash purchase of inventory, it is actually swapping one current asset (Bank) for another (Inventory). The GST paid to the supplier is not part of the valuation of inventory because the benefit will not be realised when the inventory is sold, but when the GST payable (or receivable) is settled.

Example

Jessie's T-shirts purchased inventory from Boonds for $2 000 plus $200 GST (EFT 4312).

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Effect on the Accounting Equation

The overall effect of the cash purchase on the Accounting equation for Jessie's T-shirts would be:

	Increase/Decrease/No effect	Amount $
Assets	Decrease (increase Inventory $2 000, decrease **Bank $2 200**)	**200**
Liabilities	Decrease (GST payable $200)	200
Owner's equity	No effect	

Conversely, when a business purchases inventory *on credit*, it will increase assets in the form of Inventory and increase liabilities in the form of Accounts Payable. The GST owing to the supplier is not part of the valuation of Inventory and will decrease the amount of GST payable.

Example

Jessie's T-shirts received the following invoice:

Boonds
Shaw Road, Collingwood
VIC, 3066
ABN: 32 624 098 001

Date: 15/07/2030
Tax invoice
Invoice: B45
Terms: Net 15 days

Customer: Jessie's T-shirts
Mussel Crescent,
Sth Melb., Vic, 3205

Item	Quantity	Price	Total
White V neck – small	50	$10.00	500
White V neck – medium	50	$10.00	500
White V neck – large	50	$10.00	500
White V neck – X large	50	$10.00	500
		Sub Total	**$2 000**
		GST	**$200**
		TOTAL	**$2 200**

Effect on the Accounting Equation

The overall effect of the credit purchase on the Accounting equation for Jessie's T-shirts would be:

	Increase/Decrease/No effect	Amount $
Assets	Increase (Inventory $2 000)	2 000
Liabilities	Increase (increase **Accounts Payable $2 200**, decrease GST Payable $200)	2 000
Owner's equity	No effect	

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Cash and credit sales

When inventory is sold, the business will receive cash for the sale, and this sales figure will be recorded as revenue, because it is an inflow of economic benefits (cash) in the form of an increase in assets (Bank), thus increasing owner's equity. This amount will be recorded at selling price.

However, at the same time cash is flowing into the business, inventory is also flowing out; this means that the inventory is no longer an asset, because it is gone! In fact, the provision of inventory to the customer creates an expense called **Cost of Sales** – an outflow of an economic benefit (the inventory that has been sold) in the form of a decrease in assets (Inventory), thus decreasing owner's equity. This amount will be recorded at cost price; that is, the original price paid for the inventory by the business.

Cost of Sales
the expense incurred when inventory flows out of the business due to a sale

Thus a sale of inventory leads to an increase in Bank (due to the cash – and GST – received from the customer), Sales revenue increases and GST payable increases. At the same time, Inventory decreases and Cost of Sales increases by the value of inventory sold.

The difference between the Sales revenue earned (recorded at selling price) and the Cost of Sales incurred (recorded at cost price) will be the Gross Profit earned on the sale.

Example (continued)

Jessie's T-shirts sold 40 T-shirts for $700 plus $70 GST (Rec. 55). The 40 T-shirts had a cost price of $500.

As a consequence of this sale, Jessie's T-shirts would receive **$770** in cash; $700 from Sales revenue and $70 GST it collects on behalf of the ATO. At the same time, Inventory on hand would decrease by $500, creating an expense called Cost of Sales of $500.

Effect on the Accounting equation

The overall effect of the cash sale on the Accounting equation for Jessie's T-shirts would be:

	Increase/Decrease/No effect	Amount $
Assets	Increase (increase **Bank $770**, decrease Inventory $500)	**270**
Liabilities	Increase (GST payable)	70
Owner's equity	Increase (Sales $700 less Cost of Sales $500 **= Profit**)	**200**

By comparison, a credit sale of inventory leads to an increase in assets in the form of Accounts Receivable, Sales revenue increases and GST payable increases. At the same time, Inventory decreases and Cost of Sales increases by the value of inventory sold. The business will receive the cash that it is owed at a later date.

Study tip

At the time of a sale, an asset (Inventory) becomes an expense (Cost of Sales).

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Example (continued)

Jessie's T-shirts sent the following invoice:

Jessie's T-shirts
Mussel Crescent, Sth Melb.,
VIC, 3205
ABN: 43 908 600 259

Date: 18/07/2030

Tax invoice
Invoice: 167
Terms: Net 30 days

Customer: Caulfield Boarding
15 Abode St
Caulfield, VIC 3162

Item	Quantity	Price	Total
White V-neck (10 of S, M, L and XL)	40	$17.50	700
		GST	70
		TOTAL	$770

Jessie's T-shirts sold 40 T-shirts for $700 plus $70 GST. Note only the sales price is shown on the invoice – we will need to determine the cost price of the T-shirts sold by looking at the relevant inventory card (this will be demonstrated in the next section); however, for our purposes the T-shirts had a total cost price of $500.

As a consequence of this sale, Jessie's T-shirts would be owed **$770** by Caulfield Boarding: $700 from Sales revenue and $70 GST it will collect on behalf of the ATO. At the same time, Inventory on hand would decrease by $500, creating an expense called Cost of Sales of $500.

Effect on the Accounting equation

The overall effect of the credit sale on the Accounting equation for Jessie's T-shirts would be:

	Increase/Decrease/No effect	Amount $
Assets	Increase (increase **Accounts Receivable $770**, decrease Inventory $500)	270
Liabilities	Increase (GST payable)	70
Owner's equity	Increase (Sales $700 less Cost of Sales $500 **= Profit**)	200

As you can see, the overall impact on the Accounting equation is the same for a cash or credit sale, the only difference is the type of current asset that is affected in the Balance Sheet.

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Review questions 11.2

1 Referring to the perpetual inventory system, **explain** the role of:
- an inventory card
- a physical count.

2 **Define** the term 'purchases' as it applies to trading firms.

3 **Explain** how the sale of inventory decreases an asset but increases an expense.

4 **State** the effect on each element of the Accounting equation of a:
- cash purchase of inventory
- credit purchase of inventory
- cash sale of inventory
- credit sale of inventory.

11.3 Returns of inventory: purchase returns and sales returns

Purchase return

Purchase returns occur when inventory is returned by the business to its supplier. This can occur for a variety of reasons such as it was the incorrect item(s), wrong colour or model or the item was damaged in transit.

Example (continued)

Jessie's T-shirts received the following document:

Boonds
Shaw Road, Collingwood
VIC, 3066
ABN: 32 624 098 001

Tax invoice
Credit Note: B94
Date: 30/7/2030

Customer: Jessie's T-shirts
Mussel Crescent,
Sth Melb., Vic, 3205

Code	Description	Quantity	Price	Total
BTBk306XL	Faulty Goods (loose stitching)	2	$5.50	$11.00
			GST	$1.10
			TOTAL	$12.10

Effect on the Accounting equation

Jessie's T-shirts has returned two T-shirts to its supplier, Boonds, due to them being faulty. Note the value of the inventory used in a purchase return is its cost price. The supplier (Boonds) accepting the return would indicate the cost of the inventory they are providing credit for and would issue the original version of the credit note to the customer (Jessie's T-shirts), while retaining a copy for its own records.

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The overall effect of the purchase return on the Accounting equation for Jessie's T-shirts would be:

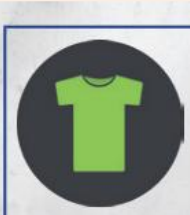
	Increase/Decrease/No effect	Amount $
Assets	Decrease (Inventory $11)	11
Liabilities	Decrease (decrease **Accounts Payable $12.10**, increase GST payable $1.10)	11
Owner's equity	No effect	

Sales return

Sales returns occur when inventory is returned to the business by the customer and again is verified via a credit note. The business will supply the original to the customer (Caulfield Boarding) and retain a copy for the business records (Jessie's T-shirts).

Example (continued)

The following credit note was issued by Jessie's T-shirts:



Jessie's T-shirts
Mussel Crescent, Sth Melb.,
VIC, 3205
ABN: 43 908 600 259

Tax invoice
Date: 18/07/2030
Credit Note: J601

Customer: Caulfield Boarding
15 Abode St
Caulfield, VIC 3162

Description	Quantity	Unit Price	Total
Wrong colour given for small T-shirts	10	$17.50	$175
		GST	$17.50
		TOTAL Credit	$192.50

*The cost price of the inventory returned was $5.50 (excl. GST) per T-shirt.

Caulfield Boarding returned 10 T-shirts to Jessie's T-shirts because they were the wrong colour. Note that a credit note for a sales return uses the selling price of the inventory as the unit price because Jessie's T-shirts needs to decrease Caulfield Boarding's account by the amount they initially charged them. Jessie's T-Shirts would need to look at its inventory records to determine the cost price of the inventory involved (which will be shown later in the chapter).

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Effect on the Accounting equation

The overall effect of the sales return on the Accounting equation for Jessie's T-shirts would be:

	Increase/Decrease/No effect	Amount $
Assets	Decrease (increase Inventory $55, decrease **Accounts Receivable $192.50**)	**137.50**
Liabilities	Decrease (GST payable $17.50)	17.50
Owner's equity	Decrease (increase Sales returns $175, decrease Cost of Sales $55)	120.00

Review questions 11.3

1 **State** the source document that recognises the return of goods.
2 **State** three reasons why there may be a need to return goods.
3 **Explain** who would have the original source document and who would have the copy for a:
   - purchase return
   - sales return.
4 **State** which value of inventory is used in a credit note to verify a:
   - purchase return of inventory
   - sales return of inventory.

   Justify your response.
5 **State** the effect on each element of the Accounting equation of a:
   - purchase return of inventory
   - sales return of inventory.

11.4 Other inventory transactions

Drawings of inventory

Drawings of inventory is the owner taking inventory home for personal use and must be recorded as such to support the *Accounting entity* assumption.

Example (continued)

Jessie's T-shirts produced this memo to account for the T-shirt withdrawn for personal use:

Jessie's T-shirts

MEMO: 1
Date: 26/8/2030

From: Jessie

To: Accounting Department
Withdrew one T-shirt (cost $5.50) for personal use

Signature: J. Shortsleave

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Effect on the Accounting equation

The overall effect of Drawings of inventory on the Accounting equation for Jessie's T-shirts would be:

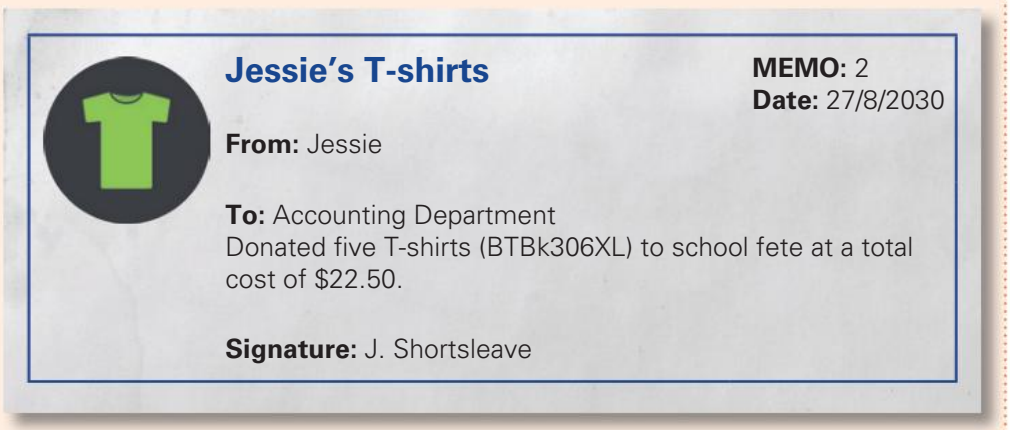
	Increase/Decrease/No effect	Amount $
Assets	Decrease (Inventory)	5.50
Liabilities	No effect	
Owner's equity	Decrease (increase Drawings)	5.50

Advertising using inventory

Advertising occurs when a business gives inventory to another entity to support such events as a school fete or a charity. This could be seen as a donation; however, businesses do this to get their name out in the community, for example, 'proudly supported or donated by Hardy and Co.', so it is a form of marketing and therefore will be recorded as Advertising (not Cost of Sales).

Example (continued)

Jessie's T-shirts produced this memo to account for the T-shirts withdrawn as advertising:



Jessie's T-shirts

MEMO: 2
Date: 27/8/2030

From: Jessie

To: Accounting Department
Donated five T-shirts (BTBk306XL) to school fete at a total cost of $22.50.

Signature: J. Shortsleave

Effect on the Accounting equation

The overall effect of advertising using inventory on the Accounting equation for Jessie's T-shirts would be:

	Increase/Decrease/No effect	Amount $
Assets	Decrease (Inventory)	22.50
Liabilities	No effect	
Owner's equity	Decrease (increase Advertising expense, decrease Profit)	22.50

Review questions 11.4

1 **State** the purpose of a memo.
2 **State** the effect on each element of the Accounting equation of:
- drawings of inventory
- donating inventory for advertising purposes.

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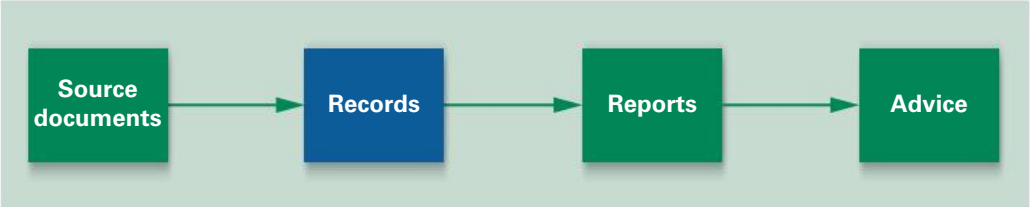
11.5 Inventory cards



Under the perpetual inventory system, all movements of inventory in and out of the business are recorded in inventory cards. Because trading firms will carry a number of different lines of inventory (different items, different colours, different sizes), the Accounting system must include a separate inventory card for each particular line of inventory. (This could potentially mean a huge number of inventory cards.) Many years ago, before computers were available, these inventory cards would have been actual cards filled in manually; as you can imagine that would be a lot of work! However, financial software that has an inventory control system that incorporates barcodes means that once inventory is scanned for either a purchase or sale, the inventory cards are automatically updated. All inventory information is only a click away.

A typical inventory card looks like the one presented in Figure 11.1:

Study tip

A line of inventory does not mean a single item, but rather a specific type, colour or size, for which there may be a number of items on hand.

Figure 11.1 Inventory card

Inventory Card

Inventory item: Black T-shirt, XL
Location: Row 16, Bay C3
Inventory code: BTBk306XL
Supplier: Boonds
Inventory method: FIFO

Date	Source Document	IN			OUT			BALANCE		
		Qty	Cost	Total	Qty	Cost	Total	Qty	Cost	Total

Top portion: details of item

The top portion of the inventory card shows non-financial details relating to the inventory itself, including a description of the item (which in this case is a 'Black T-shirt: extra large'). Its code – BTBk306XL – is also identified for easy reference within the firm, as is the method used to record the cost of inventory moving in and out of the business; in this case it is the First In, First Out (FIFO) method. The location can also be very important, particularly for inventory stored in a large warehouse with many different storage bays. Lastly, the name of the supplier is identified to assist reordering.

Note: a firm that sells T-shirts would have a variety of T-shirts in different sizes and colours, so each different size and colour will need its own inventory card. Therefore, there will be a different inventory card for each size of each colour.

Bottom portion: transactions

The bottom portion of the inventory card is used to record the actual transactions. It is divided into four main sections: Date and Details, IN, OUT and BALANCE.

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Date and Details

The first section is used to record standard information relating to the date and details of each inventory transaction. In this case, 'Details' refers to the source document that verifies each transaction.

IN, OUT and BALANCE columns

These columns record exactly what they state:

- IN column records all inventory coming into the business. This will mainly be due to purchases but could also be due to a sales return or an inventory gain (which is discussed later in this chapter).
- OUT column records all inventory leaving the business. This could be through sales, drawings, purchase returns, an inventory loss or perhaps advertising.
- BALANCE column shows the inventory on hand available for sale (totalled at cost price).

A summary table is provided in Figure 11.2:

Figure 11.2 Summary of transactions that cause a movement of inventory in a business

Inventory IN	Inventory OUT
Cash credit purchases	Cash credit sales
Sales returns	Purchase returns
Inventory gains	Drawings
Capital contribution	Advertising
	Inventory loss

Note that whereas the journals and reports show transactions in dollar terms only, inventory cards also show the quantity or number of items of inventory and their cost – the cost price of each individual inventory item. The Total of each transaction is calculated by multiplying the Quantity by the Cost.

Total = Quantity × Cost

Review questions 11.5

1 **Identify** four details that will be provided in the top portion of an inventory card but not in the inventory figure reported in the Balance Sheet.
2 **Identify** two details that are provided when transactions are recorded in the inventory card but are not provided in the journals or reports.
3 **State** the transactions that could be recorded in the 'IN' column of an inventory card.
4 **State** the transactions that could be recorded in the 'OUT' column of an inventory card.
5 **State** how many inventory cards a typical trading firm would require. (Beware: this is a trick question!)

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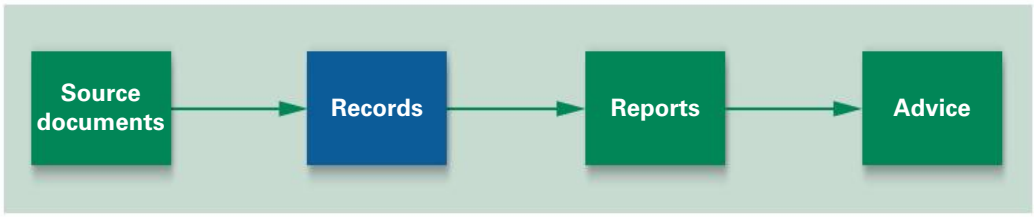
11.6 Recording transactions in inventory cards



Where cost prices are constant

Purchases

Aug. 5 Purchased 15 Black XL T-shirts from Boonds @ $4.50 plus 45c GST each (EFT 5463)

A purchase means that inventory is coming into the business, so this transaction must be recorded in the IN column as quantity 15 at a cost of $4.50, giving a total value for the purchase of $67.50 (15 × $4.50). The effect is to increase the number of items on hand in the BALANCE column to 25 T-shirts (10 on hand plus the 15 just purchased) at $4.50, for a total value of $112.50.

Note that although the business pays $4.95 for each T-shirt, this is not the cost price of the inventory; each T-shirt costs $4.50, but the supplier (Boonds) is collecting an extra 45c as GST. Only the cost price of $4.50 is recorded in the inventory card, as the other 45c is not inventory but a reduction in the GST liability.

Study tip

The cost price of inventory does not include GST; no GST is ever recorded in the inventory card.

Sales

Aug. 12 Cash sale of 8 Black XL T-shirts for $10 each plus $1 GST (Rec. 32)

A sale means that inventory is leaving or moving out of the business, so this transaction must be recorded in the OUT column. However, we have a dilemma regarding the unit price to be recorded: the price of the T-shirts is given on the source document (Rec. 32) as $10 plus $1 GST, but there are no $10 T-shirts listed in the inventory card. How can this be?

Remember that the price on the receipt ($10 each plus $1 GST) will be the selling price, but the inventory card is recorded at cost price ($4.50 each). The cost price of the inventory is not revealed to the customer in order to protect the Gross Profit on the sale. (You don't want the customers to know how much profit you are making on the sale!)

Therefore, this sale is recorded as 8 T-shirts at a cost of $4.50 (not $10), meaning that the value of the inventory leaving the store is $36.00 (8 × $4.50). The effect is to decrease the number of items on hand in the BALANCE column to 17 T-shirts (25 on hand less the 8 just sold) at $4.50, with a total value of $76.50.

Figure 11.3 shows how this purchase and sale would be recorded in the inventory card.

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Study tip

The only value ever recorded in an inventory card is cost price.

Figure 11.3 Recording transactions in the inventory card

Inventory Card

Inventory item: Black T-shirt, XL **Location:** Row 16, Bay C3
Inventory code: BTBk306XL **Supplier:** Boonds

Date	Source Document	IN			OUT			BALANCE		
		Qty	Cost	Total	Qty	Cost	Total	Qty	Cost	Total
Aug. 1	Balance							10	4.50	45.00
5	EFT 5463	15	4.50	67.50				25	4.50	112.50
12	Rec. 32				8	4.50	36.00	17	4.50	76.50

The $36.00 recorded in the OUT column represents the outflow of inventory that occurs when inventory is sold: it is the Cost of Sales for that particular sale. By adding up all the figures in the OUT column that relate to sales, the business can determine its total Cost of Sales for that item for the period.

Where cost prices are changing

Frequently, the cost price charged by the supplier will change during the period. That is, the items on hand may have the same selling price and be identical in the eyes of the customer but may have different cost prices. These differing cost prices must be recorded in the inventory cards.

Purchases

Aug.17 Purchased 12 T-shirts on credit from Boonds for $5 each plus 50c GST (Inv. B45)

As this is a purchase and will increase the inventory on hand, this transaction must be recorded in the IN column as quantity 12, cost $5, total $60 (12 × $5). (Remember GST is not recorded in the inventory card.) There are now 29 black XL T-shirts on hand, and the BALANCE column must reflect this, but we cannot simply aggregate the inventory as 29 units, as not all were purchased at $4.50, and not all were purchased at $5. Which cost for each item should be used for the balance? The only value ever recorded in an inventory card is cost price.

The answer is *both*. Even though the black XL T-shirts are identical in the eyes of the customers, because the cost prices of the inventory batches differ – 17 were purchased for $4.50 each, while the 12 new black XL T-shirts were purchased for $5 each – they must be listed separately in the BALANCE column of the inventory card.

Sales

Aug. 23 Credit sale of 20 T-shirts for $10 plus $1 GST each (Inv. 165)

This sale means that inventory is moving *out* of the business, so this transaction must be recorded in the OUT column, and once again the *cost price* must be used. However, the balance before this transaction is shown at two different cost prices – 17 units at $4.50 each, and 12 units at $5 each. Which inventory has been sold?

There are two methods we will consider when recording transactions in inventory cards, which will determine the cost price allocated to Cost of Sales when an item of inventory is sold and affect the value of the inventory recorded in the Balance Sheet at the end of the reporting period.

Identified Cost, as the name suggests, identifies the actual cost of the inventory item when it is purchased and when it is sold. This method requires the ability to be able

Identified Cost
the actual cost price of the inventory that is purchased and sold is identified and recorded

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to track an individual item of inventory in the business until it is sold. It is associated with larger inventory items or more expensive specialised items that have distinguishable factors such as high-end electronics, furniture or vehicles.

First In, First Out (FIFO) the assumption that the inventory that is purchased first will be sold first

The other method we will consider is the **First In, First Out (FIFO)** method. This method works on the assumption that the first inventory in (purchased) will be the first out of the store (sold). This method is used by businesses that sell inventories that are:

- high volume and not distinguishable; that is, it is not practical to try to distinguish between each item of inventory's cost price or it is not cost effective to do so.
- perishable, such as food
- following fashions or trends (so the business is not left with last season's inventory)
- related to general technology, which tends to become outdated quickly.

For our example, using Identified Cost we are able to distinguish which T-shirts have been sold. The 20 T-shirts sold were made up of the following inventory:

- 11 units at $4.50
- 9 units at $5.00.

Figure 11.4 shows how these transactions would be recorded in the inventory card using Identified Cost:

Figure 11.4 Recording transactions in the inventory card using Identified Cost with changing cost prices

Inventory Card

Inventory item: Black T-shirt, XL
Location: Row 16, Bay C3
Inventory code: BTBk306XL
Supplier: Boonds
Inventory method: Identified Cost

Date	Source Document	IN			OUT			BALANCE		
		Qty	Cost	Total	Qty	Cost	Total	Qty	Cost	Total
Aug. 1	Balance							10	4.50	45.00
5	EFT 5463	15	4.50	67.50				25	4.50	112.50
12	Rec. 32				8	4.50	36.00	17	4.50	76.50
17	Inv. B45	12	5.00	60.00				17	4.50	76.50
								12	5.00	60.00
23	Inv. 165				11	4.50	49.50	6	4.50	27.00
					9	5.00	45.00	3	5.00	15.00

Purchases

Aug. 25 Purchased another 10 T-shirts on credit from Boonds at a price of $6.05 each including GST (Inv. B59)

This transaction must be recorded in the IN column as quantity 10, cost $5.50, total $55 (10 × $5.50). There are now 19 black XL T-shirts on hand, and the BALANCE column must list every cost price separately in the BALANCE column of the inventory card.

Drawings

Aug. 26 The owner took home one $5.50 T-shirt for himself (Memo 1)

The owner taking inventory home for personal use will cause inventory to move out of the business, so this transaction must be recorded in the OUT column, and once again the cost price must be used.

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Advertising

Aug. 27 Jessie's T-shirts gave five T-shirts to support the local school fete raffle (Memo 2). The five T-shirts given to the school fete had a cost price of $4.50 each.

The owner is now giving inventory to a school fete and again this will cause inventory to move out of the business, so this transaction must be recorded in the OUT column.

Figure 11.5 shows how these transactions would be recorded in the inventory card using Identified Cost:

Figure 11.5 Recording using Identified Cost

Inventory Card

Inventory item: Black T-shirt, XL
Location: Row 16, Bay C3
Inventory code: BTBk306XL
Supplier: Boonds
Inventory method: Identified Cost

Date	Source Document	IN			OUT			BALANCE		
		Qty	Cost	Total	Qty	Cost	Total	Qty	Cost	Total
Aug. 1	Balance							10	4.50	45.00
5	EFT 5463	15	4.50	67.50				25	4.50	112.50
12	Rec. 32				8	4.50	36.00	17	4.50	76.50
17	Inv. B45	12	5.00	60.00				17	4.50	76.50
								12	5.00	60.00
23	Inv. 165				11	4.50	49.50	6	4.50	27.00
					9	5.00	45.00	3	5.00	15.00
25	Inv. B59	10	5.50	55.00				6	4.50	27.00
								3	5.00	15.00
								10	5.50	55.00
26	Memo 1				1	5.50	5.50	6	4.50	27.00
								3	5.00	15.00
								9	5.50	49.50
27	Memo 2				5	4.50	22.50	1	4.50	4.50
								3	5.00	15.00
								9	5.50	49.50

Credit sale

Aug. 28 The business sold seven T-shirts at a cost of $16.50 including GST (Inv. 185) to Bert's Shirts. (Identified Cost indicated the following inventory was sold: one at $4.50, two at $5.00 and the remainder at $5.50.)

The owner is selling inventory, therefore remember to only use the cost price of the inventory and record this transaction in the OUT column.

Sales return

Aug. 29 Bert's Shirts returned two T-shirts that displayed faulty stitching (Cr. Note J607). (The inventory returned each had a cost price of $5.50.)

Sales returns occur when inventory is returned to the business by the customer. Due to inventory coming back into the business from the customer, this transaction will be recorded in the IN column. The Identified Cost method will highlight the cost of the

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inventory returned by the customer and can be identified by the cost price recorded in the inventory card from the original sale.

Purchase return

Aug. 30 Jessie's T-shirts returned the two T-shirts to the supplier (Cr. Note X52 – the cost price indicated was $5.50.

Due to inventory leaving the business to return to the original supplier, this transaction will be recorded in the OUT column. The cost of the inventory returned to the supplier will be identified by the cost price recorded in the supplier's credit note. This will be the process regardless of which inventory cost method is used.

Figure 11.6 shows how these transactions would be recorded in the inventory card using Identified Cost:

Figure 11.6 Recording using Identified Cost

Inventory Card

Inventory item: Black T-shirt, XL **Location:** Row 16, Bay C3
Inventory code: BTBk306XL **Supplier:** Boonds
Inventory method: Identified Cost

Date	Source Document	IN			OUT			BALANCE		
		Qty	Cost	Total	Qty	Cost	Total	Qty	Cost	Total
Aug. 1	Balance							10	4.50	45.00
5	EFT 5463	15	4.50	67.50				25	4.50	112.50
12	Rec. 32				8	4.50	36.00	17	4.50	76.50
17	Inv. B45	12	5.00	60.00				17	4.50	76.50
								12	5.00	60.00
23	Inv. 165				11	4.50	49.50	6	4.50	27.00
					9	5.00	45.00	3	5.00	15.00
25	Inv. B59	10	5.50	55.00				6	4.50	27.00
								3	5.00	15.00
								10	5.50	55.00
26	Memo 1				1	5.50	5.50	6	4.50	27.00
								3	5.00	15.00
								9	5.50	49.50
27	Memo 2				5	4.50	22.50	1	4.50	4.50
								3	5.00	15.00
								9	5.50	49.50
28	Inv. 185				1	4.50	4.50			
					2	5.00	10.00	1	5.00	5.00
					4	5.50	22.00	5	5.50	27.50
29	Cr. Note J607	2	5.50	11.00				1	5.00	5.00
								7	5.50	38.50
30	Cr. Note X52				2	5.50	11.00	1	5.00	5.00
								5	5.50	27.50

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Review questions 11.6

1 **State** the effect on the BALANCE of a transaction recorded in the:
   - IN column
   - OUT column.
2 **Explain** why the cost price is not shown on the source document that provides the evidence of a sale.
3 **Explain** how the inventory card is used to determine the Cost of Sales for each transaction.
4 **Explain** the Identified Cost method as it applies to inventory cards.

11.7 The physical count: Identified Cost

Through the inventory cards, the owner should have an up-to-date record of all movements of inventory in and out of the business, and therefore an accurate figure for inventory on hand. However, this assumes not only that all inventory transactions have been recorded, but also that they have all been recorded accurately. Unfortunately, this will not always be the case, so there is a need to verify the accuracy of the inventory cards by conducting a physical count. A **physical count** involves someone physically counting of all the items of inventory on hand, followed by the assignment of a cost price to these items. This physical count figure can then be compared against the inventory cards to verify their accuracy. The role of a physical count is thus to verify the accuracy of the inventory cards so that the inventory figure reported in the Balance Sheet is free from bias (i.e. *Verifiable* and a *Faithful representation*), and in the process, detect any inventory gains or losses.

physical count
the process of counting every item of inventory on hand to verify the accuracy of the inventory cards and detect any inventory loss or gain

Inventory loss

An **inventory loss** occurs when the physical count reveals a quantity of inventory less than the quantity indicated on the inventory cards. This can occur because of:

- theft
- damage
- an oversupply to customers
- an undersupply by suppliers
- a recording error in the inventory cards.

The result of the physical count will be recorded on a memo, an internal Accounting document, and passed to the Accounting department so that the records can be updated.

inventory loss
an expense that occurs when the physical count shows less inventory than is shown on the inventory cards

Example

Aug. 31 Physical count revealed four black XL T-shirts on hand (Memo 15). (Identified Cost indicated that there were five black XL T-shirts valued at $5.50 and one at $5.00.)

According to the inventory card, there should be six black XL T-shirts on the shelves, but the physical count reveals that there are only four. Therefore, two T-shirts have been lost and the inventory card needs to be updated to reflect the actual number of T-shirts on hand.

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Figure 11.7 Recording an inventory loss in the inventory card using Identified Cost

Inventory item: Black T-shirt, XL **Location:** Row 16, Bay C3
Inventory code: BTBk306XL **Supplier:** Boonds
Inventory method: Identified Cost

Date	Source Document	IN			OUT			BALANCE		
		Qty	Cost	Total	Qty	Cost	Total	Qty	Cost	Total
Aug. 30	Cr. Note X52				2	5.50	11.00	1	5.00	5.00
								5	5.50	27.50
31	Memo 15				2	5.50	11.00	1	5.00	5.00
								3	5.50	16.50

Study tip

Cost of Sales and inventory loss are both expenses that do not involve an outflow of cash, but rather an outflow of inventory.

After recording the inventory loss, the inventory card will show the actual number of units on hand, and an accurate value of inventory on hand can be reported in the Balance Sheet. Inventory loss itself is classified as an expense because it is an outflow of an economic benefit in the form of a decrease in assets (Inventory) that results in a decrease in owner's equity.

Effect on the Accounting equation

The overall effect of the inventory loss on the Accounting equation for Jessie's T-shirts would be:

	Increase/Decrease/No effect	Amount $
Assets	Decrease (Inventory)	11
Liabilities	No effect	
Owner's equity	Decrease (increase Inventory loss expense, decreases Profit)	11

Inventory gain

An **inventory gain** occurs when the physical count reveals a quantity of inventory on hand greater than the number indicated in the inventory card. This can occur because of:

- an undersupply to customers
- an oversupply by suppliers
- a recording error in the inventory cards.

inventory gain
a revenue that occurs when the physical count shows more inventory on hand than is shown in the inventory card

Example

Sept. 30 Physical count revealed inventory on hand of 15 black XL T-shirts (Memo 24); the balance of the inventory card showed 14 on hand. Identified Cost indicated that the cost price of the additional item was $5.00.

In this case, the physical count shows that the business has in inventory one T-shirt more than the balance showed in the inventory card, indicating an inventory gain.

An inventory gain is classified as revenue because it increases assets (Inventory) and results in an increase in owner's equity (via an increase in revenue – inventory gain).

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Figure 11.8 Recording an inventory gain in the inventory card using Identified Cost

Inventory Card

Inventory item: Black T-shirt, XL
Location: Row 16, Bay C3
Inventory code: BTBk306XL
Supplier: Boonds
Inventory method: Identified Cost

Date	Source Document	IN			OUT			BALANCE		
		Qty	Cost	Total	Qty	Cost	Total	Qty	Cost	Total
Sept. 28	Rec. 81				10	5.00	50.00			
					6	6.00	36.00	14	6.00	84.00
Sept. 30	Memo 24	1	5.00	5.00				1	5.00	5.00
								14	6.00	84.00

Effect on the Accounting equation

The overall effect of the inventory gain on the Accounting equation for Jessie's T-shirts would be:

	Increase/Decrease/No effect	Amount $
Assets	Increase (Inventory)	5
Liabilities	No effect	
Owner's equity	Increase (Inventory gain revenue increases Profit)	5

Review questions 11.7

1 Referring to two Qualitative characteristics, **explain** the role of a physical count.
2 **Define** the term 'inventory loss'.
3 **State** four reasons for an inventory loss.
4 **Explain** how an inventory loss is classified in the Income Statement.
5 **Explain** the effect of an inventory loss on the Accounting equation.
6 **Define** the term 'inventory gain'.
7 **State** two reasons for an inventory gain.
8 **Explain** how an inventory gain is classified in the Income Statement.
9 **Explain** the effect of an inventory gain on the Accounting equation.

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11.8 Where cost prices are changing: First In, First Out

We will now examine the same scenario using the First In, First Out (FIFO) method. Remember this alternative method of recording inventory works on the assumption that the first inventory in (purchased) will be the first out of the store (sold). This method is mainly used by businesses that sell inventories where it is not cost effective or it is impractical to identify each item of inventory separately or where inventories are perishable, fashionable or technological in nature.

Purchases

Aug. 17 Purchased 12 T-shirts on credit from Boonds for $5 each plus 50c GST (Inv. B45)

Methods like Identified Cost and FIFO are necessary because businesses need a way of valuing their inventory at the time of *sale*. At the time of *purchase*, however, no such method is necessary as all items can be valued according to the cost price given by the supplier. This means the choice between Identified Cost and FIFO makes no difference to the way purchases or purchase returns are recorded: they are valued using the cost price noted on the invoice or credit note generated by the supplier.

Sales

Aug. 23 Credit sale of 20 T-shirts for $10 plus $1 GST each (Inv. 165)

Sales, on the other hand, are a different matter. This sale means that inventory is moving out of the business, so this transaction must be recorded in the OUT column, and once again the *cost price* must be used. However, the balance before this transaction is shown at two different cost prices – 17 units at $4.50 each, and 12 units at $5 each. Which inventory has been sold?

Unless inventory is marked or identified in some way, it is not possible to identify whether the customer has taken from the shop T-shirts worth $4.50 per unit or $5 per unit. For this reason, the FIFO method assumes that the inventory that was purchased first will be sold first. In the example provided, it means we will assume that the 17 T-shirts valued at $4.50 each will be sold first, with the remaining three T-shirts (to make up the 20 sold) assumed to be from the $5 batch.

Figure 11.9 shows how these transactions would be recorded in the inventory card using FIFO:

Figure 11.9 Recording transactions in the inventory card using FIFO with changing cost prices

Inventory Card

Inventory item: Black T-shirt, XL
Location: Row 16, Bay C3
Inventory code: BTBk306XL
Supplier: Boonds
Inventory method: FIFO

Date	Source Document	IN			OUT			BALANCE		
		Qty	Cost	Total	Qty	Cost	Total	Qty	Cost	Total
Aug. 1	Balance							10	4.50	45.00
5	EFT 5463	15	4.50	67.50				25	4.50	112.50
12	Rec. 32				8	4.50	36.00	17	4.50	76.50
17	Inv. B45	12	5.00	60.00				17	4.50	76.50
								12	5.00	60.00
23	Inv. 165				17	4.50	76.50			
					3	5.00	15.00	9	5.00	45.00

Study tip

Order does matter in an inventory card. Always list the cost in the BALANCE column in the order in which the inventory entered the business.

Study tip

Identified Cost 'tells' you the cost price of the items; under FIFO you use the order of inventory in the Balance column.

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Purchases

Aug. 25 Purchased another 10 T-shirts on credit from Boonds at a price of $6.05 each including GST (Inv. B59)

This transaction must be recorded in the IN column as quantity 10, cost $5.50, total $55 (10 × $5.50). There are now 19 black XL T-shirts on hand, and the BALANCE column must list every cost price separately in purchase order in the BALANCE column of the inventory card.

Drawings

Aug. 26 The owner took home one T-shirt for himself (Memo 1)

The owner taking inventory home for personal use will cause inventory to move out of the business, so this transaction must be recorded in the OUT column. Following the FIFO assumption, this will allocate a cost price of $5.

Advertising

Aug. 27 Jessie's T-shirts gave five T-shirts to support the local school fete raffle (Memo 2)

The owner is now giving inventory to a school fete and again this will cause inventory to move out of the business, so this transaction must be recorded in the OUT column. There are two values of inventory present; however, we will continue to use up the $5 inventory before we go to the $5.50, following the FIFO assumption.

Figure 11.10 shows how these transactions would be recorded in the inventory card using FIFO:

Video 11.1
Inventory cards: FIFO

Figure 11.10 Recording using FIFO

Inventory Card

Inventory item: Black T-shirt, XL
Location: Row 16, Bay C3
Inventory code: BTBk306XL
Supplier: Boonds
Inventory method: FIFO

Date	Source Document	IN			OUT			BALANCE		
		Qty	Cost	Total	Qty	Cost	Total	Qty	Cost	Total
Aug. 1	Balance							10	4.50	45.00
5	EFT 5463	15	4.50	67.50				25	4.50	112.50
12	Rec. 32				8	4.50	36.00	17	4.50	76.50
17	Inv. B45	12	5.00	60.00				17	4.50	76.50
								12	5.00	60.00
23	Inv. 165				17	4.50	76.50			
					3	5.00	15.00	9	5.00	45.00
25	Inv. B59	10	5.50	55.00				9	5.00	45.00
								10	5.50	55.00
26	Memo 1				1	5.00	5.00	8	5.00	40.00
								10	5.50	55.00
27	Memo 2				5	5.00	25.00	3	5.00	15.00
								10	5.50	55.00

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Credit sale

Aug. 28 The business sold seven T-shirts at a cost of $16.50 including GST (Inv 185) to Bert's Shirts

The owner is selling inventory, therefore remember to only use the cost price of the inventory and record this transaction in the OUT column. Following the FIFO principle, to sell seven units we will use up the three units of $5 and the four remaining T-shirts will come from the $5.50 inventory.

Sales return

Aug. 29 Bert's Shirts returned two T-shirts that displayed faulty stitching (Cr. Note J607)

Sales returns occur when inventory is returned to the business by the customer. Due to inventory coming back into the business from the customer, this transaction will be recorded in the IN column. Following the FIFO assumption, we can assume that the last inventory out would be the first back in. Therefore, we will allocate the return at a cost price of $5.50.

Purchase return

Aug. 30 Jessie's T-shirts returned the two T-shirts to the supplier (Cr. Note X52 – the cost price indicated was $5.50)

Due to inventory leaving the business to return to the original supplier, this transaction will be recorded in the OUT column. The cost of the inventory returned to the supplier will be identified by the cost price recorded in the supplier's credit note. This will be the process regardless of which inventory cost method is used.

Figure 11.11 shows how these transactions would be recorded in the inventory card using FIFO:

Figure 11.11 Recording using FIFO

Inventory Card

Inventory item: Black T-shirt, XL
Inventory code: BTBk306XL
Inventory method: FIFO
Location: Row 16, Bay C3
Supplier: Boonds

Date	Source Document	IN			OUT			BALANCE		
		Qty	Cost	Total	Qty	Cost	Total	Qty	Cost	Total
Aug. 25	Inv. B59							9	5.00	45.00
								10	5.50	55.00
26	Memo 1				1	5.00	5.00	8	5.00	40.00
								10	5.50	55.00
27	Memo 2				5	5.00	25.00	3	5.00	15.00
								10	5.50	55.00
28	Inv. 185				3	5.00	15.00			
					4	5.50	22.00	6	5.50	33.00
29	Cr. Note J607	2	5.50	11.00				8	5.50	44.00
30	Cr. Note X52				2	5.50	11.00	6	5.50	33.00

Review questions 11.8

1. **Explain** the FIFO (First In, First Out) assumption as it applies to inventory cards.
2. **Explain** how the FIFO method can provide different figures for the financial reports when compared with using Identified Cost in times of increasing prices.

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11.9 The physical count: FIFO

Just a reminder that the role of a physical count is to verify the accuracy of the inventory cards so that the inventory figure reported in the Balance Sheet is *free from bias* (i.e. Verifiable and a Faithful representation), and in the process, detect any inventory loss or inventory gain.

Inventory loss

Example

Aug. 31 Physical count revealed four black XL T-shirts on hand (Memo 15); the inventory card for black XL T-shirts showed a balance of six T-shirts.

According to the inventory card, there should be six black XL T-shirts on the shelves, but the physical count reveals that there are only four. Therefore, two T-shirts have been lost, and the inventory card needs to be updated to reflect the actual number of T-shirts on hand.

The FIFO method would calculate the value of inventory lost using the oldest cost price of available inventory on hand, as indicated in the inventory card as illustrated in Figure 11.12:

Study tip

Just like a sale, an inventory loss is recorded according to FIFO: the first inventory in is assumed to be the first inventory lost.

Figure 11.12 Recording an inventory loss in the inventory card using FIFO

Inventory Card

Inventory item: Black T-shirt, XL
Location: Row 16, Bay C3
Inventory code: BTBk306XL
Supplier: Boonds
Inventory method: FIFO

Date	Source Document	IN			OUT			BALANCE		
		Qty	Cost	Total	Qty	Cost	Total	Qty	Cost	Total
Aug. 30	Cr. Note X52				2	5.50	11.00	6	5.50	33.00
31	Memo 15				2	5.50	11.00	4	5.50	22.00

After recording the inventory loss, the inventory card will show the actual number of units on hand, and an accurate value of inventory on hand can be reported in the Balance Sheet.

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Inventory gain

An inventory gain occurs when the physical count reveals a quantity of inventory on hand greater than the number indicated in the inventory card.

Example

Sept. 30 Physical count revealed inventory on hand of 15 black XL T-shirts (Memo 24). The balance of the inventory card showed 14 on hand.

In this case, the physical count shows that the business has in inventory one T-shirt more than the balance showed in the inventory card, indicating an inventory gain. The FIFO method would value the inventory gain using the latest cost price recorded in the IN column as shown in the inventory card in Figure 11.13:

Figure 11.13 Recording an inventory gain in the inventory card using FIFO

Inventory Card

Inventory item: Black T-shirt, XL
Location: Row 16, Bay C3
Inventory code: BTBk306XL
Supplier: Boonds
Inventory method: FIFO

Date	Source Document	IN			OUT			BALANCE		
		Qty	Cost	Total	Qty	Cost	Total	Qty	Cost	Total
Sept. 28	Rec. 81				10	5.00	50.00			
					6	6.00	36.00	14	6.00	84.00
Sept. 30	Memo 24	1	6.00	6.00				15	6.00	90.00

Study tip

FIFO records inventory gains at the latest cost price recorded in the IN column in the inventory card.

Review questions 11.9

1 **Explain** how FIFO and Identified Cost method differ in recording an inventory loss in the inventory card.
2 **Explain** how FIFO and Identified Cost method differ in recording an inventory gain in the inventory card.

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11.10 Comparison of methods: FIFO versus Identified Cost

If we compare the two methods side by side (just focusing on August 2030), we can see that different outcomes have been achieved:

Inventory Card

Inventory item: Black T-shirt, XL
Location: Row 16, Bay C3
Inventory code: BTBk306XL
Supplier: Boonds
Inventory method: Identified Cost

Date	Source Document	IN			OUT			BALANCE		
		Qty	Cost	Total	Qty	Cost	Total	Qty	Cost	Total
Aug. 1	Balance							10	4.50	45.00
5	EFT 5463	15	4.50	67.50				25	4.50	112.50
12	Rec. 32				8	4.50	36.00	17	4.50	76.50
17	Inv. B45	12	5.00	60.00				17	4.50	76.50
								12	5.00	60.00
23	Inv. 165				11	4.50	49.50	6	4.50	27.00
					9	5.00	45.00	3	5.00	15.00
25	Inv. B59	10	5.50	55.00				6	4.50	27.00
								3	5.00	15.00
								10	5.50	55.00
26	Memo 1				1	5.50	5.50	6	4.50	27.00
								3	5.00	15.00
								9	5.50	49.50
27	Memo 2				5	4.50	22.50	1	4.50	4.50
								3	5.00	15.00
								9	5.50	49.50
28	Inv. 185				1	4.50	4.50			
					2	5.00	15.00	1	5.00	5.00
					4	5.50	22.00	5	5.50	27.50
29	Cr. Note J607	2	5.50	11.00				1	5.00	5.00
								7	5.50	38.50
30	Cr. Note X52				2	5.50	11.00	1	5.00	5.00
								5	5.50	27.50
31	Memo 15				2	5.50	11.00	1	5.00	5.00
								3	5.50	16.50

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Inventory Card

Inventory item: Black T-shirt, XL
Inventory code: BTBk306XL
Inventory method: FIFO
Location: Row 16, Bay C3
Supplier: Boonds

Date	Source Document	IN			OUT			BALANCE		
		Qty	Cost	Total	Qty	Cost	Total	Qty	Cost	Total
Aug. 1	Balance							10	4.50	45.00
5	EFT 5463	15	4.50	67.50				25	4.50	112.50
12	Rec. 32				8	4.50	36.00	17	4.50	76.50
17	Inv. B45	12	5.00	60.00				17	4.50	76.50
								12	5.00	60.00
23	Inv. 165				17	4.50	76.50			
					3	5.00	15.00	9	5.00	45.00
25	Inv. B59	10	5.50	55.00				9	5.00	45.00
								10	5.50	55.00
26	Memo 1				1	5.00	5.00	8	5.00	40.00
								10	5.50	55.00
27	Memo 2				5	5.00	25.00	3	5.00	15.00
								10	5.50	55.00
28	Inv. 185				3	5.00	15.00			
					4	5.50	22.00	6	5.50	33.00
29	Cr. Note J607	2	5.50	11.00				8	5.50	44.00
30	Cr. Note X52				2	5.50	11.00	6	5.50	33.00
31	Memo 15				2	5.50	11.00	4	5.50	22.00

The Identified Cost method identifies the exact cost price of the inventory leaving the business. Therefore, it will provide the actual cost of inventory sold and the actual value of inventory on hand. The alternative method, FIFO, is an assumption only; it may not match the actual flow of goods (i.e. customers may buy the T-shirts that were purchased more recently, rather than those which were first in). However, without actually marking inventory, there is no way of knowing the actual cost price of the inventory that has been sold, thus FIFO is not only an acceptable but necessary assumption.

As you can see from the two inventory cards, the IN column is the same, regardless of the method; however, each method will give different outcomes with changing prices in the OUT column. The table below indicates the differences between the two recording methods.

Method	Cost of Sales (after Sales returns)	Advertising	Value of inventory at end
Identified Cost	$161.00	$22.50	$21.50
First In, First Out	$153.50	$25.00	$22.00

Each method will give different figures for the financial reports and therefore different outcomes. Despite this occurring over particular reporting periods, it will even out over time as the entire inventory is sold.

As a general rule, in times of rising prices for inventory, FIFO would be assigning the cheaper inventory to be sold first, leaving the more expensive inventory in the inventory card. This has the effect of reporting a lower Cost of Sales and a higher Net

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Profit and inventory in the Balance Sheet. The opposite would hold true if there was a consistent decline in inventory prices: Cost of Sales would be higher as the more expensive inventory is assumed to be sold first, thus lowering Net Profit. The inventory at end would be lower as well because it is recorded at the lower price.

Review questions 11.10

1 **Explain** why FIFO and Identified Cost can give different figures for financial reports in times of changing prices.
2 **Explain** the impact using FIFO can have on the financial reports in times of rising prices.

11.11 Benefits of the perpetual system

As the backbone of the perpetual system, the benefits of inventory cards are also the benefits of the perpetual system:

- **Assists in the reordering of inventory**
  The inventory cards will show when the minimum inventory levels have been reached so an order can be placed with the supplier.
- **Fast- and slow-moving lines of inventory can be identified**
  The owner can examine the inventory cards to identify the items that are selling well and those that are not and adjust inventory purchases accordingly.
- **Inventory losses and gains can be detected**
  This can be detected by comparing the balances of the inventory cards against the physical count.
- **Interim reports can be prepared without the need for physical counts**
  The level of inventory on hand and the amount of Cost of Sales can be determined from the inventory cards (although the level of inventory loss or gain will not be known).

Inventory cards and ICT

Inventory cards can be maintained either manually or on a computerised basis, but in a store with hundreds of different inventory items, manual recording would be very time consuming. However, the use of barcodes and an appropriate software program allows inventory cards to be computerised. (Businesses that have a small range or specialised lines of inventory might use a manual system, as the cost of a computer system and software might not be justifiable.)

This technology allows goods to be scanned as they move in and out of the business, with the software automatically updating the inventory records. At the end of the day, the owner/manager can print out a report that would show sales, inventory levels and other essential information that can be used to inform decisions. This could extend to warnings when inventory levels are low, or even automatic reordering.

Review questions 11.11

1 **Explain** the benefits of the perpetual system of inventory recording.
2 **Explain** how ICT can improve the use of the perpetual inventory system.

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Where have we been?

- Trading businesses aim to generate profit by purchasing goods and then selling them at a higher price.
- Inventory is the generic term applied to the goods held by a trading firm for the purposes of resale, and it is not only the main source of revenue for a trading business but also one of its most significant assets.
- The perpetual inventory system involves the continuous recording of inventory movements in inventory cards.
- Identified Cost tracks each individual piece of inventory through the business to its point of sale.
- First In, First Out (FIFO) assumes that the first inventory into the store is the first inventory to leave.
- The role of a physical count is to verify the accuracy of the inventory cards and, in the process, detect any inventory loss or inventory gain so that the inventory figure reported in the Balance Sheet is free from bias (i.e. *Verifiable* and provides a *Faithful representation*).
- Inventory cards assist reordering, allow for the identification of fast- and slow-moving lines, allow for the detection of an inventory loss or gain and allow interim reports to be prepared without conducting a physical count.
- ICT can allow small businesses to use the perpetual inventory system to record inventory movements.

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Exercises

Exercise 11.1
Identifying inventory

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CRPS Accounting has provided the following list of its clients and asked for some assistance in identifying the asset each business would report as inventory:

Asset	Business
Bookcases	Hide Fashions
Computer	LX Construction Machinery
Leather jackets	Lekkis Motor Traders
Equipment	Timber Town Furniture
Vehicles	PC World

Required

a. **Explain** why Lekkis Motor Traders would not classify the computer as inventory.
b. **Identify** which business would classify each asset as inventory.

Exercise 11.2
Inventory transactions

page 179

For each of the following transactions, **state** the effect on each element of the Accounting equation.

a. Paid $100 plus $10 GST for the purchase of inventory.
b. Sold inventory on credit for $550 including $50 GST. (The inventory had a cost price of $200.)
c. Credit purchase of inventory for $330 (inclusive of GST).
d. Inventory purchased for $400 was sold for $715 cash including $65 GST.

Exercise 11.3
Inventory cards

page 180

Jackson Jewellers sells a variety of watches, including the Gismo, which it purchases from Ryan International. As at 30 September 2030, Jackson Jewellers had five Gismo watches on hand valued at $210 each. The following are transactions relating to Gismo watches that occurred during October 2030:

Oct.	1	Purchased 4 watches at $210 plus $21 GST each (EFT 3427)
	5	Cash sale of 3 watches for $390 plus $39 GST (Rec. 843)
	9	Cash sale of 1 watch for $429 including $39 GST (Rec. 844)
	13	Cash sale of 2 watches for $440 including $40 GST each (Rec. 846)
	18	Purchased 10 watches on credit for $210 plus $21 GST each (Inv. W 304)
	20	Sold 5 watches on credit for $440 inclusive of GST each (Inv. 107)
	26	Purchased 4 watches for $210 plus $21 GST each (EFT 4635)

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Required

a. **Record** the transactions for October 2030 in the inventory card for Gismo watches.
b. **Explain** why GST on purchases of inventory is not recorded in the inventory card.
c. **Explain** how the sale of inventory creates an expense.
The owners of Jackson Jewellers are approached by a supplier stating they could provide replica Gismos at a third of the price the owners are currently paying.
d. **Discuss** whether Jackson Jewellers should purchase from this new supplier and the potential financial impacts of accepting this decision.

Exercise 11.4
Inventory cards and FIFO

page 182

Len Sherbert owns and operates The Perfume Shop and has provided the following information relating to Funk perfume, which is purchased from Cologne Ltd.:

April	1	Opening balance: 5 bottles valued at $60 each.
	3	Purchased 12 bottles at $60 plus $6 GST each (EFT 2880)
	8	Cash sale of 10 bottles at $220 including $20 GST each (Rec. 35)
	11	Purchased 15 bottles on credit for $70 plus $7 GST each (Inv. P90)
	15	The owner took 1 bottle home for his wife (Memo 44)
	21	Sold 10 bottles at $200 plus $20 GST each (Rec. 36)
	23	Purchase return of 5 bottles that were found to be damaged from last purchase (Cr. Note 87)
	25	Received delivery of 20 bottles, paying $88 including $8 GST per bottle (EFT 8194)
	30	Sold 15 bottles at $220 inclusive of GST each (Rec. 37)

Required

a. **Record** the transactions for April 2030 in the inventory card for Funk perfume.
b. Referring to your answer to part **a**, **explain** the operation of the FIFO assumption.
c. **Calculate** the Cost of Sales for Funk perfume for April 2030.
d. **Calculate** the Gross Profit on Funk perfume for April 2030.

Exercise 11.5
Inventory loss and gain

page 184

Chiltern Chainsaws sells timber cutting equipment, and after recording all transactions for August 2030, its inventory cards showed 12 chainsaws on hand worth $400 each. A physical count on 31 August 2030 showed 10 chainsaws on hand (Memo 13).

Required

a. Referring to one Qualitative characteristic, **explain** the role of a physical count.
b. **State** two reasons for the difference between the inventory cards and the physical count.
c. **Record** Memo 13 in the inventory card for chainsaws.

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Exercise 11.6
Inventory loss and gain

page 185

Maxwell's Hardware sells a number of different tools, including the Silver hammer. After recording all transactions for November 2030, the inventory card showed 43 hammers on hand, but a physical count on 30 November 2030 counted 47 (Memo 91). The hammers have a cost price of $15 each.

Required

a. **Explain** one reason for the difference between the physical count and the balance shown on the inventory card.
b. **Record** Memo 91 in the inventory card for Silver hammers.
c. Apart from the detection of inventory loss or gain, **state** one benefit of recording transactions in inventory cards.

Exercise 11.7
Inventory cards, FIFO, Identified Cost and physical count

page 186

Loud As sells stereos and other hi-fi equipment, and as at 1 December 2030 had five Rockweiler stereos on hand worth $1 000 each. The transactions for December were:

Dec.	3	Sold 2 stereos for $2 000 plus $200 GST (Rec. L49)
	6	Purchased 6 stereos for $1 100 plus $110 GST each (EFT 9123)
	14	Sold 2 stereos to Blown nightclub for $2 200 including $200 GST each (Inv. 301) (Identified Cost 2 at $1 000)
	17	Sales return of 1 stereo from Blown nightclub due to malfunction (Cr. Note 23)
	19	Purchase return of problematic stereo to supplier, receiving a credit of $1 000 (Cr. Note X56)
	21	Bought 10 stereos from Rockweiler at a bargain price of $1 000 plus $100 GST each (EFT 1627)
	25	Sold 3 stereos to BJ HiFi for $2 200 inclusive of GST each (Rec. L51) (Identified Cost 3 at $1 100)
	29	Owner took home a stereo to install at her house (Memo 44) (Identified Cost $1 000)
	31	A physical count revealed 12 stereos on hand (Memo 45) (Identified Cost indicated 9 at $1 000 and 3 at $1 100)

Required

a. **Record** the transactions for December 2030 in the inventory card for Rockweiler stereos using Identified Cost.
b. **Record** the transactions for December 2030 in the inventory card for Rockweiler stereos using FIFO.
c. **Explain** why inventory does not need to be recorded in the order of purchase in Identified Cost where it does under FIFO.
d. **Model** the potential outcomes in figures that will occur in the financial reports due to the method used. **Justify** which method you would recommend Loud As use.
e. **Suggest** two reasons (apart from theft) for the difference between the physical count and the balance shown in the inventory card.
f. Referring to your answers in part **a** and **b**, **state** the effect on each element of the Accounting equation of the transaction on 31 December 2030.
g. **Explain** why inventory loss is classified as an expense.

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Exercise 11.8
Inventory cards and cash journals using FIFO

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Cuong's Electrical World buys and sells electrical products such as DVD players and TVs. The owner maintains individual inventory cards for all inventory and uses the FIFO method of recording. As at 1 June 2030, there were four Samsong DVD players (code no. 250) on hand at a cost price of $100 each. Samsong DVD players are purchased from the supplier, SingSam. The following transactions took place during June 2030:

June	2	Purchased 10 DVD players for $110 plus $11 GST each (Inv. 54)
	4	Paid $1 200 plus $120 GST for new shop fittings (EFT 1255)
	7	Sold 6 DVD players for $297 (including $27 GST) each (Rec. 89)
	9	Paid wages $540 (EFT 1265)
	12	Bought 5 DVD players at $120 plus $12 GST each (EFT 2157)
	16	Owner contributed $1 000 cash (Rec. 90)
	18	Sold 6 DVD players for a total of $1 782 including $162 GST (Rec. 91)
	21	Paid wages $580 (EFT 7253)
	25	Purchased 8 DVD players at $132 inclusive of GST each (Inv. 79)
	27	Purchase return of 2 DVD players due to damage $264 (Cr. Note 18)
	29	Donated 5 DVD players to the local hospital (Memo 4)
	30	A physical count showed 7 DVD players on hand (Memo 5)

Required

a. **Record** the relevant transactions for June 2030 in the inventory card for Samsong DVD players.

b. **Explain** one way in which inventory cards can be used to improve the management of inventory.

c. **Record** the relevant transactions for June 2030 in the journals of Cuong's Electrical World.

d. **State** the effect on each element of the Accounting equation of the transaction on:
- 2 June 2030
- 7 June 2030
- 30 June 2030.

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Exercise 11.9
Recording for inventory using FIFO

page 192

Rob Giromondo owns and operates a business called Dinkum Furniture, which sells desks and other furniture. All desks are sold for $110 each, which includes $10 GST. On 1 September 2030, there were 15 desks on hand worth $50 each. The following transactions relating to desks occurred during September 2030:

Sept.	3	Sold 7 desks to Melbourne University (Rec. 56)
	10	Gave 2 desks to his daughter's school fete as prizes for the raffle (Document 3)
	16	Purchased 20 desks at $60 plus $6 GST each from Master Crafstmen (EFT 9320)
	23	Sales to Newtown High School of 18 desks (Rec. 57)
	30	A physical count revealed there were 5 desks on hand (Memo 4)

Required

a. Referring to one Qualitative characteristic, **explain** why the desks are not recorded in the inventory card at their selling price.
b. **State** the source document that would be used as evidence of the transaction on 10 September 2030.
c. **Record** the transactions for September 2030 in the inventory card for desks.
d. **Explain** one way that inventory cards could be used to reduce inventory loss.
e. **State** the effect (overstated/understated/no effect) on each element of the Accounting equation if the transaction on 30 September 2030 was not recorded.
f. **Calculate** Cost of Sales for desks for September 2030.
g. **Calculate** Gross Profit on desks for September 2030.

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Exercise 11.10
Recording for inventory – FIFO vs Identified Cost

page 194

Gia Lucchetti is the owner and manager of Lucchetti Paints, a business that sells paint and painting equipment. Ceiling paint is sold for $77 per can including $7 GST. On 1 August 2030, the inventory card for ceiling paint showed:

		Qty	Cost	Total
Aug. 1	Balance	10	35	350
		8	40	320

The following transactions occurred during August 2030:

Aug.	1	Sold 15 cans of paint (Rec. 231) (Identified Cost: 7 at $35 and the remainder at $40)
	3	Paid electricity bill $140 plus $14 GST (EFT 1284)
	5	Paid wages $780 (EFT 2185)
	8	Purchased 4 cans of paint for $44 inclusive of GST each (EFT 6183)
	9	Gia withdrew $400 cash for personal use (EFT 1587)
	12	Received a loan from JH Finance for $5000 (Rec. 232)
	16	Paid $440 including $40 GST for advertising (EFT 1898)
	19	Gia took 2 cans of paint to use on her home renovations (Memo 20) (Identified Cost: 2 at $35)
	22	Paid wages $620 (EFT 1990)
	25	Purchased 10 cans of paint from Splash Ltd at $45 plus $4.50 GST each (Inv. 901)
	27	Purchase return of 2 cans of paint (purchased on 25 August 2030) due to leakage (Cr. Note 25).
	28	Sold 6 cans of paint to Industry Painters (Inv. 309) (Identified Cost: 2 at $40 and the remainder at $45)
	31	A physical count revealed 4 cans of paint on hand (Memo 21) (Identified Cost: identified 1 at $35 and 2 at $45 was missing)

Required

a. **Record** the relevant transactions for August 2030 in the inventory card for ceiling paint using:
- Identified Cost
- FIFO.

b. **State** two benefits Gia derives by recording transactions in inventory cards.

c. **Record** the relevant transactions for August 2030 in the journals of Lucchetti Paints.

d. Referring to one Accounting assumption, **explain** why the transaction on 19 August 2030 must be recorded in the inventory card.

e. Assuming FIFO, **explain** the effect on owner's equity as at 31 August 2030 if the transaction on 19 August 2030 had **not** been recorded.

f. **Model** the potential outcomes on the Gross Profit of ceiling paint for August 2030 using Identified Cost and FIFO. **Justify** which method you would recommend Lucchetti Paints use.

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Chapter 12
Reporting and managing inventory

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Learning intentions

After completing this chapter, you should be able to:

- **explain** the importance of Cost of Sales
- **calculate** Cost of Sales from the inventory cards
- **distinguish** between Cost of Sales and Cost of Goods Sold
- **prepare** an Income Statement for a trading business
- **report** inventory in the Balance Sheet
- **calculate** Inventory Turnover and **explain** its significance.

Key terms

After completing this chapter, you should be familiar with the following terms:

- Net Sales
- Cost of Goods Sold
- Adjusted Gross Profit
- Gross Profit Margin (GPM)
- inventory sheet
- Inventory Turnover.

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12.1 Reporting for trading firms

Essentially, the process of reporting for a trading business is the same as that applied to service businesses, with three general-purpose financial reports used to communicate financial information to the owner:

- *Cash Flow Statement* – reports on cash received and paid in regard to the Operating, Investing and Financing cash flows of the business and the change in the firm's cash balance over the reporting period
- *Income Statement* – reports on revenue earned and expenses incurred over the reporting period
- *Balance Sheet* – reports on assets, liabilities and owner's equity at a particular point in time.

However, the reports of a trading firm must also report for Inventory in both the Income Statement and Balance Sheet, and we will explore this difference in this chapter.

Review questions 12.1

1 **State** the item that a trading firm must account for in its financial reports.
2 **Explain** why this item has a significant impact on the Income Statement and Balance Sheet.

12.2 Cost of Sales

Chapter 11 pointed out that when a sale is made it results in an outflow of inventory, creating an expense called Cost of Sales: an outflow of economic benefits (the inventory that has been sold) in the form of a decrease in assets (Inventory) and a decrease in owner's equity. Therefore, in order to determine the profit of a trading business, we must first have an accurate figure for Cost of Sales.

However, unlike wages, rent or advertising expenses, Cost of Sales does not involve a cash flow, and so it is not recorded in the Cash Payments Journal. How then is the Cost of Sales expense determined? This is where the inventory card comes into play. If we total the amounts relating to sales (as recorded in the OUT column) and deduct the amounts relating to sales returns (as recorded in the IN column) on all the inventory cards, then we will be able to determine the Cost of Sales for the reporting period.

Cost of Sales is determined by adding together the value of each sale recorded in the OUT section of the inventory cards and deducting the value of each sales return recorded in the IN section of the inventory cards.

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Example

Tyre City has provided the following inventory card for Yukihimo P225/65R14 tyres for July 2030. All inventory is sold at a 100% mark-up:

Inventory Card

Inventory item: Yukihimo P225/65R14 **Location:** Row 10, Bay D45
Inventory code: Y132 **Supplier:** Yukihimo
Inventory method: FIFO

Date	Source Document	IN			OUT			BALANCE		
		Qty	Cost	Total	Qty	Cost	Total	Qty	Cost	Total
July 1	Balance							15	45	675
3	Memo 22				5	45	225	10	45	450
5	EFT 267	15	45	675				25	45	1125
12	Rec. 54				11	45	495	14	45	630
17	Inv. 832	18	50	900				14	45	630
								18	50	900
23	Inv. 72				14	45	630			
					6	50	300	12	50	600
31	Memo 25				2	50	100	10	50	500

Video 12.1
Calculating Cost of Sales

The sales for the period are recorded in the OUT section, with the amount recorded in the Total column representing the Cost of Sales for each transaction. Therefore, if we add together the amounts in the Total column we should be able to determine the Cost of Sales for Yukihimo tyres for July 2030.

However, before we make any calculations, we should examine the transactions in the OUT section a little more closely. A sale is verified by a receipt or an invoice, but two of the transactions – on 3 July 2030 and 31 July 2030 – are referenced by a memo, indicating that they are not sales. The transaction on 3 July 2030 could be drawings of inventory for personal use, or perhaps a donation as a form of advertising, while the transaction on 31 July 2030 is likely to be an inventory loss. (We would need to look at the actual memo to find out for sure.) These transactions are movements of inventory out of the business, but they are clearly not sales, and so must **not** be included in the calculation of Cost of Sales. (The techniques for reporting these other non-sale inventory transactions will be discussed later in this chapter.)

The Cost of Sales for Yukihimo tyres for July 2030 would thus be calculated as:

July	12	Rec. 54		$495
	23	Inv. 72	(630 + 300)	$930
Cost of Sales for Yukihimo tyres for July 2030				$1 425

Total Cost of Sales

By adding the amounts relating to sales in the OUT section of the inventory card for Yukihimo tyres, we can determine their Cost of Sales. However, a tyre shop would have a large range of tyres, and each type of tyre would have its own inventory card. In order to calculate Cost of Sales for *all* inventory, the process would need to be repeated for each and every inventory card, with the total reported as Cost of Sales for the reporting period.

Study tip

Sales can be identified in the inventory card by a receipt or invoice in the OUT column; sales returns by a credit note in the IN column.

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The Cost of Sales for July 2030 would thus be calculated as:

Cost of Sales for Yukihimo tyres for July 2030	$1 425
Cost of Sales for Greatyear tyres for July 2030	1200
Cost of Sales for Bridgerock tyres for July 2030	1780
Cost of Sales for Michelton tyres for July 2030	940
Total Cost of Sales for July 2030	**$5 345**

This total – derived from all the inventory cards – will be reported as an expense in the Income Statement for July 2030, as Cost of Sales $5 345.

Review questions 12.2

1 **Define** the term 'Cost of Sales'.
2 **Explain** how the inventory cards can be used to determine Cost of Sales.
3 **State** three items that might be recorded in the OUT section of an inventory card but are not included in the calculation of Cost of Sales.

12.3 Cash Flow Statement for trading firms

As you learned in Chapter 7, any transaction involving a cash flow to or from the business will be recorded in the Cash Flow Statement. Therefore, any movement of inventory that causes a cash flow will be recorded as an Operating Cash Flow because it is in the ordinary course of business. The transactions that we will be interested in are Cash purchases (outflow) and Cash sales (inflow). The expense 'Cost of Sales' that we previously identified above will not be recorded in the Cash Flow Statement as it involves a movement of inventory, *not* a movement of cash.

Review questions 12.3

1 **State** the classification under which inventory cash flows would be reported.
2 **Explain** why Cost of Sales is not reported in the Cash Flow Statement.

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12.4 Income Statement for trading firms

Calculating profit for a service firm is relatively straightforward: expenses are deducted from revenue to determine the Net Profit or Loss. The process for a trading firm is very similar, but given the size and significance of Cost of Sales, this expense is identified separately in the Income Statement. In fact, the Income Statement will now show two separate figures for profit: Gross Profit and Net Profit.

Example

Tyre City has provided the following information relating to its trading activities for August 2030. It had a bank balance of $10600 at the start of August.

Sales Journal

Date	Account Receivable	Inv. No.	Sales	GST	Accounts Receivable
Aug. 2030					
	TOTALS	**$**	**10000**	**1000**	**11000**

Cash Receipts Journal

Date	Details	Source Document	Bank	Sales	Accounts Receivable	Sundries	GST
Aug. 2030	Loan – Bank of Guam					5000	
	TOTALS	**$**	**62420**	**46200**	**6600**	**5000**	**4620**

Cash Payments Journal

Date	Details	Source Doc.	Bank	Inventory	Drawings	Wages	Sundries	GST
Aug. 2030	Freight In						1200	
	Advertising						2000	
	Loan – Principal						500	
	Interest on loan						200	
	Delivery to customers							
	TOTALS	**$**	**48560**	**30000**	**5000**	**4800**	**5300**	**3460**

Additional information:

- The inventory cards for August 2030 revealed the following:

Cost of Sales	$30800
Inventory on hand	$13200

- Sales returns (selling price excl. GST) $1800
- A physical count on 31 August 2030 showed $12400 worth of inventory on hand.

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The Cash Flow Statement for Tyre City for August 2030 is shown in Figure 12.1:

Figure 12.1 Cash Flow Statement for a trading business

TYRE CITY
Cash Flow Statement for August 2030

	$	$
CASH FLOWS FROM OPERATING ACTIVITIES		
Cash sales	46 200	
Receipts from Accounts Receivable	6 600	
GST received	4 620	57 420
Inventory	(30 000)	
Wages	(4 800)	
GST paid	(3 460)	
Freight in	(1 200)	
Advertising	(2 000)	
Interest on loan	(200)	
Delivery to customers	(1 400)	(43 060)
Net Cash Flows from Operating Activities		**14 360**
CASH FLOW FROM INVESTING ACTIVITIES		
Net Cash Flows from Investing activities		
CASH FLOW FROM FINANCING ACTIVITIES		
Loan received – Bank of Guam		5 000
Drawings	(5 000)	
Loan repayment	(500)	(5 500)
Net Cash Flows from Financing activities		**(500)**
Net Increase (Decrease) in cash position		**13 860**
Add Bank Balance at start (1 August 2030)		**10 600**
Bank Balance at end (31 August 2030)		**24 460**

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The Income Statement for Tyre City for August 2030 is shown in Figure 12.2:

Figure 12.2 Income Statement for a trading business

TYRE CITY Income Statement for August 2030		
	$	$
Revenue		
Cash sales	46200	
Credit sales	10000	56200
Less Sales returns		1800
		54400[1]
Less Cost of Goods Sold[2]		
Cost of Sales	30800	
Freight in	1200	32000
Gross Profit[3]		**22400**
Less Inventory loss		800
Adjusted Gross Profit[4]		**21600**
Less Other expenses		
Wages	4800	
Advertising	2000	
Interest on loan	200	
Delivery to customers	1400	8400
Net Profit[5]		**$13 200**

This report is in many ways similar to the Income Statement for a service firm:

- The title is identical.
- Items such as GST received and loans are excluded from revenue.
- Items such as drawings, GST paid and loan repayments are excluded from expenses.
- The final figure is Net Profit, calculated by deducting expenses from revenue. However, the way certain revenue and expenses are presented is quite different.

1 Net Sales

The overall sales figure for a reporting period calculated by Total sales less Sales returns is **Net Sales**. The actual amount of Sales returns should be monitored closely as this could have ramifications for the firm's reputation and for future sales. It is a good indicator of the quality of inventory.

Net Sales
Total Sales less Sales returns

Cost of Goods Sold
a heading used in the Income Statement for all costs incurred to bring inventory into a location and condition ready for sale

2 Cost of Goods Sold

The most significant set of expenses for a trading business will be those directly related to inventory, so these expenses are given special prominence in the Income Statement. The most important of these expenses will be Cost of Sales, but there may be other costs the business has incurred in order to get its inventory ready for sale. These costs are reported under the heading **Cost of Goods Sold**, which will obviously include Cost of Sales, but also other expenses like freight/cartage/delivery inwards, import duties, custom duties, modifications, packaging and other buying expenses.

These are all expenses directly related to inventory, and more specifically, getting inventory into the business – onto the shelf and ready for sale. Any cost after that point that is involved in *selling* the inventory – like delivery *to customers* – is considered an Other expense (see below).

Study tip

Cost of Sales is an expense item; Cost of Goods Sold is an expense heading that includes Cost of Sales.

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Note also that Cash purchases of inventory ($30 000) is **not** included, as it is not an expense: the purchase of inventory does not involve an outflow of economic benefits because it does not decrease assets overall. A purchase of inventory simply swaps one asset (Bank) for another (Inventory).

3 Gross Profit

A trading business earns profit by buying goods at one price and selling them at another (higher) price, so the owner must be able to assess whether the selling price is high enough to cover the cost of the inventory and all the firm's other expenses, and still provide for Net Profit. For this reason, the Income Statement for a trading firm shows whether the business has earned a *Gross Profit*, which is calculated as:

Gross Profit = Net sales *less* Cost of Goods Sold

4 Adjusted Gross Profit

Adjusted Gross Profit
Gross Profit less Inventory loss (or plus Inventory gain)

The Inventory loss or gain is determined by comparing the inventory card figures to the physical count. An Inventory loss is then deducted from Gross Profit to determine **Adjusted Gross Profit**. (An Inventory gain would of course be added to Gross Profit.) Reporting the Inventory loss or gain separately allows the owner to identify problems with inventory management so that corrective action can be taken.

5 Net Profit

All costs incurred to get inventory ready for sale are included as part of Cost of Goods Sold, leaving all the other costs that are required to keep the business operating (like wages, advertising, rent or interest) to be reported as Other expenses. Note that delivery to customers is reported here rather than as part of Cost of Goods Sold, as it is incurred *after* the sale occurs. Net Profit is thus determined by deducting these other expenses from Adjusted Gross Profit.

Review questions 12.4

1. **Define** the term 'Net Sales'.
2. **Explain** the importance of monitoring the level of Sales returns.
3. **Define** the term 'Cost of Goods Sold'.
4. **State** four expense items that may be reported as part of Cost of Goods Sold.
5. **Explain** why the purchase of inventory is not reported as an expense. **Explain** where a cash purchase of inventory is reported.
6. **Explain** why it is important to identify Gross Profit in the Income Statement of a trading business.
7. **Explain** how an Inventory loss or gain is determined.
8. **Explain** why Inventory loss and gain are reported separately in the Income Statement.
9. **State** the effect on Adjusted Gross Profit of an:
   - Inventory loss
   - Inventory gain.

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12.5 Financial indicators and the Income Statement

The Income Statement will convey, in dollar terms, what a business achieved in terms of a profit (or loss). However, financial indicators will present information about profitability – the ability of the firm to earn profit – in *relative terms*, comparing items from the Income Statement against each other, and against items from the Balance Sheet. This will be explored in detail in Chapter 18, but it is worth considering two of these financial indicators here in the context of using the Income Statement to assist decision-making.

Net Profit Margin (NPM)

The goal of any trading firm is that once a sale is made, as much of that revenue as possible is retained as profit. The Net Profit Margin (NPM) calculates the percentage of Net Sales revenue that is retained as Net Profit. It measures how much of each dollar of Net Sales revenue remains as Net Profit after expenses are deducted. It is a good indicator of overall expense control.

Net Profit Margin is calculated as shown in Figure 12.3:

Figure 12.3 Formula: Net Profit Margin

$$\text{Net Profit Margin (NPM)} = \frac{\text{Net Profit}}{\text{Net Sales}} \times 100$$

A high Net Profit Margin means that a large percentage of Net Sales revenue is retained as Net Profit (because a low percentage is consumed by expenses).

Example

In August 2030 Tyre City had earned $54 400 in Net Sales, and $13 200 in Net Profit.

The Net Profit Margin of Tyre City would be calculated as shown in Figure 12.4:

Figure 12.4 Calculation: Net Profit Margin

$$\text{NPM} = \frac{\text{Net Profit}}{\text{Net Sales}} \times 100$$

$$= \frac{\$13\,200}{\$54\,400} \times 100$$

$$= \mathbf{24.26\%}$$

This Net Profit Margin indicates that **24.26%** of Net Sales is retained as Net Profit, or 75.74% of Net Sales is consumed by expenses. Therefore, for every $1 of Net Sales generated, approximately 24 cents is retained as Net Profit.

Looking at this figure in isolation, it is difficult to ascertain whether this Net Profit Margin would be seen as satisfactory or not. We require a benchmark for comparison to inform us of the performance. Benchmarks can be:

- **previous period's ratios**
- **budgeted performance**
- **competitors' performance** (industry averages).

Study tip

When assessing performance, look *backwards* (to previous figures), *forwards* (to budget figures) and *sideways* (to competitors or industry averages).

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For example, if the previous period's Net Profit Margin was 15%, the owner of Tyre City would be very happy with the improvement; however, if the industry average was 30%, then the owner would be concerned and concede that further improvement in expense control is required to meet the industry standard.

Gross Profit Margin (GPM)

Gross Profit Margin (GPM)
a profitability indicator that measures the average mark-up by calculating the percentage of Net Sales revenue that is retained as Gross Profit

The Net Profit Margin measures the control a business has of its expenses as a whole, but for a trading business the control of its Cost of Goods Sold is particularly important. The **Gross Profit Margin (GPM)** assesses how effectively the business has managed its Cost of Goods Sold by measuring the percentage of each dollar of Sales revenue that is retained as Gross Profit. Gross Profit evaluates the adequacy of the firm's mark-up (the difference between the selling price and cost price of its inventory). The Gross Profit Margin can be used to gauge the average mark-up on all goods sold during a particular period.

Gross Profit Margin is calculated as shown in Figure 12.5:

Figure 12.5 Formula: Gross Profit Margin

$$\text{Gross Profit Margin (GPM)} = \frac{\text{Gross Profit}}{\text{Net Sales}} \times 100$$

A high Gross Profit Margin means that a large percentage of Net Sales revenue is retained as Gross Profit (because a low percentage is consumed by Cost of Goods Sold).

Example

In August 2030 Tyre City had earned $54 400 in Net Sales, and $22 400 in Gross Profit.

The Gross Profit Margin of Tyre City would be calculated as shown in Figure 12.6:

Figure 12.6 Calculation: Gross Profit Margin

$$\text{GPM} = \frac{\text{Gross Profit}}{\text{Net Sales}} \times 100$$

$$= \frac{\$22\,400}{\$54\,400} \times 100$$

$$= 41.18\%$$

This Gross Profit Margin indicates that 41.18% of Net Sales revenue is retained as Gross Profit, or 58.82% of Net Sales is consumed by Cost of Goods Sold. It indicates that for every dollar of Net Sales generated, approximately 41 cents is retained as Gross Profit.

Assessing Gross Profit Margin

The size of the Gross Profit Margin indicates the size of the average mark-up – the gap between selling and cost prices. Should this gap increase, the business will make more Gross Profit *per sale*, but this is not always the case and does not always translate into greater profit overall.

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For instance, a *higher selling price* will increase the average mark-up, but it carries the risk of lowering demand, and thus reducing the volume of sales. This could lead to:

- a higher Gross Profit *per item* (and a higher Gross Profit Margin)
- Gross Profit *in dollar terms* falling, if sales volume drops too far.

The alternative to increasing selling price is to reduce the purchase price of our goods, hence reducing the Cost of Goods Sold. This can be achieved by:

- finding a supplier with a *lower cost price*, ensuring a similar quality of product. Poor quality inventory could mean a loss of customers and a decrease in sales volume, as well as higher sales returns.
- attempting to purchase inventory in bulk lots to achieve a lower cost price per unit (this will depend on the type of inventory you sell, for example perishable items are at a risk of spoiling, and the ability to store without increasing storage costs or the risk of theft or damage).

Review questions 12.5

1 **Define** the term 'profitability'.
2 **Explain** why financial indicators can be useful in assessing profitability.
3 **Show** the formula to calculate the Net Profit Margin.
4 **Explain** how the Net Profit Margin can be used to assess profitability.
5 **Show** the formula to calculate the Gross Profit Margin.
6 **Explain** how the Gross Profit Margin can be used to assess profitability.
7 **Identify** three benchmarks that can be used to assess the Net Profit Margin and Gross Profit Margin.
8 **Explain** why the Gross Profit Margin is always higher than the Net Profit Margin.
9 **Explain** the importance of a sufficient mark-up.
10 **Explain** two ways a business could increase its average mark-up.
11 **Explain** how an increase in mark-up could actually lead to a decrease in Gross Profit.

12.6 Balance Sheet for a trading business

In terms of the Balance Sheet, inventory will be reported as a current asset: a resource controlled by the business from which future economic benefits are expected in the next 12 months.

However, *Relevance* dictates that there is no need to report the balance of each individual line of inventory, as this information will not be useful for the types of decisions that are informed by the Balance Sheet. Instead, a single figure for inventory will be reported, and this figure will be determined by using an **inventory sheet**.

inventory sheet
a listing of the quantity and value of each line of inventory on hand

An inventory sheet is simply a listing of all the inventory lines, the number of units on hand, and the value of those units. Figure 12.7 shows the inventory sheet for Tyre City as at 31 August 2030:

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Figure 12.7 Inventory sheet

Item	Code	Qty	Value
Yukihimo tyres	Y132	12	$660
Greatyear tyres	G148	20	1 400
Bridgerock tyres	B166	10	500
Michelton tyres	M125	16	1 360
Inventory on hand 31 August 2030			**$3 920**

This sheet would be based on the figures determined by the physical count, with the inventory cards adjusted (for any inventory loss or gain) to match the figure shown on the inventory sheet.

Alternatively, the value of inventory can be determined using a formula that combines data from the journals, inventory cards and other information. Figure 12.8 shows the formula for calculating the balance of inventory on hand using the data for Tyre City:

Figure 12.8 Inventory formula

Balance at start	14 000	From the *previous* Balance Sheet (1 August 2030)
+ Cash purchases	30 000	From the Cash Payments Journal
+ Credit purchases	nil	From the Purchases Journal
– Purchase returns	nil	From any additional information
	44 000	**Goods available for sale**
– Cost of Sales *	(30 800)	From the inventory cards
Balance as per inventory cards	13 200	From the inventory cards
– Inventory loss	(800)	From the inventory cards
Balance as per physical count	**$12 400**	**For the *next* Balance Sheet (31 August 2030)**

The cost price of sales returns would have already been deducted from this amount.

In this example the balance of inventory on hand at the end (31 August 2030) was given, both from the inventory cards ($13 200) and from the physical count ($12 400), so all information needed to complete the Income Statement and Balance Sheet was available.

The balance of inventory on hand at the start (1 August 2030) was **not** given, but using the formula and the other information it is possible to calculate that it must have been $14 000.

Review questions 12.6

1. **Explain** how inventory is classified in the Balance Sheet.
2. Referring to one Qualitative characteristic, **explain** why the Balance Sheet does not list the balance of every line of inventory.
3. **Explain** the role of an inventory sheet.
4. **Show** the formula to calculate the balance of inventory on hand.

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12.7 Inventory Turnover

The success of a trading firm rests on its ability to turn inventory into sales. It is vitally important that a firm sells its inventory quickly so that it has cash to meet its financial obligations in time, and so that it can purchase more inventory to generate more sales. The speed at which individual lines of inventory are sold can of course be determined by examining the inventory cards, but if the owner wishes to make an overall assessment of the firm's inventory management procedures, it may be useful to calculate **Inventory Turnover**. This is an efficiency indicator that measures the average number of days taken to sell inventory.

Inventory Turnover an efficiency indicator that measures the average number of days it takes for a business to convert its inventory into sales

Figure 12.9 Formula: Inventory Turnover

$$\text{Inventory Turnover} = \frac{\text{Average inventory} \times 365}{\text{Cost of Goods Sold}}$$

Average inventory is used in an attempt to reflect the inventory on hand carried *throughout* the period, while multiplying by 365 converts the turnover into days. Average inventory is calculated as:

Figure 12.10 Formula: Average inventory

$$\text{Average inventory} = \frac{\text{Inventory at start + inventory at end}}{2}$$

Fast Inventory Turnover – as measured by *low days* – means, on average, inventory is sold quickly. This will enhance the firm's ability to generate cash from the sale of inventory and assist its liquidity.

Example

As at 1 January 2030, Stainless Cutlery had inventory on hand worth $55 000. During 2030 its Cost of Sales was $300 000, and on 31 December 2030 Inventory on hand was $45 000.

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The Inventory Turnover of Stainless Cutlery for 2030 would be calculated as is shown in Figure 12.11:

Figure 12.11 Calculation: Average inventory

$$\text{Average inventory} = \frac{\$55\,000 + \$45\,000}{2}$$
$$= \$50\,000$$

Figure 12.12 Calculation: Inventory Turnover

$$\text{Inventory Turnover} = \frac{\$50\,000 \times 365}{\$300\,000}$$
$$= 61 \text{ days}^*$$

*Rounded to nearest day

This Inventory Turnover indicates that on *average* it took Stainless Cutlery 61 days to sell its inventory, or that it took 61 days to turn its inventory into sales.

Assessing Inventory Turnover

An acceptable rate of Inventory Turnover depends largely on the nature of the inventory. Inventory that is relatively inexpensive or susceptible to spoilage (such as fresh produce) or technological obsolescence (such as mobile phones) should be turned over quickly, but other items may not sell for weeks.

Even considering these factors, there is no set level at which Inventory Turnover is considered satisfactory. Rather, Inventory Turnover should be measured against a benchmark such as:

- *past figures for Inventory Turnover* – established trends
- *budgeted Inventory Turnover* – predicted figures or targets that were hoped to be achieved
- *Inventory Turnover* of similar businesses or industry averages.

Managing Inventory Turnover

If Inventory Turnover is *too slow*, it could be improved by:

1 **Increasing the level of sales** to increase Cost of Sales and reduce the number of days taken to sell inventory.

This could be achieved by improving the inventory mix, increasing marketing or advertising, or discounting slow lines of inventory.

2 **Decreasing inventory holdings** to reduce the amount of inventory on hand.

This could be done by purchasing less inventory (but perhaps more frequently through just-in-time ordering) and discontinuing slow-selling inventory items.

It is, of course, possible that Inventory Turnover could be *too fast*, meaning that costs such as delivery may be higher (because deliveries are more frequent) and the business could lose the possibility of earning discounts for buying in bulk, or that potential profit is being lost as the selling price is too low. The owner must therefore strike a balance between ordering enough inventory to meet demand, and not ordering so much that storage costs and inventory losses (through theft and damage) increase.

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Review questions 12.7

1 **State** two ways inventory cards can be used to manage inventory.
2 **State** what is measured by Inventory Turnover.
3 **Show** the formula to calculate Inventory Turnover.
4 **Explain** why fast Inventory Turnover is beneficial for liquidity.
5 **State** three benchmarks that could be used to assess Inventory Turnover.
6 **State** two actions that could be implemented to improve Inventory Turnover.

12.8 Inventory management

As we noted in Chapter 11, effective inventory management is essential to the survival of a trading business as inventory is the firm's main source of revenue and is likely to be one of its most significant assets.

There are certain strategies a business owner can employ to ensure that the businesses inventory is managed wisely to maximise the potential for sales, including:

- **Set minimum and maximum inventory levels**
  A minimum inventory level ensures that the business has enough inventory on hand to meet customer demand. Insufficient inventory on hand will mean a loss of sales, and therefore a loss of profit. In addition, setting a minimum inventory level assists in reordering when inventory levels are getting low. At the same time, a maximum level ensures that the business does not have too much of a particular item, which may lead to additional storage costs. An overabundance of a particular line that may go out of fashion or become technologically obsolete also creates the risk that the business will be burdened with inventory it cannot sell.
- **Rotate inventory**
  Particularly for perishable items, older products must be positioned in front so that they are taken first. Otherwise, inventory may remain unsold, resulting in spoilage and wastage. A similar approach could apply to older versions of electronic inventory or clothing, which could simply be moved to a different location in the store to encourage sales.
- **Ensure inventory is up to date**
  Items affected by fashion or technology must be the most current version available. Older and out-of-date versions should be discounted for quick sale.
- **Maintain an appropriate inventory mix**
  By examining the inventory cards, the owner will be able to identify those lines that are selling well and those that are not. The owner would be wise to expand those lines that are selling well and to discontinue those inventory lines that are not.
- **Promote the sale of complementary goods**
  Complementary goods are 'add-on sales' that are generated to support the original item sold. For example, a business selling tents may also position sleeping bags, inflatable mattresses and gaslights nearby to encourage more sales.
- **Effective marketing**
  Strategies such as advertising and other promotions will hopefully lead to increased sales and faster Inventory Turnover.

Review questions 12.8

1 **Explain** three strategies that could be employed to manage inventory.

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Where have we been?

- Cost of Sales is determined by adding together the value of each sale recorded in the OUT section and deducting the value of each sales return recorded in the IN section of the inventory cards.
- Reporting Gross Profit allows the owner to assess whether the selling price is high enough to cover the cost of the inventory and all the firm's other expenses, and still provide for Net Profit.
- In the Cash Flow Statement, cash flows relating to inventory are recorded under Operating cash flows.
- In the Balance Sheet, inventory will be reported as a Current asset: a resource controlled by the business from which future economic benefits are expected in the next 12 months.
- Inventory Turnover is an efficiency indicator that measures the average number of days taken to sell inventory.
- Inventory management strategies include setting minimum and maximum inventory levels, rotating inventory, ensuring inventory is up to date, maintaining an appropriate inventory mix, promoting the sale of complementary goods and effective marketing.

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Exercises

Please note: asterisks indicate that an answer for that question is available in the Selected Answers section at the end of this book.

Exercise 12.1
Calculating Cost of Sales

page 200

Chris Chendo operates a music store called Sonics and has provided the following inventory card for Ibsen guitars for November 2030:

Inventory Card

Inventory item: Ibsen Guitars
Location: Bay 21
Inventory code: IB335
Supplier: Ibsen Music
Inventory method: FIFO

Date	Source Document	IN			OUT			BALANCE		
		Qty	Cost	Total	Qty	Cost	Total	Qty	Cost	Total
Nov. 1	Balance							3	350	1 050
7	Rec. 15 – 16				2	350	700	1	350	350
11	Inv. 705	5	400	2 000				1	350	350
								5	400	2 000
15	Memo 12				1	350	350	5	400	2 000
22	Rec. 17 – 30				2	400	800	3	400	1 200
26	Inv. 713	6	420	2 520				3	400	1 200
								6	420	2 520
30	Memo 18				1	400	400	2	400	800
								6	420	2 520

Required

a. **Suggest** one possible reason for the transaction on 15 November 2030 (Memo 12).
b. **State** one other type of transaction that will be recorded in the OUT column but excluded from the calculation of Cost of Sales.
c. **Calculate** Cost of Sales for Ibsen Guitars for November 2030.
d. Referring to your answer to part **c**, **explain** why this is unlikely to be the figure reported as Cost of Sales in the Income Statement for Sonics for November 2030.

Exercise 12.2
Calculating Cost of Sales

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Julie Hibbert is the owner of House of Tennis and has provided the inventory card for Majesty tennis racquets for July 2030:

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Inventory Card

Inventory item: Majesty tennis racquets
Location: Shelf near counter
Inventory code: MT-122-C
Supplier: Dilnot Tennis
Inventory method: Identified Cost

Date	Source Document	IN			OUT			BALANCE		
		Qty	Cost	Total	Qty	Cost	Total	Qty	Cost	Total
July 1	Balance							4	45	180
6	EFT 304	10	50	500				4	45	180
								10	50	500
12	?				4	45	180			
					2	50	100	8	50	400
19	Inv. T54	12	50	600				20	50	1 000
23	Inv. 44				6	50	300	14	50	700
31	Memo 16				2	50	100	12	50	600

Additional information:

- All sales are marked up 100%.
- Memo 16 was the only memo issued during July 2030.

Required

a. **State** a possible source document that might verify the transaction that occurred on 12 July 2030.
b. **Describe** the transaction that occurred on 19 July 2030.
c. **Explain** why the purchase of inventory is not classified as an expense.
d. **Calculate** Cost of Sales for Majesty tennis racquets for July 2030.
e. **Explain** the effect of an inventory gain on Cost of Sales.

Exercise 12.3
Financial reports

page 202

Gemima Finkelstein owns WhereIsIt Maps and has provided the following information relating to the firm's trading activities for March 2030:

Sales Journal

Date	Accounts Receivable	Inv. No.	Sales	GST	Accounts Receivable
March					
	Total	**$**	**5 000**	**500**	**5 500**

Cash Receipts Journal

Date	Details	Source Document	Bank	Sales	Accounts Receivable	Sundries	GST
March	Capital contribution					5 000	
	TOTALS	**$**	**33 300**	**23 000**	**3 000**	**5 000**	**2 300**

Cash Payments Journal

Date	Details	Source Document	Bank	Inventory	Drawings	Wages	Sundries	GST
March	Buying expenses						1 200	
	Advertising						1 000	
	GST settlement						500	
	TOTALS	**$**	**25 820**	**17 000**	**1 500**	**2 700**	**2 700**	**1 920**

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Additional information:

- Gemima's capital as at 1 March 2030 was $34 000.
- The firm's bank balance as at 1 March was $1 800.
- The inventory cards for March 2030 showed Cost of Sales of $15 800, and Inventory on hand of $7 400.
- A physical count on 31 March 2030 showed Inventory on hand of $7 100.
- The industry average for Gross Profit Margin is 25% and Net Profit Margin is 5%.

Required

* **a.** **Prepare** a Cash Flow Statement and an Income Statement for WhereIsIt Maps for March 2030.

b. Referring to your answer to part **a**, **explain** your treatment of:
- GST settlement
- Buying expenses.

* **c.** **Prepare** the owner's equity section of the Balance Sheet for WhereIsIt Maps as at 31 March 2030.

d. **Calculate** the Gross Profit Margin and Net Profit Margin for Wherelsit Maps. **Comment** on the results.

Exercise 12.4
Income Statement

page 205

Dion Virente is the owner of The Photography Place and has provided the following information relating to the firm's trading activities for October 2030:

THE PHOTOGRAPHY PLACE
Cash Flow Statement for October 2030

	$	$
CASH FLOWS FROM OPERATING ACTIVITIES		
Cash sales	20 000	
Cash received from Accounts Receivable	15 000	
GST received	2 000	37 000
Inventory	(21 000)	
Wages	(4 800)	
GST paid	(2 370)	
Freight out	(1 400)	
Advertising	(800)	
Interest on loan	(200)	
Import duties	(500)	(31 070)
Net Cash Flows from Operating Activities		**5 930**
CASH FLOW FROM FINANCING ACTIVITIES		
Loan – ANZ		2 000
Drawings		(3 000)
Net Cash Flows from Financing activities		**(1 000)**
Net Increase (Decrease) in cash position		**4 930**
Bank Balance at start (1 October 2030)		**1 200**
Bank Balance at end (31 October 2030)		**6 130**

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Additional information:

- Credit sales were $23 000 (plus GST) for October.
- Sales returns for October were $1 200 (plus GST).
- Dion's capital as at 1 October 2030 was $45 000.
- The inventory cards for October 2030 showed Cost of Sales of $23 000 and Drawings of inventory of $600.
- A physical count on 31 October 2030 revealed an Inventory gain of $300.

Required

* **a.** **Prepare** an Income Statement for The Photography Place for October 2030.

b. Referring to your answer to part **a**, **explain** your treatment of:

- Import duties
- Freight out.

* **c.** **Prepare** the owner's equity section of the Balance Sheet for The Photography Place as at 31 October 2030.

Exercise 12.5
Financial reports

page 207

John Darcy operates a small bookshop at Highworld Shopping Centre called Baxter's Books. Books are bought and sold on cash terms only. The journals of Baxter's Books for 2030 showed the following information:

Cash Receipts Journal

Date	Details	Source Document	Bank	Sales	Sundries	GST
	Capital contribution				6 000	
	TOTALS	**$**	**160 000**	**140 000**	**6 000**	**14 000**

Cash Payments Journal

Date	Details	Source Doc.	Bank	Inventory	Drawings	Wages	Sundries	GST
	Freight in						11 000	
	Selling expenses						5 800	
	Accounting fees						3 200	
	TOTALS	**$**	**182 800**	**98 000**	**25 000**	**28 000**	**20 000**	**11 800**

Additional information:

- The inventory cards for 2030 showed Cost of Sales of $96 000, Drawings of inventory of $1 500 and Inventory on hand as at 31 December 2030 of $20 000.
- A physical count on 31 December 2030 revealed Inventory on hand of $18 500 (Memo 63).
- As at 1 January 2030 Capital was $75 000 and Bank $18 500.
- The industry average Gross Profit Margin is 40% and Net Profit Margin is 12%.

Required

* **a.** **Prepare** a Cash Flow Statement and an Income Statement for Baxter's Books for 2030.

b. **Explain** why the Income Statement for a trading firm shows Gross Profit.

* **c.** **Prepare** the owner's equity section of the Balance Sheet for Baxter's Books as at 31 December 2030.

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d. **State** the effect on each element of the Accounting equation of the adjustment for the physical count.
e. **Calculate** the Gross Profit Margin and Net Profit Margin for Baxter's Books for 2030. **Comment** on the firm's performance and **justify** by giving two recommendations.
f. Assuming Baxter's Books used Identified Cost for inventory recording, **model** the potential outcomes on the financial statements if the business had adopted the FIFO approach in times of decreasing prices.

Exercise 12.6
Inventory Turnover

page 211

As at 1 January 2030, Wally's Timber Yard held Inventory on hand worth $25 000. During 2030, the business generated sales of $180 000, incurring Cost of Sales of $91 250 in the process. As at 31 December 2030, Inventory on hand had increased to $35 000. In 2029, Inventory Turnover was 100 days.

Required

a. **Calculate** the Inventory Turnover of Wally's Timber Yard for 2030.
b. Referring to your answer to part **a**, **explain** whether Wally should be satisfied with this Inventory Turnover.
c. **Explain** one effect on liquidity if Inventory Turnover is too slow.
d. **Explain** one strategy Wally could adopt to improve Inventory Turnover without affecting Net Profit.

Exercise 12.7
Inventory Turnover

page 212

Gia's Dancewear has provided the following information relating to the firm's activities for December 2030:

Sales revenue	$26 000
Net Profit	$2 000
Average Inventory on hand	$3 600
Cost of Sales	$18 000
Average Total Assets	$50 000

The industry average Inventory Turnover is 80 days.

Required

a. **Calculate** the Inventory Turnover of Gia's Dancewear for December 2030.
b. Referring to your answer to part **a**, **explain** whether Gia should be satisfied with this Inventory Turnover.
c. **Explain** one problem that may occur if Inventory Turnover is too fast.

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Exercise 12.8
Reporting and managing inventory

page 213

Benita Superior owns and manages a sporting goods store in Northcote called Superior Sports. Benita has provided the following information for 2030:

Assistant's wages	$9200
Cost of Sales	$73000
GST settlement	$620
Rent	$10000
Inventory on hand – 1 January 2030	$12500
Cartage inwards	$2300
GST received	$10500
Heating and power	$1200
Credit sales	$110000
Sales returns	$5000
Inventory Turnover: industry average	35 days

Additional information:

- A physical count on 31 December 2030 revealed $5500 Inventory on hand. The inventory cards at the same date showed Inventory on hand worth $6000.
- In 2029, Superior Sports had an Inventory Turnover of 55 days.

Required

a. Using the formula, **calculate** cash purchases of inventory for 2030.
b. **Explain** why cash purchases of inventory are **not** reported in the Income Statement.
* **c.** **Prepare** an Income Statement for Superior Sports for 2030.
d. **Explain** why the Income Statement for a trading firm shows both Gross Profit and Net Profit.
e. **Calculate** the Inventory Turnover for Superior Sports for 2030.
f. Referring to your answer to part **e**, **explain** whether Benita should be pleased with the Inventory Turnover for 2030.
g. **State** two possible reasons for the change in Inventory Turnover from 2029 to 2030.
h. **Explain** one advantage and one disadvantage of holding lower levels of inventory.
i. **Explain** two principles of inventory management that Benita should employ.
j. **Explain** if Benita should be concerned if Sales returns had increased by 50%. **Advise** her as to what course of action she should take.

Exercise 12.9
Reporting and managing inventory

page 217

Mario Belleto is the owner/operator of Antique Arts, an art dealership in Moonee Ponds. Inventory is recorded using the perpetual system, and valued using First In, First Out (FIFO). Mario has provided the following information for the year ended 30 June 2030:

Credit sales	$47500
Cost of Sales	$19000
Inventory on hand – 1 July 2029	$7400
Inventory on hand – 30 June 2030	$7800

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Mario used to own a fruit shop, which consistently generated an Inventory Turnover of 6.2 days, and he has been quite disappointed with the Inventory Turnover of Antique Arts, which was 165 days for the year ended 30 June 2029.

Required

a. **Calculate** the Inventory Turnover for Antique Arts for the year ended 30 June 2030.
b. Referring to your answer to part **a**, **state** two reasons why Mario should not be disappointed with the Inventory Turnover for the year ended 30 June 2030.
c. **Calculate** the percentage mark-up Mario has applied to his inventory.
d. **Explain** how decreasing the percentage mark-up may affect:
- Inventory Turnover
- Gross Profit.

Mario has provided the following information for the year ended 30 June 2031:

Inventory on hand – 1 July 2030	$7 800
Sales	$38 500
Sales returns	$1 500
Capital – 1 July 2030	$18 700
Cartage out	$1 400
Drawings	$2 000
Cash at bank	$3 000
Credit purchases of inventory	$18 600
Wages	$3 300
Packaging expenses	$1 900
Advertising	$650

Additional information:
- At the start of July, Mario introduced a new packaging system for small antiques; after inventory is sold, it is sealed in bubble wrap before it is delivered to the customer.
- Drawings consisted of $1 600 cash and an antique lamp worth $400.
- On 30 June 2031, a physical count revealed $6 500 Inventory on hand while the inventory cards showed Inventory on hand as $6 100.

e. **Calculate** Cost of Sales for the year ended 30 June 2031.
* **f.** **Prepare** an Income Statement for Antique Arts for the year ended 30 June 2031.
* **g.** **Prepare** the owner's equity section of the Balance Sheet for Antique Arts as at 30 June 2031.
h. **Explain** the effect on owner's equity as at 30 June 2031 if Mario had failed to record the withdrawal of the lamp.
i. **Explain** one inventory management principle (other than establishing minimum and maximum inventory levels) that Mario should implement.
j. **Calculate** the Gross Profit Margin and Net Profit Margin for Antique Arts.
k. **Explain** if Antique Arts should be satisfied with the responses in part **j** if the following industry averages were discovered:
- Gross Profit Margin 60%
- Net Profit Margin 30%

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Chapter 13
Accounts Payable for a trading business

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Learning intentions

After completing this chapter, you should be able to:

- **distinguish** between credit transactions for service firms and trading firms
- **identify** credit transactions from source documents
- **explain** the role of special journals and subsidiary records
- **discuss** the benefits and costs of settlement discounts
- **calculate** settlement discounts
- **record** transactions in special journals and subsidiary records including:
  - credit purchases of inventory (including GST)
  - purchase returns (including GST)
  - payments to Accounts Payable (with discount)
- **explain** the impact of transactions on the Accounting equation
- **prepare** an Accounts Payable Schedule
- **explain** the benefits of using subsidiary records for Accounts Payable
- **discuss** ethical considerations in relation to business decision-making.

Key terms

After completing this chapter, you should be familiar with the following terms:

- credit terms
- Accounts Payable record
- Accounts Payable Schedule
- settlement discount
- discount revenue.

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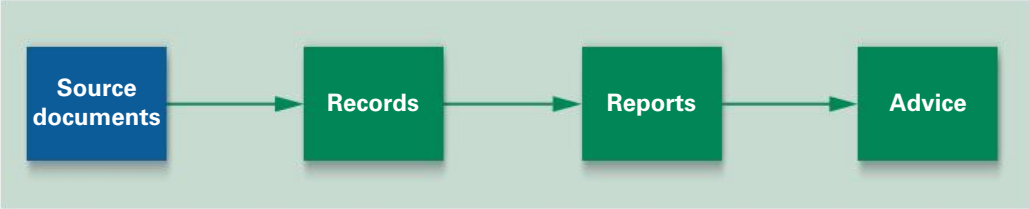
13.1 Trading firms and credit transactions

Chapter 9 discussed how to record credit transactions for a service firm, with the business providing a service to its customers, or purchasing and receiving its materials from its suppliers, *before* receiving or paying cash. Many trading businesses also utilise credit transactions, effectively dividing a sale or purchase of its inventory into two transactions:

- the exchange of inventory; and
- the exchange of cash at a later date.

The Accounting system for a trading business must therefore be able to identify and record both of these transactions.

Source document: invoice



As is the case for a service business, the details of a credit transaction for a trading business will be verified by an invoice like the one shown in Figure 13.1:

Figure 13.1 Invoice

35 Rosella St
Frankston, VIC 3199

A. Potter Studios
ABN: 90 876 444 361

TAX INVOICE

Date: 3/4/2030
Invoice: 29
Original terms: 5/7, n/60

Sold to: Uptown Ceramics
12 Southgate Way
Langwarrin, Victoria, 3190
ABN: 33 020 871 455

Item	Qty	Unit price $	Total $
Egyptian vase	20	20	400
GST (10%)			40
		$	440

Video 13.1
Interpreting a purchase invoice

The invoice is issued by the seller/supplier (who is named at the top of the invoice, in this case, A. Potter Studios) and delivered to the customer (Uptown Ceramics) with the inventory (20 Egyptian vases). As a source document and tax invoice, the invoice also identifies:

- the ABN of the seller (and in this case the buyer, but this is not always required)
- the credit terms of the transaction (5/7, n/60)
- the GST on the sale ($40 i.e. 10% of the $400 selling price)
- the total amount owing to the seller (**$440**).

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Invoices are thus vital in ensuring that the information is *Verifiable* and provide a *Faithful representation* of the firm's financial events that is complete, free from error and neutral (without bias).

Credit terms

Because the customer will not pay the cash on the day the sale is made, it is important that the invoice identifies exactly when payment must be made, and this is specified in the **credit terms**. In this example, the notation '5/7, n/60' means that if the amount owing is paid in seven days, a 5% discount will be given, but the net amount must be paid in 60 days. (Discounts are explained in detail in Section 13.6.)

credit terms
the number of days a credit customer has to pay the balance owing, including the number of days to earn a settlement discount and percentage discount offered for early payment

Credit sale or credit purchase?

To determine whether an invoice provides evidence of a credit purchase or a credit sale, it is necessary to identify the business for whom the accounts are being kept, and where that firm's name appears on the invoice. If 'our business' is named at the *top*, the document is a sales invoice and the transaction is a credit sale. If our business is named in the *middle* of the invoice, the document is a purchase invoice and the transaction is a credit purchase.

The invoice in Figure 13.1 would be treated as a credit sale in the records of A. Potter Studios, as it is named at the top of the invoice as the seller. In the records of Uptown Ceramics, however, it would be treated as a credit purchase, as Uptown Ceramics is named in the middle as the purchaser.

Study tip

The name of the seller is always identified at the top of an invoice.

Review questions 13.1

1 **Explain** the term 'credit transaction'.
2 **Identify** the source document used to verify a credit transaction and **list** the details it must provide.
3 **Explain** why credit terms must be noted on an invoice and what they show.
4 **Explain** how a business can distinguish between a sales invoice and a purchase invoice.
5 Referring to the link between two Qualitative characteristics, **explain** the importance of source documents in the Accounting process.

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13.2 Credit purchases of inventory

A credit purchase occurs when a business buys inventory (or other assets) from a supplier but is not required to pay until a later date. A service business is most likely to purchase its supplies and materials on credit, but for a trading business the main item purchased on credit will be inventory. For this reason, when Accounting for a trading business the term 'purchases' is used to refer to purchases of *inventory* that need not be paid until a later date.

Ethical considerations

When compared with service businesses, trading businesses are more closely identified with the inventory they purchase, as it is through the sale of this inventory that they generate sales and profit. This makes it critical that trading businesses consider the benefits of ethical purchasing.

Study tip

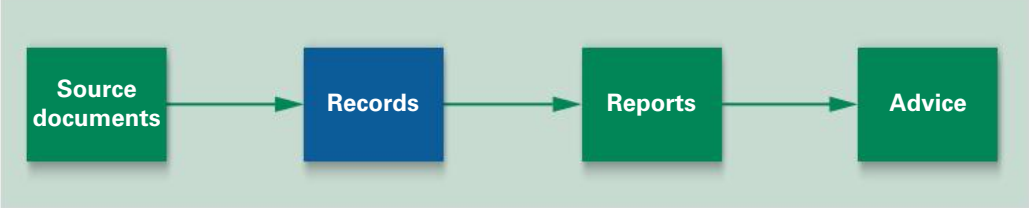
See Section 11.1 for a more detailed discussion of ethical considerations regarding purchasing inventory.

Chapter 11 outlined some of the ethical considerations involved in purchasing inventory, including whether the inventory is:

- safe, legal and 'socially responsible'
- produced in a socially and environmentally responsible manner
- able to do what has been advertised
- priced fairly.

A business that does not factor ethical considerations into its purchasing decisions could encounter difficulties as customers may be unwilling to purchase 'unethical' items. Indeed, there may be an advantage in purchasing items from socially and environmentally responsible suppliers, with consumers more willing to purchase these items (and sometimes at a higher price) from an honest and ethical business.

Recording: Purchases Journal



Every credit purchase should be verified by a purchase invoice, but a collection of invoices does not represent usable Accounting information, so a trading business uses a Purchases Journal to summarise all purchases of inventory on credit during a particular period.

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Example

During April 2030 Uptown Ceramics had the following transactions:

April 3 Purchased inventory on credit from A. Potter Studios for $400 plus $40 GST (Inv. 29)

3 Paid $220 to Account Payable – Stoneware House (EFT 68)

8 Purchased inventory from Pots 'n' Pitchers for $429 including $39 GST (Inv. X401)

9 Paid $440 to Account Payable* – A. Potter Studios for settlement of account (EFT 5261)

15 Bought inventory from A. Potter Studios worth $600 plus GST (Inv. 35)

19 Paid $200 to Account Payable* – Pots 'n' Pitchers (EFT 75)

20 Purchased pottery products from Stoneware House for $385 including GST (Inv. AV12)

21 Paid Account Payable* – A. Potter Studios for settlement of account (EFT 2643)

23 Credit purchase from Pots 'n' Pitchers for $420 plus GST (Inv. X432)

29 Purchased inventory from A. Potter Studios for $330 including GST (Inv. 39)

* Please note that for the first example, payments to Accounts Payable will not take discount received into account. This will occur in section 13.6.

The description and the source document (invoice) can be used to identify the credit purchases, and Figure 13.2 shows how these transactions would be recorded in the Purchases Journal for Uptown Ceramics for April 2030:

Figure 13.2 Purchases Journal

Purchases Journal

Date	Account Payable	Inv. No.	Inventory	GST	Accounts Payable
Apr. 3	A. Potter Studios	29	400	40	440
8	Pots 'n' Pitchers	X401	390	39	429
15	A. Potter Studios	35	600	60	660
20	Stoneware House	AV12	350	35	385
23	Pots 'n' Pitchers	X432	420	42	462
29	A. Potter Studios	39	300	30	330
	TOTALS	**$**	2 460	246	2 706

As was the case for a Purchases Journal for a *service* business, transactions are recorded in the Purchases Journal for a *trading* business on the date they occur, with each transaction identifying the name of each individual Account Payable. (A separate record will be maintained elsewhere for each individual Account Payable). The source document (the purchase invoice number) is recorded so that the details of each transaction can be checked, upholding *Verifiability* and ensuring the information provides a *Faithful representation* of the financial events.

Study tip

Purchase invoices do not run in sequence in the Purchases Journal because they are issued by the firm's suppliers (who will also issue invoices to all of their other customers).

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Classification columns

The Inventory column records the value of the inventory that has been purchased (its cost price, excluding GST), which will also be recorded in the inventory card, with the GST column showing the GST charged on the purchase, calculated as 10% of the price of the purchase (as recorded in the Inventory column). The Accounts Payable column shows the total amount owed to Accounts Payable, calculated by adding together the value of the inventory purchased and the GST.

Just as the GST paid to suppliers (discussed in Chapter 7) will be forwarded to the ATO by the supplier, so too will the GST on credit purchases. As a result, any GST the business pays or incurs on its own purchases can be deducted from its GST liability.

Effect on the Accounting equation

The overall effect of total credit purchases on the Accounting equation of Uptown Ceramics as at 30 April 2030 would be:

	Increase/Decrease/No effect	Amount $
Assets	Increase (Inventory)	2 460
Liabilities	Increase (increase Accounts Payable $2 706, decrease GST payable $246)	2 460
Owner's equity	No effect	

By recording all the credit purchases in the Purchases Journal, the business has a summary of how much inventory it has purchased on credit during the period. In this case, Uptown Ceramics has purchased $2 460 worth of inventory during April 2030. As a result, it has been charged GST of $246, meaning that the amount it owes to its Accounts Payable has increased by a total of $2 706.

Ethical considerations

Review questions 13.2

1 **Explain** why a trading business should include ethical considerations when purchasing inventory.
2 **Explain** what the potential impacts on the financial statements could be regarding the ethical considerations you raised in the previous question.
3 **Explain** the role of the Purchases Journal for a trading business.
4 **Identify** the source document used to verify all transactions in the Purchases Journal.
5 **Explain** the effect of 'GST on credit purchases' on:
   - the valuation of inventory
   - GST payable.
6 Referring to the Purchases Journal, **state** one reason why the amount recorded in the Accounts Payable column is greater than the value of inventory purchased.
7 **State** the effect of a credit purchase of inventory on the Accounting equation.

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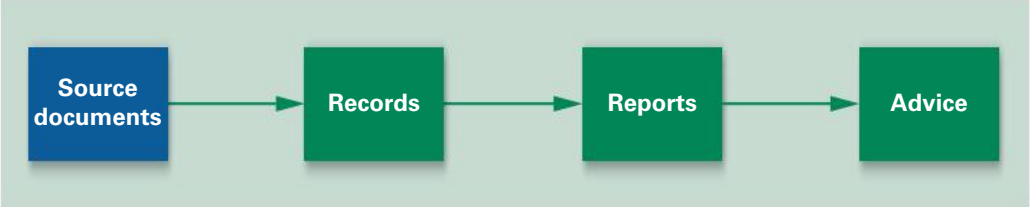
13.3 Payments to Accounts Payable

Whereas a credit purchase is recorded in the Purchases Journal on the day the inventory is purchased, the other half of the transaction – the payment of cash to the Account Payable – is recorded like all cash payments: in the Cash Payments Journal, on the day the cash is paid.

Source document



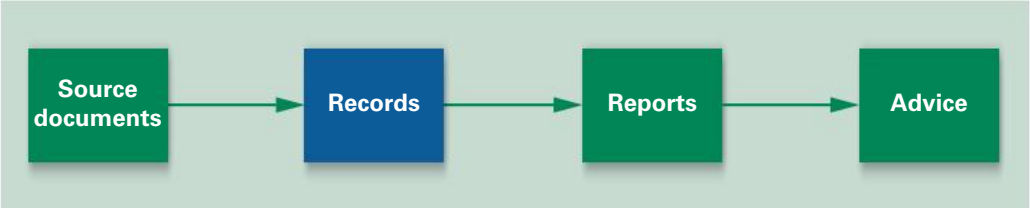
Payments to Accounts Payable will be made electronically via Electronic Funds Transfer (EFT). Figure 13.3 shows the EFT payment receipt that provides evidence of a payment to Account Payable – A. Potter Studios:

Figure 13.3 Payment to an Account Payable: Electronic Funds Transfer receipt

Transaction details	
Merchant	*A. Potter Studios*
Description	*Settlement of Account*
Account	*WIZ BANK 555-000 123456*
Scheduled payment date	*09 April 2030*
Amount	*-$440*
Transaction ID	*add21267-ee2a-4704-8d5d-125eebe5b3f9*
EFT receipt number	*5250373*
Type	*EFT*
From	*WIZ BANK 555-000 123456*
To	*A. Potter Studios*
Biller code	*132475*
Customer reference number	*88455427972*

On an EFT payment receipt, settlement of account indicates that the cash has been paid to an Account Payable (A. Potter Studios) to settle the amount outstanding. Note that there is *no* GST on a payment to an Account Payable, because the GST is recognised and reported only at the time the *purchase* is made.

Recording: Cash Payments Journal



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Like all cash payments, payments made to Accounts Payable are recorded in the Cash Payments Journal. Let's return to the earlier example for Uptown Ceramics, highlighting the payments made to Accounts Payable.

Example

During April 2030 Uptown Ceramics had the following transactions:

April 3 Purchased inventory on credit from A. Potter Studios for $400 plus $40 GST (Inv. 29)
3 Paid $220 to Account Payable – Stoneware House (EFT 68)
8 Purchased inventory from Pots 'n' Pitchers for $429 including $39 GST (Inv. X401)
9 Paid $440 to Account Payable – A. Potter Studios for settlement of account (EFT 5261)
15 Bought inventory from A. Potter Studios worth $600 plus GST (Inv. 35)
19 Paid $200 to Account Payable – Pots 'n' Pitchers (EFT 75)
20 Purchased pottery products from Stoneware House for $385 including GST (Inv. AV12)
21 Paid Account Payable – A. Potter Studios for settlement of account (EFT 2643)
23 Credit purchase from Pots 'n' Pitchers for $420 plus GST (Inv. X432)
29 Purchased inventory from A. Potter Studios for $330 including GST (Inv. 39)

These payments – together with any other cash payments – would be recorded in the Cash Payments Journal of Uptown Ceramics as shown in Figure 13.4:

Figure 13.4 Cash Payments Journal: Payments to Accounts Payable

Cash Payments Journal *

Date	Details	Source Document	Bank	Accounts Payable	Drawings	Wages	Sundries	GST
April 3	Stoneware House	EFT 68	**220**	220				
6	Wages	EFT 69	**750**			750		
7	Drawings	ATM 399	**600**		600			
9	A. Potter Studios	EFT 5261	**440**	440				
15	Electricity	BPAY 262	**275**				250	25
19	Pots 'n' Pitchers	EFT 75	**200**	200				
20	Wages	EFT 215	**750**			750		
21	Drawings	ATM 400	**600**		600			
	A. Potter Studios	EFT 2643	**660**	660				
28	Rent	267	**1320**				1200	120
	TOTALS	**$**	**5815**	**1520**	**1200**	**1500**	**1450**	**145**

*Other probable entries have been added to show a more complete Cash Payments Journal.

Payments to Accounts Payable will be frequent, and so are recorded in their own classification column, just like (in this example) Drawings, Wages and GST. Total cash paid to Accounts Payable by Uptown Ceramics in April 2030 is thus $1 520.

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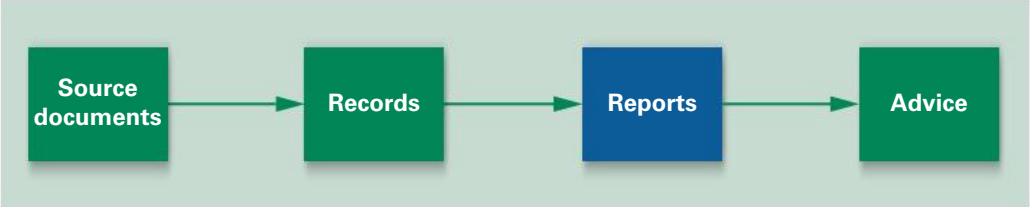
Effect on the Accounting equation

The overall effect of payments to Accounts Payable on the Accounting equation of Uptown Ceramics as at 30 April 2030 would be:

	Increase/Decrease/No effect	Amount $
Assets	Decrease (Bank)	1 520
Liabilities	Decrease (Accounts Payable)	1 520
Owner's equity	No effect	

Calculating Accounts Payable balance



With total credit purchases recorded in the Purchases Journal, and total payments to Accounts Payable recorded in the Cash Payments Journal, the total balance owed to Accounts Payable at the end of the period can now be calculated and reported in the Balance Sheet.

Assuming Uptown Ceramics owed $320 to its Accounts Payable as at 1 April 2030, its Accounts Payable balance as at 30 April 2030 would be calculated using the formula shown in Figure 13.5:

Figure 13.5 Accounts Payable formula

Accounts Payable balance at start	320	From the *previous* Balance Sheet (as at 1 April 2030)
+ Credit purchases including GST	2 706	From the Purchases Journal
	3 026	
– Payments to Accounts Payable	(1 520)	From the Cash Payments Journal
Accounts Payable balance at end	**$1 506**	**For the *next* Balance Sheet (as at 30 April 2030)**

This new balance of the total owed to Accounts Payable (of **$1 506**) can now be reported as a Current liability in the Balance Sheet for Uptown Ceramics as at 30 April 2030.

Review questions 13.3

1. **Identify** the source document used to verify cash paid to an Account Payable.
2. **Explain** why there is no GST to account for when cash is paid to an Account Payable.
3. **State** one reason why payments to Accounts Payable are recorded in their own classification column in the Cash Payments Journal.
4. **State** the effect of a payment to an Account Payable on the Accounting equation.
5. **Show** the formula to calculate the balance of Accounts Payable at the end of the period, identifying the sources of the information it uses.

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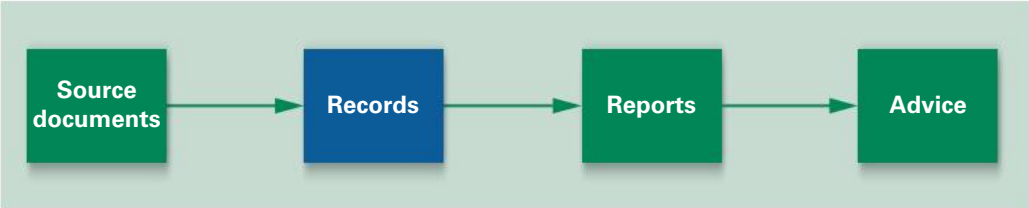
13.4 Subsidiary records: Accounts Payable

The Purchases Journal is essential in the preparation of the Accounting reports because it summarises total credit purchases for a period. However, this type of summarised information will be less useful in the micromanagement of inventory and Accounts Payable. The inventory cards (discussed in Chapter 11) provide detailed information relating to inventory, but additional subsidiary records are required to provide detailed information about Accounts Payable.

Accounts Payable records



Although we have recorded the total purchased from Accounts Payable, there is at present no record of the transactions with each individual Account Payable. This will be provided by maintaining a set of subsidiary records called **Accounts Payable records**, with a separate record for each individual Account Payable showing each individual transaction affecting that Account Payable's balance.

Accounts Payable record
a subsidiary Accounting record that records each individual transaction with each individual Account Payable, and shows the balance owing to that Account Payable at any point in time

Figure 13.6 shows the Accounts Payable records for Uptown Ceramics, after all credit purchases and payments to Accounts Payable for April 2030 have been recorded:

Figure 13.6 Accounts Payable records

Account Payable – A. Potter Studios

Date	Details	Document	Amount $	Balance $
April 3	Purchase (incl. GST)	Inv. 29	440	440
9	Payment	EFT 5261	(440)	–
15	Purchase (incl. GST)	Inv. 35	660	660
21	Payment	EFT 2643	(660)	–
29	Purchase (incl. GST)	Inv. 39	330	330

Account Payable – Pots 'n' Pitchers

Date	Details	Document	Amount $	Balance $
April 1	Balance			100
8	Purchase (incl. GST)	Inv. X401	429	529
19	Payment	EFT 75	(200)	329
23	Purchase (incl. GST)	Inv. X432	462	791

Account Payable – Stoneware House

Date	Details	Document	Amount $	Balance $
April 1	Balance			220
3	Payment	EFT 68	(220)	–
20	Purchase (incl. GST)	Inv. AV12	385	385

Each Accounts Payable record has the standard columns for Date, Details and Source document, with further columns to record the Amount of the transaction and the Balance.

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Like an inventory card, the Accounts Payable record has a running balance, which is adjusted after every transaction is recorded so that at any time the business can know exactly how much it owes to each Account Payable. Purchases (of inventory including GST) increase the balance owing, whereas cash paid (to Accounts Payable), purchase returns and discounts *decrease* that balance. (These last two types of transaction will be discussed in Section 13.5 and 13.6.)

The Accounts Payable schedule

To check that the same information has been recorded (albeit in a different form) in the journals and Accounts Payable records, an **Accounts Payable Schedule** (or Accounts Payable Reconciliation) is prepared by listing the name and balance of each individual Account Payable's record. This occurs at the end of the period, before the Balance Sheet is prepared.

Accounts Payable Schedule
a listing of the name and balance of each Accounts Payable record

Figure 13.7 shows the Accounts Payable Schedule for Uptown Ceramics as at 30 April 2030:

Figure 13.7 Accounts Payable Schedule

UPTOWN CERAMICS
Accounts Payable Schedule as at 30 April 2030

Account Payable	Balance $
A. Potter Studios	330
Pots 'n' Pitchers	791
Stoneware House	385
Balance as per Accounts Payable formula	**$1506**

The total of the Accounts Payable Schedule is calculated by adding together the balances of the individual Account Payable's records. If the transactions have been recorded correctly, this total (of **$1506**) should match the figure calculated using the Accounts Payable formula. (This can be checked in Figure 13.5.) This double-check ensures that the figure reported in the Current liabilities section of the Balance Sheet provides a *Faithful representation* of the balance of Accounts Payable – one that is complete and free from error.

In fact, it would be unethical to understate the balance owed to Accounts Payable by omitting an amount owed to an individual Account Payable as it would mean users could not rely on the Balance Sheet to make decisions. Fortunately, the preparation of an Accounts Payable Schedule reduces the possibility that this will occur.

Ethical considerations

Applying *Relevance* means that only the total Accounts Payable balance of **$1506** will be reported in the Balance Sheet, as the balances of each individual Account Payable are not likely to make a difference to the decision-making that this report supports. The individual details are available to assist the owner in managing Accounts Payable but are not necessary in a general-purpose report like the Balance Sheet.

Review questions 13.4

1. **Identify** two subsidiary records in which a credit purchase must be recorded.
2. **Explain** the role of Accounts Payable records.
3. **Identify** the types of transactions that will:
   - increase the balance of an Accounts Payable record
   - decrease the balance of an Accounts Payable record.
4. Referring to one Qualitative characteristic, **explain** the purpose of preparing an Accounts Payable Schedule.
5. **Explain** why it would be unethical to omit amounts owed to Accounts Payable from the Balance Sheet.

Ethical considerations

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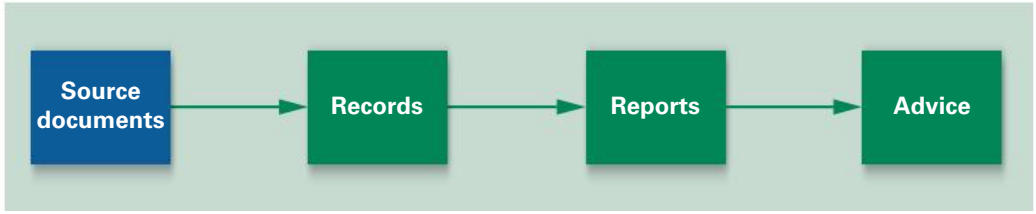
13.5 Purchase returns

Chapter 11 explained that for a variety of reasons it may be necessary for a business to return inventory to one of its suppliers by making a purchase return. A purchase return will be recorded in the OUT column of the relevant inventory card and so will decrease the value of inventory on hand. As a result, the business will no longer owe its supplier for that inventory or for the GST charged on that purchase. This decrease in the balance owed must be recorded in the Accounts Payable record for that supplier.

Example

On 30 April 2030, Uptown Ceramics returned inventory to Stoneware House worth $140 plus GST because it was damaged (Cr. Note CQ05).

Source document



As noted in Chapter 11, the source document to verify a purchase return will be the credit note issued by the supplier, with the name of the supplier noted at the top of the document and the name of 'our business' (in this case Uptown Ceramics) identified in the middle.

The credit note will identify not only what and how many items of inventory have been returned, but also a cost price for the inventory and a reason for the return.

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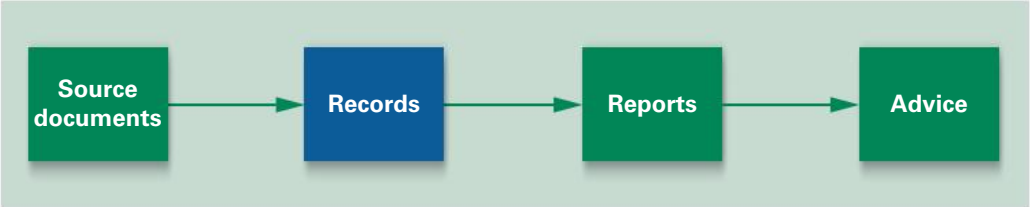
Recording: Accounts Payable record



This transaction would be recorded in the Accounts Payable record of Stoneware House as is shown in Figure 13.8:

Figure 13.8 Accounts Payable record: Purchase return

Account Payable – Stoneware House				
Date	Details	Document	Amount $	Balance $
April 1	Balance			220
3	Payment	EFT 68	(220)	–
20	Purchase (incl. GST)	Inv. AV12	385	385
30	Purchase return (incl. GST)	Cr. Note CQ05	(154)	231

Note that this decreases the amount owed to Stoneware House by $154: $140 for the inventory that has been returned and $14 for the GST that is no longer owed to the supplier.

Although the GST on the purchase return decreases the amount owed to the supplier, it actually increases the GST owed to the ATO, as Uptown Ceramics can no longer claim that part of its GST liability that will be paid to the ATO by its supplier – Stoneware House.

Effect on the Accounting equation

The effect of this purchase return on the Accounting equation of Uptown Ceramics as at 30 April 2030 would be the opposite of a credit purchase:

	Increase/Decrease/No effect	Amount $
Assets	Decrease (Inventory)	140
Liabilities	Decrease (decrease Accounts Payable $154, increase GST payable $14)	140
Owner's equity	No effect	

Ethical considerations

When returning inventory, it is important that a trading business acts ethically, returning inventory only within the terms of its relationship with the supplier. It may be possible to 'fool' a supplier occasionally by returning inventory that was actually damaged in the shop, but the reputational damage and loss of supply that could result from this unethical action may undermine longer term profitability.

Review questions 13.5

1 **Identify** the source document used to verify a purchase return and the two subsidiary records in which a purchase return must be recorded.
2 **Explain** how a purchase return affects the balance in an Accounts Payable record.
3 **State** the effect of a purchase return on the Accounting equation.

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13.6 Discount revenue

settlement discount a reduction in the amount paid by a credit customer in return for early repayment

discount revenue a revenue in the form of a decrease in liabilities (Accounts Payable) and an increase in owner's equity, earned when Accounts Payable are paid early and a settlement discount is given by the supplier

One of the more common options used by suppliers to encourage their credit customers to pay early is to offer a **settlement discount**, which rewards those customers by reducing the amount that they are required to pay. The discount itself is the amount that will not have to be paid but will still be deducted from the amount owing.

The discount offered by the supplier reduces the amount paid (to the Account Payable) in return for that payment being made early, with this **discount revenue** decreasing liabilities (Accounts Payable) and increasing owner's equity (without requiring a decrease in Bank or any other asset).

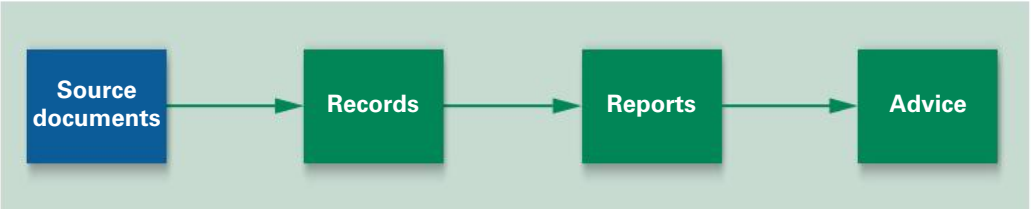
Let's return to the earlier example, concentrating on the transactions with A. Potter Studios but this time considering the settlement discount.

Example

During April 2030, Uptown Ceramics had the following transactions with A. Potter Studios:

April	3	Purchased inventory on credit from A. Potter Studios for $400 plus $40 GST (Inv. 29)
	9	Paid Account Payable – A. Potter Studios for settlement of account (EFT 5261)
	15	Bought inventory from A. Potter Studios worth $600 plus GST (Inv. 35)
	21	Paid Account Payable – A. Potter Studios for settlement of account (EFT 2643)
	29	Purchased inventory from A. Potter Studios for $330 including GST (Inv. 39)

Source document



The source document for a payment to an Account Payable will be the same with or without a discount and will most likely be an EFT receipt. In this example, the payment is verified by an EFT receipt and notes that it is for settlement of account, confirming both that it is a payment to an Account Payable and also that it will reduce to zero the balance owed to that supplier.

However, to determine whether a discount applies and, if so, the amount of the discount, it is necessary to check the payment document against the purchase invoice, the terms noted on the invoice, and the date of both the purchase and the payment. In Figure 13.1 the credit terms of this purchase were noted at 5/7, n/60. This means Uptown Ceramics has 60 days to pay the net amount (balance owing) on the invoice, but if it pays within 7 days it will receive a discount of 5% of the total invoice price.

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Calculating the discount

The payment made on 9 April 2030 falls just within the 7 day discount period from the purchase date of 3 April 2030 meaning Uptown Ceramics it is entitled to a discount of 5%.

The discount revenue earned on 9 April 2030 would be calculated as is shown in Figure 13.9:

Figure 13.9 Calculation: Discount revenue

Discount revenue = Discount rate × Amount owing
= 5% × $440
= $22

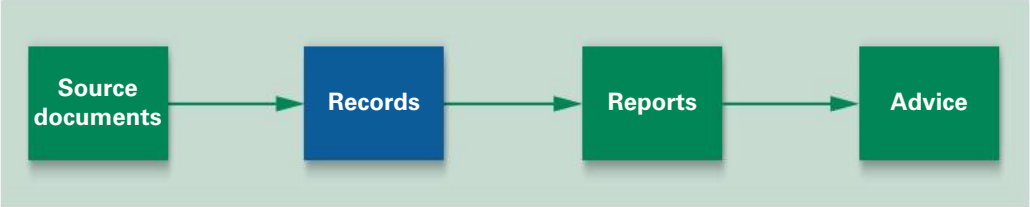
By paying early, Uptown Ceramics earns a discount of 5% on the full balance of $440 (including the GST) that it owes to A. Potter Studios. This discount of $22 means it is only required to pay $418, but the balance it owes to A. Potter Studios is reduced by the total amount of $440 ($418 plus $22).

The same process would be used to calculate the discount earned on 21 April 2030, leading to Discount revenue of $33 and a Cash payment of $627 but an overall reduction in the amount owed to A. Potter Studios of $660.

Study tip

In credit terms, the second and fourth numbers refer to the number of days.

Recording: Cash Payments Journal



Given the discount revenue earned, the amounts paid to A. Potter Studios on 9 and 21 April 2030 would reduce, and be recorded in the Cash Payments Journal as shown in Figure 13.10.

Study tip

GST can be adjusted so that businesses do not have to absorb the GST they do not collect, but this is beyond the scope of this course.

Figure 13.10 Cash Payments Journal: Payments to Accounts Payable with discount

Cash Payments Journal*

Date	Details	Source Document	Bank	Discount revenue	Accounts Payable	Drawings	Wages	Sundries	GST
April 3	Stoneware House	EFT 68	220		220				
6	Wages	EFT 69	750				750		
7	Drawings	ATM 399	600			600			
9	A. Potter Studios	EFT 5261	**418**	**22**	440				
15	Electricity	BPAY 262	275					250	25
19	Pots 'n' Pitchers	EFT 75	200		200				
20	Wages	EFT 215	750				750		
21	Drawings	ATM 400	600			600			
	A. Potter Studios	EFT 2643	**627**	**33**	660				
28	Rent	267	1 320					1 200	120
	TOTALS	**$**	**5 760**	**55**	**1 520**	**1 200**	**1 500**	**1 450**	**145**

*Other probable entries have been added to show a more complete Cash Payments Journal.

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The cash actually paid to Accounts Payable is recorded in the Bank column in the usual way, but any Discount revenue is recorded in its own column, with the amount recorded in the Accounts Payable column reflecting the total by which the amount owed will decrease; that is, the cash paid *plus* the discount revenue.

In this example, $418 cash has been paid to A. Potter Studios on 9 April, so this amount is recorded in the Bank column. In addition, the discount of $22 is recorded in the Discount revenue column. Together, the cash paid plus the discount revenue ($418 plus $22) means a total reduction in the balance owed to A. Potter Studios of **$440**, so it is this total that is recorded in the Accounts Payable column. The same process is followed on 21 April. A total reduction is shown in the Accounts Payable column for $660, which comprises of the amount actually paid of $627 in the Bank column and the discount revenue amount of $33.

This would reduce the overall Cash payments to $5 760, which includes payments to Accounts Payable of $1 465, but by including the Discount revenue of $55, the balance owed to Accounts Payable would still reduce by the full **$1 520**.

Study tip

Due to the discount revenue, the amount recorded in the Accounts Payable column should be larger than the amount recorded in the Bank column.

Double-checking mechanism

In the Cash Payments Journal, the total of the Bank column plus the Discount revenue column should equal the sum of the totals of the other (classification and Sundries) columns.

Using the figures from the Cash Payments Journal in Figure 13.10, the double-check would show:

Bank	5 760	=	Accounts Payable	1 520
Discount revenue	55	+	Drawings	1 200
		+	Wages	1 500
		+	Sundries	1 450
		+	GST	145
Total	**5 815**		**Total**	**5 815**

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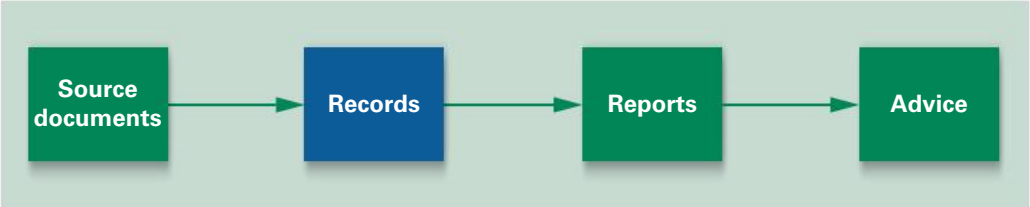
Recording: Accounts Payable record



The two payments to A. Potter Studios – both of them involving discounts – would be recorded in the Accounts Payable records as shown in Figure 13.11:

Figure 13.11 Accounts Payable record: Discount revenue

Account Payable – A. Potter Studios				
Date	Details	Document	Amount $	Balance $
April 3	Purchase (incl. GST)	Inv. 29	440	440
9	Payment/Discount revenue	EFT 5261	(440)	–
15	Purchase (incl. GST)	Inv. 35	660	660
21	Payment/Discount revenue	EFT 2643	(660)	–
29	Purchase (incl. GST)	Inv. 39	330	330

Effect on the Accounting equation

Using the transaction on 9 April 2030 as an example, a payment to settle an Account Payable where discount revenue is involved will have the following effect on the Accounting equation:

	Increase/Decrease/No effect	Amount $
Assets	Decrease (Bank)	418
Liabilities	Decrease (Account Payable)	440
Owner's equity	Increase (Discount revenue increases Net Profit)	22

Benefits and costs

While paying Accounts Payable early may generate discount revenue, it is not without its costs and may not be suitable in all business circumstances. As is the case with many decisions, the owner must weigh the potential benefits of paying early against any potential costs.

Benefits

- Less cash is paid to Accounts Payable, meaning a small amount of cash is retained to make other payments such as wages or other expenses.
- Net Profit is increased, as the discount earned is revenue.

Costs

- Cash is paid to Accounts Payable faster, meaning there may be less time to generate cash from sales.
- Cash is unavailable to make other payments, such as wages or other expenses.

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Calculating Accounts Payable balance

With these two new transactions in mind, the formula to calculate the balance of Accounts Payable must be amended. Figure 13.12 shows the formula to calculate the balance of Accounts Payable, taking into consideration purchase returns and discount revenue:

Figure 13.12 Accounts Payable formula: amended

Accounts Payable balance at start	320	From the *previous* Balance Sheet (as at 1 April 2030)
+ Credit purchases including GST	2 706	From the Purchases Journal
	3 026	
– Purchase returns including GST	(154)	
– Payments to Accounts Payable	(1 465)	From the Cash Payments Journal
– Discount revenue	(55)	
Accounts Payable balance at end	**$1 352**	**For the *next* Balance Sheet (as at 30 April 2030)**

This new balance of the total owed to Accounts Payable (of **$1 352**) can be checked against the Accounts Payable Schedule to verify its accuracy (but remember that the amount owed to Accounts Payable – Stoneware House has reduced by $154 due to the purchase return, which had not been accounted for in Figure 13.7).

Review questions 13.6

1. **Define** the term 'settlement discount'.
2. **Explain** why discounts received from Accounts Payable are classified as revenue.
3. **Explain** what is meant by the terms '5/7, n/60'.
4. **Identify** the source documents used to verify a payment to an Accounts Payable where a discount is involved.
5. **State** the effect of a payment to an Account Payable with discount revenue on the Accounting equation.
6. **List** the benefits of paying Accounts Payable early.
7. **List** the costs of paying Accounts Payable early.
8. **Show** the formula to calculate the balance of Accounts Payable at the end of the period, taking into account purchase returns and discounts.

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13.7 Statement of Account

As noted in Chapter 6, a Statement of Account provides a summary of all the transactions in a particular period with a particular Account Receivable or Account Payable. Because these transactions have already occurred – and have already been recorded – the Statement of Account is not a source document that must be recorded, but rather a document that can be used to verify the balance of an Account Payable or Account Receivable record.

Figure 13.13 shows the Statement of Account from Account Payable – A. Potter Studios for April 2030:

Figure 13.13 Statement of Account

A. Potter Studios
ABN: 90 876 444 361
35 Rosella St, Frankston, VIC 3199

STATEMENT OF ACCOUNT

Account of:	Uptown Ceramics 12 South Gate Way, Langwarrin, Victoria, 3910 ABN: 33 020 871 455		**For period:** April 2030	
Date	**Description**	**Sales**	**Payments**	**$**
April 3	**Sale: Inv. 29**	**440**		440
9	Payment received: (EFT 5261) Discount given		418 22	–
15	**Sale: Inv. 35**	**660**		660
21	Payment received: (EFT 2643) Discount given		627 33	–
29	**Sale: Inv. 39**	**330**		330
	Balance owing: 30 April 2030			**$330**

This Statement of Account summarises the various credit purchases (including GST) made by Uptown Ceramics during April 2030, as well as the cash payments it made and the discount revenue it earned by making those payments early. If Uptown Ceramics had made any purchase returns to A. Potter Studios, these would also appear on this statement. It may be a reminder to pay the Account Payable the balance owing, but no further recording is required when this statement is received.

However, each transaction should be checked firstly against the source document that was issued at the time, and then against what has been recorded in the Accounts Payable record to ensure *Verifiability*. (Note that the final balance of **$330** is the same as that shown in the Accounts Payable record in Figure 13.11.) This checking ensures that the Accounts Payable record for A. Potter Studios provides a *Faithful representation* of the amount owing, helping to ensure an accurate figure for Accounts Payable overall.

If any discrepancies are detected, the business should make a further check against the actual source documents used to verify the individual transactions, and then contact the supplier to discuss correcting the situation. Ethically, this should include not just the cases where the supplier reports on the Statement of Account a balance *higher* than that actually owed (perhaps due to a failure to record a return or a payment), but also if the balance is *lower* than that actually owed (perhaps due to a failure to report a credit purchase).

Ethical considerations

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Ethical considerations

Review questions 13.7

1 **Explain** the purpose of a Statement of Account.
2 **Explain** how a Statement of Account can be used to ensure the reports provide a Faithful representation of the firm's financial position.
3 **Suggest** one ethical dilemma that may be discovered through the use of a Statement of Account.

13.8 Benefits of using subsidiary records for Accounts Payable

When combined with the recording in the Purchases Journal and Cash Payments Journal, Accounts Payable records assist with:

- **Detection of errors**
  By checking the balance calculated using the formula against the Accounts Payable Schedule, errors can be detected, thus helping to ensure that the figures used in the Balance Sheet are complete and free from error, and provide a *Faithful representation* of the amount owing to Accounts Payable.
- **Ease of reporting**
  By preparing an Accounts Payable Schedule, only one figure needs to be reported in the Balance Sheet, with insignificant details omitted. These details – like the names and balances of individual Accounts Payable – would not affect decision-making, so in reporting just the total, *Relevance* is upheld.
- **Management of Accounts Payable**
  The records of individual transactions with each individual Account Payable allow for better management by helping to ensure that invoices are received and checked, and debts are paid to Accounts Payable on time leading to the earning of discount revenue. Responsibility for carrying out these actions can be allocated to specific staff members, increasing effectiveness and efficiency.

Review questions 13.8

1 **Explain** how subsidiary records can ensure the reports provide a Faithful representation of amounts owing to Accounts Payable.
2 Referring to one Qualitative characteristic, **explain** why individual Accounts Payable are not reported in the Balance Sheet.
3 **Explain** how subsidiary records can improve the management of Accounts Payable.

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Where have we been?

- A credit transaction occurs when the goods are exchanged but the cash is not exchanged until a later date and is verified by an invoice.
- A credit purchase will be verified by a purchase invoice and recorded in the Purchases Journal, which summarises all credit purchases of inventory in a reporting period.
- Cash payments to Accounts Payable can be verified by an EFT or ATM receipt and are recorded in the Cash Payments Journal, which summarises all cash payments in a period.
- GST is recognised and reported only at the time the purchase is made, rather than when cash is paid to an Account Payable.
- Purchase returns reduce the balance owed to Accounts Payable but increase the balance owed to the ATO.
- Settlement discounts are offered to encourage customers to pay early.
- Discount revenue reduces both the cash paid and the balance owed to the Account Payable.
- Individual Account Payable records are maintained to aid in the recording, reporting and management of Accounts Payable.
- The balance of Accounts Payable at the end of the period can be calculated using either a formula or an Accounts Payable Schedule.
- The Accounts Payable Schedule is used to check the balance at the end of the period.

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Exercises

Please note: asterisks indicate that an answer for that question is available in the Selected Answers section at the end of this book.

Exercise 13.1
Source documents

page 221

The following document was provided by the manager of Milliner Time, a hat shop in Toorak:

Felt Good Felts
(ABN: 33 209 111 023)
Warrnambool

Invoice: 65
Terms: 2/7, n/30
Tax Invoice

Charge to: Milliner Time (ABN: 40 321 440 646)
Toorak Rd, Toorak, 3142

Date 2030	Details	Qty	Unit price $	Total $
Nov 3	Ladies' hats, white	5	50	250
	GST (10%)			25
			Total	275

Required

a. **Identify** the source document. **Describe** the transaction it verifies.
b. **Explain** what is meant by the terms '2/7, n/30'.
c. **Record** this transaction in the Purchases Journal of Milliner Time.
d. **Explain** why the GST on credit purchases does not affect the valuation of inventory.
e. **State** the effect of this transaction on the Accounting equation of Milliner Time.

Exercise 13.2
Purchases Journal

page 222

Sparks Electrical Supplies has provided the following list of transactions for July 2030:

July 2 Credit purchase of inventory from ACDC Industries for $3600 plus $360 GST (Inv. AI61)
7 Bought inventory on credit from Scott Supplies for $4400 including $400 GST (Inv. 633)
16 Purchased inventory from Mickle and Sons for $3300 inclusive of GST (Inv. M15)
23 Purchased inventory from Scott Supplies for $2860 including $260 GST (Inv. 642)
28 Received delivery of inventory from ACDC Industries, at a cost of $2700 plus $270 GST (Inv. AI73)

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Required

a. **Explain** the role of the Purchases Journal.

*** b.** **Record** the transactions for July 2030 in the Purchases Journal of Sparks Electrical Supplies.

c. **Explain** why the source documents in the Purchases Journal do not run in sequence.

d. **Explain** the effect of 'GST on credit purchases' on the GST payable to the ATO.

Exercise 13.3
Purchases Journal and Cash Payments Journal

page 223

Shoes by Imelda purchases all its inventory on credit. As at 31 August 2030, its Account Payable records showed the following balances:

Style House	$500
Fine Footwear	1 200
Johnny Choose	830
Balance of Accounts Payable as at 31 August 2030	**$2530**

During September 2030, the following transactions occurred:

Sept.	1	Paid Fine Footwear $900 (EFT 1272)
	3	Purchased shoes on credit from Johnny Choose for $420 plus $42 GST (Inv. 34A)
	7	Paid wages – $720 (EFT 29)
	8	Purchased inventory from Style House for $825 including $75 GST (Inv. 1002)
	11	Paid $5 500 including GST for new office equipment (EFT 2573)
	14	Owner withdrew $450 cash (ATM Rec. 85)
	16	Purchased inventory from Fine Footwear for $360 plus GST (Inv. FF331)
	19	Paid Style House $700 (EFT 2794)
	21	Paid wages – $780 (EFT 30)
	24	Credit purchase of inventory from Style House for $660 including GST (Inv. 1017)
	27	Cash drawings – $490 (ATM Rec. 86)
	30	Paid Johnny Choose $700 (EFT 6275)

Required

*** a.** **Record** the transactions for September 2030 in the journals of Shoes by Imelda.

b. **Explain** the effect of the transaction on 30 September 2030 on the Balance Sheet of Shoes by Imelda.

c. **Calculate** the balance of Accounts Payable as at 30 September 2030.

d. **Explain** why there is no GST to account for when cash is paid to an Account Payable.

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Exercise 13.4
Journals and Accounts Payable

page 225

Macedon Mowers sells mowers and other gardening equipment. All inventory is purchased on credit, and as at 31 March 2030 its Account Payable records showed the following balances:

Bushman Tools	$12 000
Viking Equipment	8 000
Malegar Mowers	13 900
Balance of Accounts Payable as at 31 March 2030	**$33 900**

During April 2030, the following transactions occurred:

April 2	Paid Viking Equipment $6 000 (EFT 8104)
5	Owner withdrew $1 200 cash (ATM Rec. 11)
7	Purchased 10 mowers from Malegar Mowers for $260 plus $26 GST each (Inv. 008)
8	Paid $940 wages (EFT 23)
10	Paid Malegar Mowers $10 000 (EFT 1705)
12	Bought chainsaws from Viking Equipment for $6 000 plus $600 GST (Inv. VT15)
13	Paid electricity bill $190 plus $19 GST (BPAY 5066)
18	Purchased mowers from Malegar Mowers for $8 250 including $750 GST (Inv. 019)
19	Paid Viking Equipment $4 000 (EFT 1907)
21	Owner withdrew $500 cash (ATM Rec. 12)
22	Paid $870 wages (EFT 24)
23	Purchased inventory from Bushman Tools for $8 800 including GST (Inv. 401C)
24	Paid Malegar Mowers $3 500 (EFT 7108)
27	Paid $143 for water bill including GST (BPAY Rec. 1039)
28	Bought chainsaws from Viking Equipment for $5 000 plus $500 GST (Inv. VT26)
29	Paid Bushman Tools $12 000 (EFT 4110)

As at 1 April 2030, the inventory card showed five mowers on hand worth $250 each.

Required

* **a.** **Record** the transactions for April 2030 in the journals of Macedon Mowers.
b. **Record** the transaction on 7 April 2030 in the inventory card for mowers.
c. **Record** the transactions for April 2030 in the Accounts Payable records of Macedon Mowers.
d. **Prepare** an Accounts Payable Schedule for Macedon Mowers as at 30 April 2030.
e. **Explain** how the preparation of an Accounts Payable Schedule can ensure the Accounting reports provide a Faithful representation of the amount owed to Accounts Payable.

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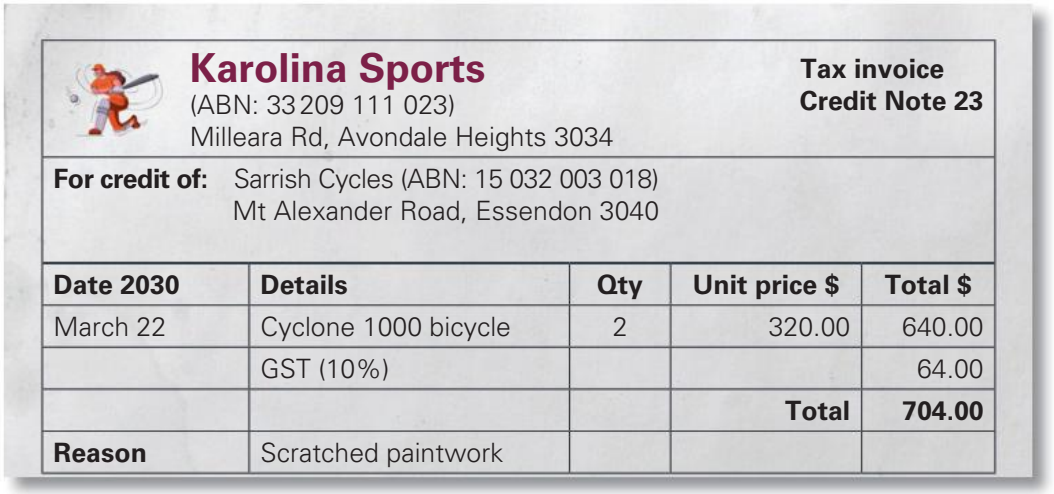
Exercise 13.5
Credit note

page 227

Sarrish Cycles sells bikes and other cycling equipment and has provided the following document:



Karolina Sports
(ABN: 33 209 111 023)
Milleara Rd, Avondale Heights 3034

Tax invoice
Credit Note 23

For credit of: Sarrish Cycles (ABN: 15 032 003 018)
Mt Alexander Road, Essendon 3040

Date 2030	Details	Qty	Unit price $	Total $
March 22	Cyclone 1000 bicycle	2	320.00	640.00
	GST (10%)			64.00
			Total	**704.00**
Reason	Scratched paintwork			

As at 28 February 2030, Sarrish Cycles had five Cyclone 1000 bikes on hand that it had purchased for $300 (plus GST) each and seven that it had purchased for $320 (plus GST) each. At this time it owed $5 500 to Karolina Sports.

Required

a. **Identify** the document and the type of transaction it verifies.
b. **Record** this transaction in the inventory card for Cyclone 1000 bikes.
c. Referring to your answer to part **b**, **explain** why it is not necessary to know whether Sarrish Cycles uses Identified Cost or FIFO to value its inventory.
d. **Record** this transaction in the Account Payable record of Karolina Sports.
e. **State** the effect of this transaction on the Accounting equation of Sarrish Cycles.

Exercise 13.6
Purchase returns

page 228

Amoré Décor sells paintings, prints and other decorations. All inventory is purchased on credit from Daglish Designs and as at 31 October 2030 the records showed the following balances:

Inventory on hand: Chamber series	$1 000 (20 prints at $50 each)
Account Payable – Daglish Designs	$4 200
Method used:	FIFO

During November 2030, the following transactions occurred:

Nov. 2	Purchased 10 copies of the Chamber series for $60 plus GST each (Inv. 76)
15	Paid Daglish Designs $3 000 (EFT 45)
23	Returned 2 of the items purchased on 2 November 2030 due to damage (Cr. Note 42)

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Required

a. **Identify** the journals in which the following documents would be recorded in the accounts of Amoré Décor:
- Invoice 76
- EFT 45.

b. **Explain** how Invoice 76 would be recorded in the journals of Daglish Designs.

c. **Record** the transactions for November 2030 in the inventory card for Chamber series prints.

d. **Record** the transactions for November 2030 in the Accounts Payable record for Daglish Designs.

e. **Explain** the effect on the Accounting equation of the transaction on 23 November 2030.

f. **Referring** to your answers to parts **c** and **d**, **discuss** whether the closing balances of these two subsidiary records would be reported in the Balance Sheet of Amoré Décor.

Exercise 13.7
Discount revenue

page 230

Macarthur Park sells garden furniture and as at 1 January 2030 it owed $600 to Account Payable – Charlie Luu. Inventory is purchased on credit terms of 5/7, n/60 and during January 2030 the following transactions occurred:

Jan.	4	Paid Charlie Luu $600 (EFT 17)
	17	Purchased inventory from Charlie Luu for $4 000 plus GST on terms of 5/7, n/60 (Inv. 115)
	21	Paid Charlie Luu in full settlement of account (EFT 24)
	28	Purchased inventory from Charlie Luu for $5 500 including GST on terms of 5/7, n/60 (Inv. 128)

Required

a. **Explain** why a discount received from Accounts Payable is recognised as revenue.

b. Referring to the transaction on 21 January 2030, **calculate**:
- the discount revenue earned
- the cash paid to Account Payable – Charlie Luu.

c. **Explain** the effect of the transaction on 21 January 2030 on the Accounting equation of Macarthur Park.

d. **Record** the transactions for January 2030 in the Accounts Payable record for Charlie Luu.

e. **Calculate** the final date on which Macarthur Park could pay Charlie Luu for Invoice 128 and still be eligible to receive a discount.

f. **Discuss** whether Macarthur Park should pay Charlie Luu early for Invoice 128.

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Exercise 13.8
Recording in journals and Accounts Payable

page 232

Diana Adams is the owner of Diana's Jewellery, which had the following balances in its Balance Sheet as at 31 January 2030:

Accounts Payable:
– Beads and Stones $8 800
– Carter Diamonds $7 150

Diana has provided the following list of transactions for February 2030:

Feb.	1	Paid GST owing to ATO $1 700 (EFT 2015)
	3	Paid Beads and Stones $8 360 for balance from January, receiving 5% discount (EFT 26)
	4	Credit purchase from Precious Inc. for $5 100 plus GST (Inv. 1702)
	5	Cash purchase of display cabinets for $16 500 including GST (EFT 3201)
	7	Paid Carter Diamonds full amount owing (EFT 29)
	9	Purchased inventory from Beads and Stones for $4 000 plus GST (Inv. 65)
	10	Paid rent for February 2030: $2 400 plus GST (BPAY Rec. 2702)
	12	Returned inventory worth $4 500 plus GST to Precious Inc. (Cr. Note 12)
	14	Paid wages $1 200 (EFT 33)
	15	Paid Beads and Stones for Invoice 65, receiving 5% discount (EFT 36)
	17	Credit purchase from Carter Diamonds for $6 600 including GST (Inv. c311)
	20	Paid electricity bill of $110 including GST (BPAY 2039)
	22	Credit purchase from Beads and Stones for $7 920 including GST (Inv. 78)
	23	Paid Carter Diamonds for Invoice c311, receiving 8% discount (EFT 38)
	24	Cash drawings $1 000 (ATM Rec. 09)
	27	Paid wages $1 250 (EFT 43)
	28	Purchased jewellery from Carter Diamonds for $4 200 plus GST (Inv. c346)

Required

a. **Calculate** the discount revenue earned by Diana's Jewellery on:
- 3 February 2030
- 15 February 2030.

* **b.** Using the formula, **calculate** the balance of Accounts Payable as at 28 February 2030.

c. **Record** the transactions for February 2030 in the Accounts Payable records of Diana's Jewellery.

* **d.** **Prepare** an Accounts Payable Schedule for Diana's Jewellery as at 28 February 2030.

Diana has suggested that it wouldn't really matter if the balance owed to Precious Inc. was omitted from the Accounts Payable Schedule.

e. Referring to at least two Qualitative characteristics, **explain** why it would be unethical for Diana's Jewellery to omit amounts owed to Accounts Payable from its Balance Sheet.

Ethical considerations

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Exercise 13.9
Accounts Payable

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Peter Ohm owns and operates a small trading business called Shock Electrics. On 31 May 2030, the business had the following balances in its Accounts Payable records:

Accounts Payable

- Sparkwell $5 700
- Electron $15 000
- General PC $4 800

The journals for June 2030 showed the following:

Purchases Journal

Date	Account Payable	Inv. No.	Inventory	GST	Accounts Payable
June 4	Electron	158	2 400	240	2 640
12	Sparkwell	A206	6 000	600	6 600
23	General PC	48c	3 000	300	3 300
	TOTALS	**$**	**11 400**	**1 140**	**12 540**

Cash Payments Journal

Date	Details	Source Doc.	Bank	Discount Revenue	Accounts Payable	Drawings	Wages	Sundries	GST
June 1	Sparkwell	EFT 201	5 244	456	5 700				
3	Drawings	ATM 32	900			900			
6	General PC	EFT 1237	4 800		4 800				
7	Wages	EFT 202	2 000				2 000		
10	Advertising	EFT 2138	1 100					1 000	100
14	Sparkwell	EFT 203	6 072	528	6 600				
21	Wages	EFT 204	2 650				2 650		
29	Electron	EFT 5239	7 000		7 000				
	TOTALS	**$**	**29 766**	**984**	**24 100**	**900**	**4 650**	**1 000**	**100**

Additional information:

- Sparkwell provided a discount of $456 on 1 June 2030 and $528 on 14 June 2030.
- On 16 June 2030, Shock Electrics returned inventory to Electron worth $1 100 including GST (Cr. Note A34).

Required

a. **Explain** one weakness in the way Shock Electrics records its cash payments.

b. **Calculate** the percentage discount offered by Sparkwell.

* **c.** Using the formula, **calculate** the total owed to Accounts Payable as at 30 June 2030.

* **d.** **State** the effect of the following transactions on the Accounting equation of Shock Electrics:
  - 6 June 2030
  - 16 June 2030.

e. **Record** the transactions for June 2030 in the Accounts Payable records of Shock Electrics.

f. **Prepare** an Accounts Payable Schedule for Shock Electrics as at 30 June 2030.

g. Other than detecting errors, **explain** two benefits of recording transactions in subsidiary records.

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Exercise 13.10
Statement of Account

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The owner of The Artist's Palette has received the following source document in the mail:

Art World
ABN: 68 803 200 163
Flinders Lane
Melbourne Victoria 3000

5 April 2030
Account # 1002

STATEMENT OF ACCOUNT

Statement for: **The Artist's Palette**
(ABN: 54 629 471 822)
Flinders Lane
Melbourne 3000

Date	Particulars	Debit $	Credit $	Balance $
March 1	Balance b/fwd			1 100
3	Sale (Inv. 1772)	1 760		2 860
10	Cash received (EFT 132) Discount allowed		1 000 100	1 760
19	Return – excess inventory (Cr. Note 35)		440	1 320
24	Sale (Inv. 1786)	3 520		4 840
	Balance – 31 March 2030			**$4 840**

Required

a. Referring to one Qualitative characteristic, **explain** the function of a Statement of Account.

b. **Identify** whether Art World allows more or less than seven days for Accounts Payable to pay early and receive a discount. **Justify** your answer.

c. **Explain** the effect of the transaction on 10 March 2030 on the equities of The Artist's Palette.

d. Given it had no legal requirement to do so, **explain** why Art World may have chosen to accept the return of inventory on 19 March 2030.

e. **Prepare** the Accounts Payable record for Art World in the financial records of The Artist's Palette.

f. **Explain** how the balance owed by The Artist's Palette would be reported in the Balance Sheet of Art World as at 31 March 2030.

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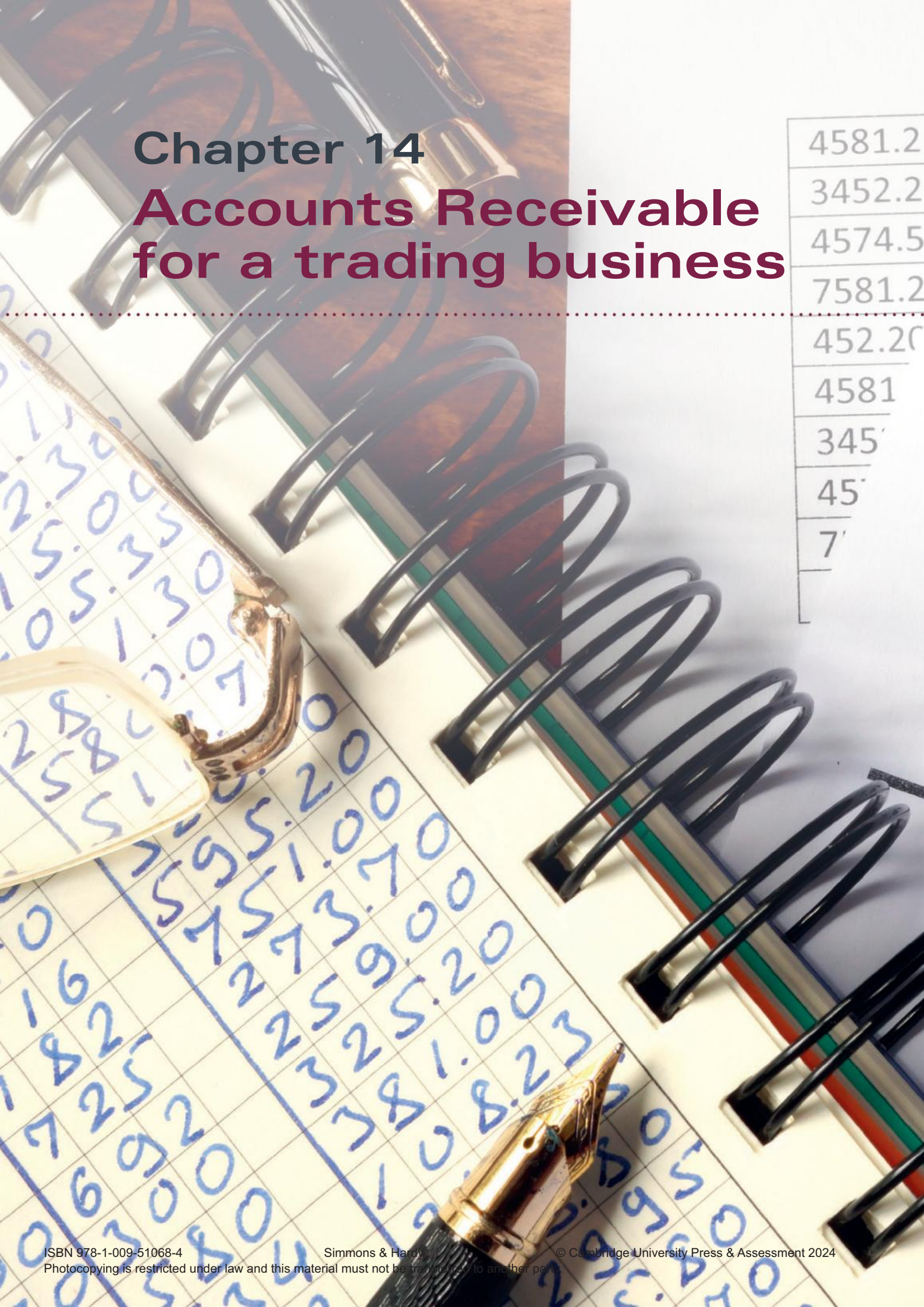

Chapter 14
Accounts Receivable for a trading business

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Learning intentions

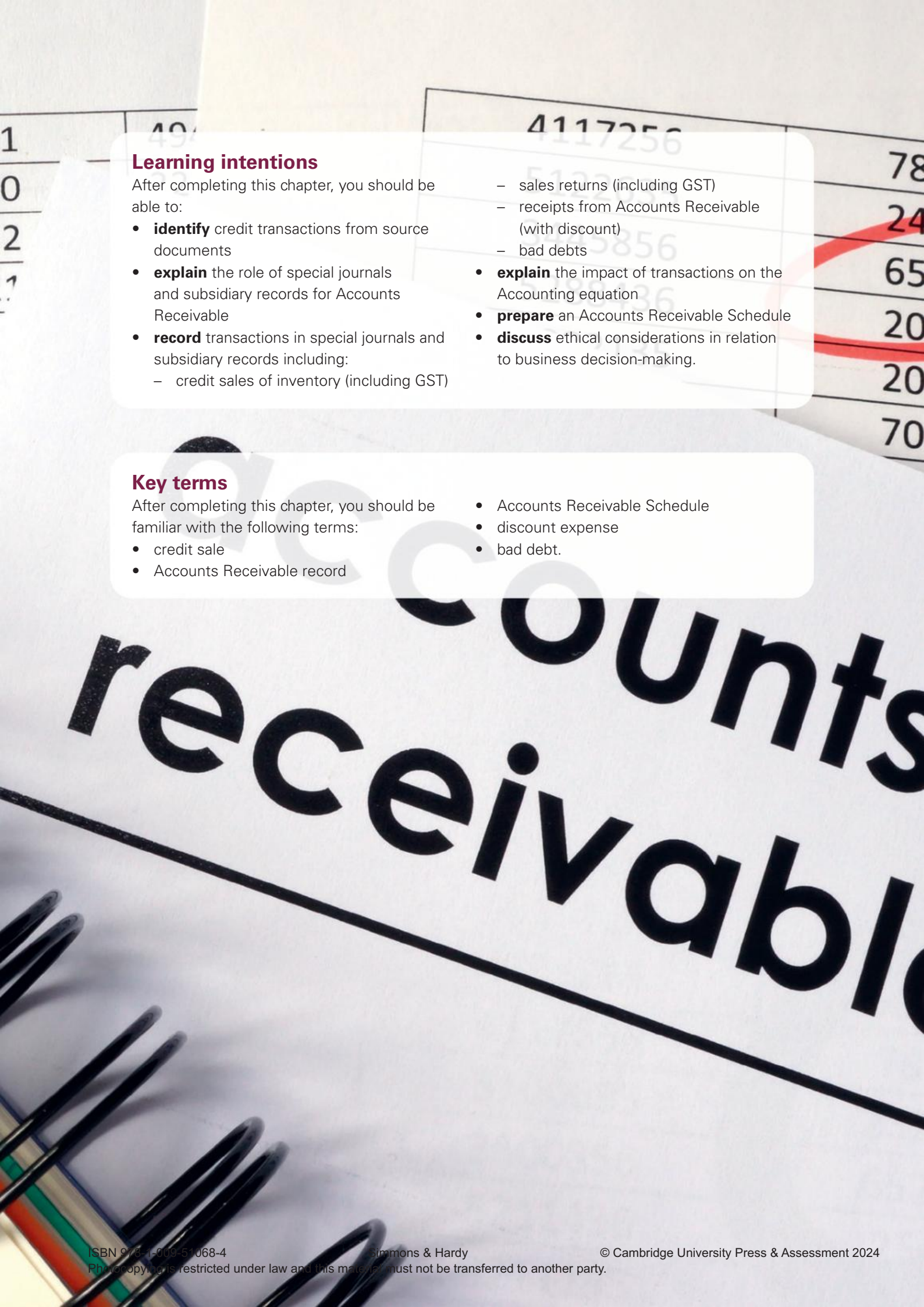
After completing this chapter, you should be able to:

- **identify** credit transactions from source documents
- **explain** the role of special journals and subsidiary records for Accounts Receivable
- **record** transactions in special journals and subsidiary records including:
  - credit sales of inventory (including GST)
  - sales returns (including GST)
  - receipts from Accounts Receivable (with discount)
  - bad debts
- **explain** the impact of transactions on the Accounting equation
- **prepare** an Accounts Receivable Schedule
- **discuss** ethical considerations in relation to business decision-making.

Key terms

After completing this chapter, you should be familiar with the following terms:

- credit sale
- Accounts Receivable record
- Accounts Receivable Schedule
- discount expense
- bad debt.



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14.1 Credit sales

credit sale
the provision of inventory to a customer who is not required to pay until a later date

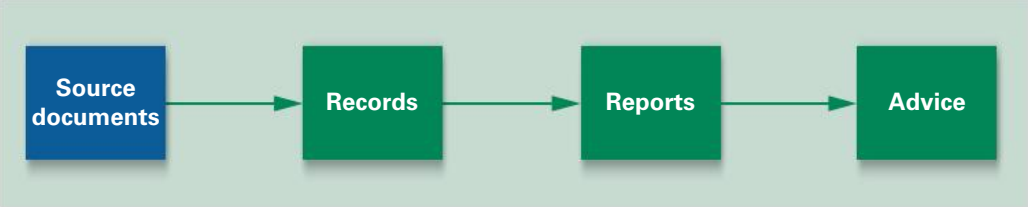
As with a cash sale, a **credit sale** increases revenue because it generates an increase in assets that leads to an increase in owner's equity. The only difference is that for a cash sale, the increase in assets is in the form of cash (so Bank increases), whereas for a credit sale, the asset that increases is Accounts Receivable.

Applying the Accrual basis assumption means that credit sales are recognised as revenue in the period in which the sale is made, as this is when the revenue is earned.

Example

On 6 April 2030, Uptown Ceramics sold 16 Egyptian vases to Stellar Gallery for $1 120 plus $112 GST (Inv. 91).

Source document: Sales invoice



The sales invoice for this credit sale is shown in Figure 14.1:

Figure 14.1 Sales invoice

Uptown Ceramics TAX INVOICE
12 Southgate Way
Langwarrin, Victoria, 3190
ABN: 33 020 871 455

Customer: Stellar Gallery Richmond, Victoria 3123 ABN: 15 032 003 018	6 April 2030 Invoice 91 Terms: 10/10, n/30

Item	Quantity	Unit Price	Total
Egyptian vases	16	70	1120
GST (10%)			112
Total			**$1 232**

Video 14.1
Interpreting a sales invoice

As with all invoices, the name of the seller – Uptown Ceramics – is shown at the top. The GST is recognised and reported at the time of the sale, so the sales invoice must show all the information necessary for it to be classified as a tax invoice, including the selling price of the inventory, the amount of the GST and the **total invoice price**.

Note that the invoice does *not* show the cost price of the sale, because the business selling the inventory does not want to show its customers the size of the mark-up it has applied. (Customers may be less willing to pay the selling price if they know how much profit the business is making!) As with cash sales, the cost price of the inventory sold would be determined in the inventory cards.

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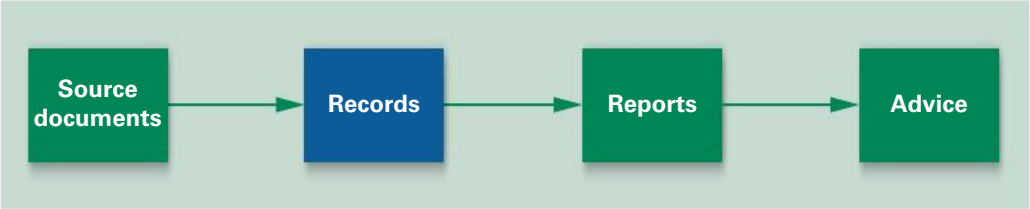
Recording: Sales Journal



Recording all credit sales in a Sales Journal allows the business to classify and summarise the transactions, so that total Credit sales can be reported with ease in the Income Statement.

Example

During April 2030, Uptown Ceramics had the following transactions:

April 5 Received $440 cash from Decorators' World in settlement of account (EFT Rec. 18)
6 Sold inventory on credit to Stellar Gallery for $1120 plus $112 GST (Inv. 91)
9 Credit sale for $990 including $90 GST to Home Junction (Inv. 92)
16 Sale of inventory to A. Minty for $660 plus GST (Inv. 93)
17 Received $1 000 cash from Accounts Receivable – Stellar Gallery (EFT Rec. 19)
18 Received $220 cash from Home Junction (EFT Rec. 20)
20 Sale to Decorators' World for **$880** including GST (Inv. 94)
23 Sold inventory to Stellar Gallery for **$473** including GST (Inv. 95)
28 Received $500 from Stellar Gallery (EFT Rec. 127)

Figure 14.2 shows the Sales Journal for Uptown Ceramics for April 2030:

Figure 14.2 Sales Journal

Sales Journal

Date	Account Receivable	Inv. No.	Sales	GST	Accounts Receivable
April 6	Stellar Gallery	91	1 120	112	**1 232**
9	Home Junction	92	900	90	**990**
16	A. Minty	93	660	66	**726**
20	Decorators' World	94	800	80	**880**
23	Stellar Gallery	95	430	43	**473**
	TOTALS	**$**	**3910**	**391**	**4301**

Study tip

Sales invoices run in sequence because they are issued by the firm that is preparing the Sales Journal.

Classification columns

The Sales column records the selling price of the inventory that has been sold, with the GST column showing the GST charged on the sale, calculated as 10% of the selling price. The Accounts Receivable column shows the total amount owed to the business, calculated by adding together the selling price charged to the customer and the GST on the sale.

Just as the GST on cash sales (discussed in Chapter 7) must be forwarded to the ATO, so too must the GST on credit sales. Any GST charged on credit sales is owed to the ATO, increasing the GST payable, but has no effect on revenue earned or Net Profit.

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By recording all the credit sales in a Sales Journal, the business has a summary of how much sales revenue has been earned from credit sales during the period. In this case, Uptown Ceramics has earned $3910 worth of sales during April 2030. In the process it has also charged its Accounts Receivable GST of $391, meaning that the amount it is owed by its **Accounts Receivable** has increased by a total of **$4301**.

Effect on the Accounting equation

Assuming the inventory cards determined Cost of Sales to be $1500, the overall effect of total credit sales on the Accounting equation of Uptown Ceramics as at 30 April 2030 would be:

	Increase/Decrease/No effect	Amount $
Assets	Increase (increase Accounts Receivable $4301, decrease Inventory $1500)	2801
Liabilities	Increase (GST payable)	391
Owner's equity	Increase (Sales revenue $3910 less Cost of sales $1500)	2410

Ethical considerations

Ethical considerations

While the aim of a trading business is to make profit by buying and selling inventory, the owner must be mindful of ethical considerations when making business decisions. These might include:

- **Social effects of the items it holds for sale**
  While legal, some items have negative social consequences and the business must consider whether selling these products is helping or hurting the society in which it operates (and on which it depends). For instance, some businesses elect to only sell fair trade products, some will not sell products that could be considered to be disrespectful to specific social groups, and given the health effects, some businesses have made decisions to not sell alcohol or tobacco products.
- **Environmental effects of the items it holds for sale**
  Items that are produced, packaged or supplied in ways that harm the environment may also be harmful to a firm's profits as customers may elect to purchase alternative products, or even go to an alternative business. Many businesses have stopped selling products using palm oil and, even before they were banned, most businesses were in the process of discontinuing their use of plastic bags because of their effect on the environment. Customers now consider 'food miles' and their equivalents when making purchases, and businesses must consider changes like this in customers' behaviour to ensure they reflect the growing environmental concerns of their customers.
- **Advertising strategies used**
  Advertising strategies that are racist or sexist, or discriminatory and harm society in other ways, can be harmful to both society and profits. Businesses that consider their obligation to promote respect and tolerance rather than mistrust and prejudice are more likely to generate commitment and loyalty from their customers in return.

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- **Prices charged**
  Businesses are entitled to charge prices that generate profits, but in so doing must not exploit their customers. Prices may need to increase to reflect an increase in costs, but this should not take advantage of customers in times of need or difficulty. Children and the aged are sometimes targeted by unscrupulous businesses who overcharge and/or underdeliver on the promises they make about their products. Prices should fairly reflect the value of the inventory being provided.

Review questions 14.1

1 Referring to one Accounting assumption, **explain** why credit sales are recognised as revenue.
2 **Explain** the role of the Sales Journal for a trading business.
3 **Identify** the source document used to verify all transactions in the Sales Journal.
4 **Explain** how the cost price of a credit sale is determined.
5 **Explain** the effect of GST on credit sales on:
   - Net Profit
   - GST payable.
6 Referring to the Sales Journal, **state** one reason why the amount recorded in the Accounts Receivable column is greater than the sales revenue earned.
7 **State** the effect of a credit sale on the Accounting equation.
8 **Explain** three ethical considerations for a business selling inventory.

Ethical consideration

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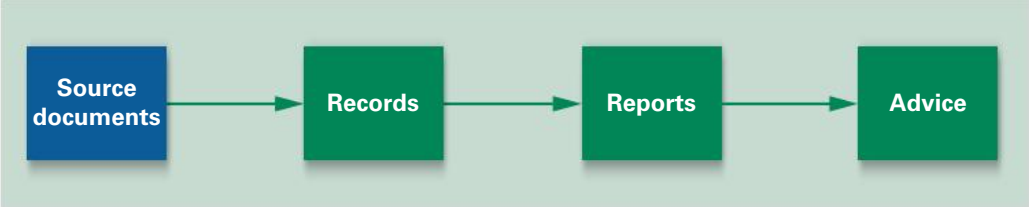
14.2 Receipts from Accounts Receivable

Credit sales are recorded in the Sales Journal on the day the inventory is sold, but the receipt from the Account Receivable is recorded in the Cash Receipts Journal on the day the cash is received.

Example

On 17 April 2030, Uptown Ceramics received $1 000 from Stellar Gallery (EFT Rec. 19).

Source document



Receipts from Accounts Receivable can be taken in person at the store or electronically via Electronic Funds Transfer. Figure 14.3 shows the receipt to provide evidence of a receipt from an Account Receivable:

Figure 14.3 Receipt from an Account Receivable: EFT receipt

Empire Bank

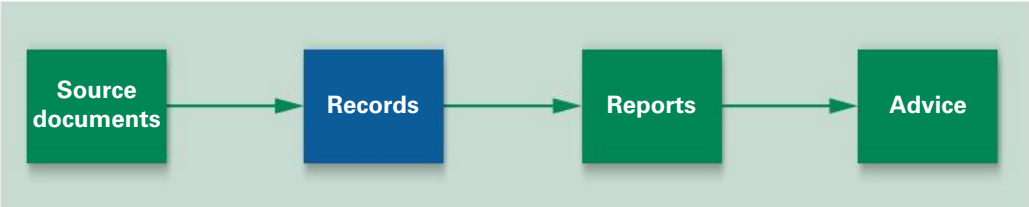
Uptown Ceramics (A/c: 892 552 001)

Funds transfer

Date of receipt	17/4/2030
From	Stellar Gallery A/c: 101 221 459
For	Payment towards balance owing
Amount	$1 000
Reference	19

As with a payment to an Account Payable, there is no GST to account for when cash is received from an Account Receivable because the GST is recognised and reported only at the time sales are made.

Recording: Cash Receipts Journal



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Like all cash receipts, those from Accounts Receivable are recorded in the Cash Receipts Journal. Let's return to the earlier example for Uptown Ceramics, highlighting the receipts from Accounts Receivable.

Example

During April 2030 Uptown Ceramics had the following transactions:

April 5 Received $440 cash from Decorators' World in settlement of account (EFT Rec. 18)
6 Sold inventory on credit to Stellar Gallery for $1 120 plus $112 GST (Inv. 91)
9 Credit sale for $990 including $90 GST to Home Junction (Inv. 92)
16 Sale of inventory to A. Minty for $660 plus GST (Inv. 93)
17 Received $1 000 cash from Accounts Receivable – Stellar Gallery (EFT Rec. 19)
18 Received $220 cash from Home Junction (EFT Rec. 20)
20 Sale to Decorators' World for $880 including GST (Inv. 94)
23 Sold inventory to Stellar Gallery for $473 including GST (Inv. 95)
28 Received $500 from Stellar Gallery (Rec. 127)

These receipts – together with any other cash receipts – would be recorded in the Cash Receipts Journal of Uptown Ceramics as shown in Figure 14.4:

Figure 14.4 Cash Receipts Journal: Receipts from Accounts Receivable

Cash Receipts Journal *

Date	Details	Source Document	Bank	Accounts Receivable	Sales	Sundries	GST
April 2	Cash sales	Rec. 123	**132**		120		12
5	Decorators' World	EFT 18	**440**	440			
8	Cash sales	Rec. 124	**462**		420		42
17	Stellar Gallery	EFT 19	**1 000**	1 000			
18	Home Junction	EFT 20	**220**	220			
22	Cash sales	Rec. 125	**319**		290		29
26	Capital contribution	Rec. 126	**5 000**			5 000	
28	Stellar Gallery	Rec. 127	**500**	500			
	TOTALS	**$**	8 073	2 160	830	5 000	83

*Other probable entries have been added to show a more complete Cash Receipts Journal.

Receipts from Accounts Receivable will be frequent and so are recorded in their own classification column just like cash sales and GST. The total cash received from Accounts Receivable by Uptown Ceramics in April 2030 is thus $2 160.

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Effect on the Accounting equation

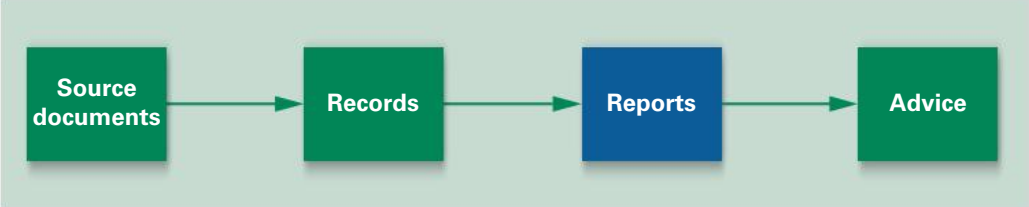
The most common error in recording cash received from Accounts Receivable is to treat it as additional revenue, rather than as simply swapping one asset (Accounts Receivable) for another (Bank). The fact that *assets do not increase overall* means that cash received from Accounts Receivable *cannot* be recorded as revenue – it does not fit the definition.

In addition, cash received from Accounts Receivable as revenue would be double counting; the revenue was already recorded as a credit sale, at the point of sale, when the goods were provided to the customer.

The overall effect of receipts from Accounts Receivable on the Accounting equation of Uptown Ceramics for April 2030 would be:

	Increase/Decrease/No effect	Amount $
Assets	No effect (increase Bank $2 160, decrease Accounts Receivable $2 160)	Nil
Liabilities	No effect	Nil
Owner's equity	No effect	Nil

Calculating Accounts Receivable balance



Using the total Credit sales including GST (from the Sales Journal) and total cash received from Accounts Receivable (from the Cash Receipts Journal), the business can calculate the total balance owed by Accounts Receivable at the end of the period.

Assuming an opening Accounts Receivable balance of $760 as at 1 April 2030, the Accounts Receivable balance of Uptown Ceramics as at 30 April 2030 would be calculated using the formula shown in Figure 14.5:

Figure 14.5 Accounts Receivable formula

Accounts Receivable balance at start	760	From the *previous* Balance Sheet (as at 1 April 2030)
+ Credit sales including GST	4 301	From the Sales Journal
	5 061	
– Receipts from Accounts Receivable	(2 160)	From the Cash Receipts Journal
Accounts Receivable balance at end	**$2 901**	**For the *next* Balance Sheet (as at 30 April 2030)**

This new balance of the total owed to the business by its Accounts Receivable (of **$2 901**) can now be reported as a Current asset in the Balance Sheet for Uptown Ceramics as at 30 April 2030.

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Review questions 14.2

1 **Identify** the source documents used to verify cash received from Accounts Receivable.
2 **Explain** why there is no GST to account for when cash is received from Accounts Receivable.
3 **State** one reason why receipts from Accounts Receivable are recorded in their own classification column in the Cash Receipts Journal.
4 **Explain** why receipts from Accounts Receivable are **not** recognised as revenue.
5 **State** the effect of receipts from Accounts Receivable on the Accounting equation.
6 **Show** the formula to calculate the balance of Accounts Receivable at the end of the period, identifying the sources of the information it uses.

14.3 Subsidiary records: Accounts Receivable

Just as individual credit purchases and payments to Accounts Payable are recorded in inventory cards and Accounts Payable records, individual credit sales and receipts from Accounts Receivable are recorded in inventory cards and Accounts Receivable records.

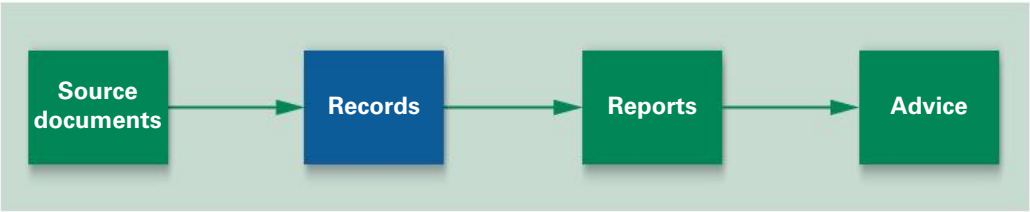
Inventory cards

When making a credit sale it is important that the business is able to calculate the Gross Profit it is making from that sale. The sales invoice will show the selling price of the inventory sold, but in order to protect the firm's mark-up it will not show the cost price. Whether the business is using Identified Cost or FIFO, the cost price of the sale must be determined in the inventory card, using the value recorded in the OUT column for that sale.

Study tip

See Chapter 11 to review inventory cards.

Accounts Receivable records



In addition to the inventory cards, separate **Accounts Receivable records** will be maintained for each individual Account Receivable, showing each individual transaction affecting that Account Receivable's balance.

Figure 14.6 shows the Accounts Receivable records for Uptown Ceramics, after all credit sales and receipts from Accounts Receivable for April 2030 have been recorded.

Accounts Receivable record
a subsidiary Accounting record that details each individual transaction with each individual Account Receivable, and shows the balance owed by that Account Receivable at any point in time

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Figure 14.6 Accounts Receivable records

Account Receivable – Stellar Gallery

Date	Details	Document	Amount $	Balance $
April 1	Balance			100
6	Sales (incl. GST)	Inv. 91	**1 232**	1 332
17	Receipt	EFT Rec. 19	(1 000)	332
23	Sales (incl. GST)	Inv. 95	**473**	805
28	Receipt	Rec. 127	(500)	305

Account Receivable – Home Junction

Date	Details	Document	Amount $	Balance $
April 1	Balance			220
9	Sales (incl. GST)	Inv. 92	**990**	1 210
18	Receipt	EFT Rec. 20	(220)	990

Account Receivable – A. Minty

Date	Details	Document	Amount $	Balance $
April 16	Sales (incl. GST)	Inv. 93	**726**	726

Account Receivable – Decorators' World

Date	Details	Document	Amount $	Balance $
April 1	Balance			440
5	Receipt	EFT Rec. 18	440	-
20	Sales (incl. GST)	Inv. 94	**880**	880

Credit sales plus the GST (as recorded in the Sales Journal) will *increase* the balance owed by an Account Receivable, whereas Receipts from Accounts Receivable (from the Cash Receipts Journal) will *decrease* that balance, as will Sales returns, Discount expense and Bad debts (each of which is covered later in this chapter).

Accounts Receivable Schedule

Accounts Receivable Schedule
a listing of the name and balance of each Accounts Receivable record

The recording in the Accounts Receivable records can be checked to see that it is complete and free from bias, and provides a *Faithful representation* of the firm's Accounts Receivable, by preparing an **Accounts Receivable Schedule**, which lists each Account Receivable and the balance each owes.

Figure 14.7 shows the Accounts Receivable Schedule for Uptown Ceramics as at 30 April 2030:

Figure 14.7 Accounts Receivable Schedule

UPTOWN CERAMICS
Accounts Receivable Schedule as at 30 April 2030

Account Receivable	Balance $
Stellar Gallery	305
Home Junction	990
A. Minty	726
Decorators' World	880
Balance as per Accounts Receivable formula	**$2 901**

The same relationship between the Accounts Receivable Schedule and the formula applies to both Accounts Receivable and Accounts Payable – the total of the Accounts

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Receivable Schedule (**$2901**) should match the figure calculated using the formula (**$2901**), and in the interests of *Relevance* only this total is reported in the Balance Sheet.

Review questions 14.3

1 **Explain** the importance of inventory cards when recording a credit sale.
2 **Explain** the role of Accounts Receivable records.
3 **State** three differences between an Accounts Receivable record and an Accounts Payable record.
4 **Identify** the types of transactions that will:
   - increase the balance of an Accounts Receivable record
   - decrease the balance of an Accounts Receivable record.
5 Referring to one Qualitative characteristic, **explain** why only total Accounts Receivable is reported in the Balance Sheet.

14.4 Sales returns

Chapter 11 explained that sometimes customers return inventory that they have purchased, and these sales returns must be recorded at their cost price in the inventory cards.

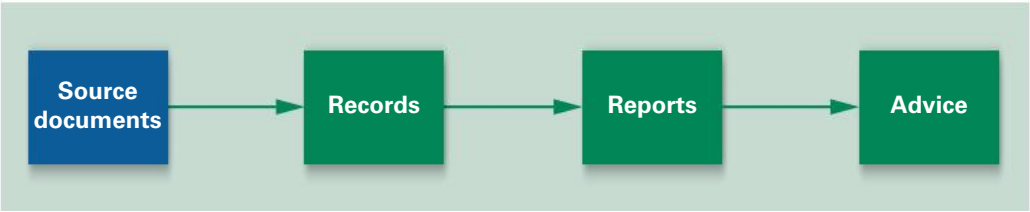
Valued at its cost price, a sales return will be recorded in the IN column of the relevant inventory card, increasing the value of Inventory on hand and resulting in a decrease in Cost of Sales.

However, in the Accounts Receivable records and reports, these returns must be recorded at their selling price. Sales returns is a negative revenue that will decrease profit, and the business will not be collecting the GST charged on that sale. As a result, both of these amounts are no longer owed to the business by its Accounts Receivable, and this decrease in the balance owed – valued at selling price – must be recorded in the Accounts Receivable record for that supplier.

Example

On 30 April 2030, A. Minty returned to Uptown Ceramics inventory worth $200 plus GST it had purchased on 16 April 2030 (Cr. Note 145).

Source document



As is the case with a purchase return, the source document to verify a sales return will be the credit note issued by the business to its customer, with the name of the business receiving the sales return (in this case Uptown Ceramics) noted at the top of the document and the name of the customer (in this case A. Minty) identified in the middle.

The credit note will identify what, and how many, items of inventory have been returned, the selling price of the inventory and a reason for the return. (As is the case with a sale, the inventory card must be used to identify the cost price of the return.)

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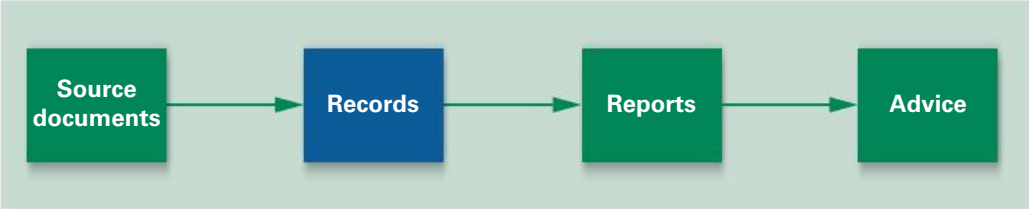
Recording: Accounts Receivable record



This transaction would be recorded in the Accounts Receivable record of A. Minty as is shown in Figure 14.8:

Figure 14.8 Accounts Receivable records

Account Receivable – A. Minty				
Date	Details	Document	Amount $	Balance $
April 16	Sales (incl. GST)	Inv. 93	726	726
30	Sales returns (incl. GST)	Cr. Note 145	**220**	506

Note that this decreases the amount owed by A. Minty by **$220**: $200 for the Sales return and $20 for the GST that is no longer owed by the customer. This GST will also reduce the GST liability of Uptown Ceramics as it is not expected to pay to the ATO what it will not collect from the customer.

Effect on the Accounting equation

Assuming a cost price of $120, the effect of this sales return on the Accounting equation of Uptown Ceramics as at 30 April 2030 would be the opposite of a credit sale:

	Increase/Decrease/No effect	Amount $
Assets	Decrease (decrease Accounts Receivable **$220**, increase Inventory $120)	100
Liabilities	Decrease (GST payable)	20
Owner's equity	Decrease (Sales returns $200 less decrease Cost of Sales $120)	80

Ethical considerations

Ethical considerations

Where goods are faulty, damaged or not 'fit for the purpose intended', the business has a legal obligation to accept the sales return, but in other cases it can be less clear cut. Indeed, it may be the case that the fault or damage has been caused by the customer.

In cases like these the business must weigh the financial and ethical costs and benefits of accepting versus not accepting the return. A business that acts ethically and responsibly may generate a market advantage from its behaviour, while a business that does not act ethically may lose market share. However, being ethical does not mean being financially foolish, and a business should not accept the cost of sales returns if the fault lies somewhere else.

Review questions 14.4

1 **Identify** the source document used to verify a sales return and the two subsidiary records in which a sales return must be recorded.
2 **Explain** how a sales return affects the balance in an Accounts Receivable record.
3 **State** the effect of a sales return on the Accounting equation.
4 **Explain** how an ethical approach to sales returns can actually generate profit.

Ethical considerations

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14.5 Discount expense

Just as settlement discounts can be used by suppliers, so too can they be used by a business to encourage its Accounts Receivable to pay earlier, giving them access to cash faster than might otherwise be the case. The discount itself is the amount that will *not* be received from the customer but will still be deducted from the amount owed by that customer.

Recorded at the time the rest of the cash is received, a discount granted to Accounts Receivable is therefore classified as **discount expense**, as it reduces the amount received from the Account Receivable, thus decreasing assets and owner's equity.

Let's return to the earlier example, concentrating on the transactions with Decorators' World, but adding an extra receipt with a settlement discount.

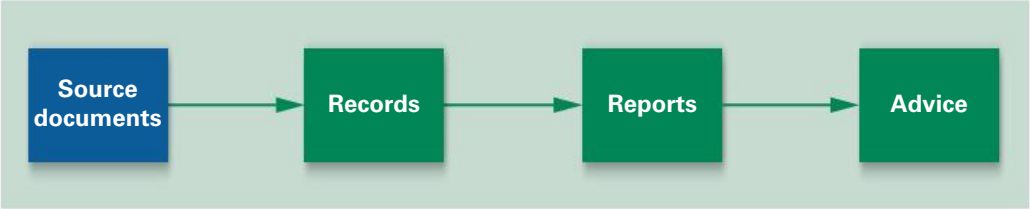
discount expense an expense in the form of a decrease in assets (Accounts Receivable) and owner's equity, incurred when cash is received early from Accounts Receivable and a settlement discount is given by the business

Example

During April 2030, Uptown Ceramics had the following transactions with Decorators' World:

April	5	Received $440 cash from Decorators' World in settlement of account (EFT Rec. 18)
	20	Sale to Decorators' World for $880 including GST (Inv. 94)
	29	Received cash from Decorators' World in full settlement of balance (EFT Rec. 21)

Source document



The source document for the cash received on 29 April 2030 is an EFT receipt but could equally be an electronic or handwritten receipt generated at the business premises. Note that no amounts are given in the description – they must be calculated by reference to the balance of the Accounts Receivable record.

Calculating the discount

The credit terms of Uptown Ceramics were previously noted as 10/10, n/30, meaning Uptown Ceramics provides a discount of 10% of the invoice price if the customer pays within 10 days, but requires the customer to pay the net amount (balance owing) on the invoice within 30 days.

The receipt on 29 April 2030 falls just within this period from the purchase date of 20 April 2030 meaning Uptown Ceramics will allow Decorators' World a discount of 10%.

The discount expense incurred on 29 April 2030 would be calculated as is shown in Figure 14.9.

Study tip

In credit terms, the second and fourth numbers refer to the number of days.

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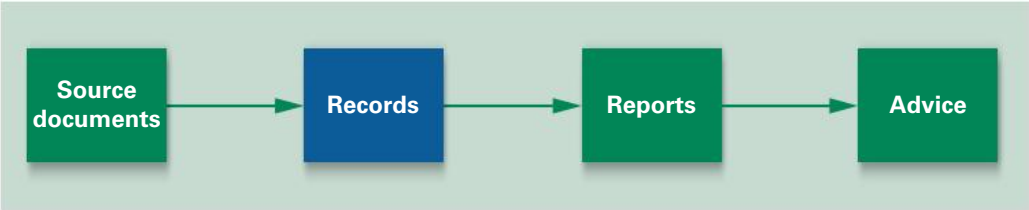
Figure 14.9 Calculation: Discount expense

Discount revenue	=	Discount rate × Amount owing
	=	10% × $880
	=	$88

In return for Decorators' World paying early, Uptown Ceramics allows them a discount of 10% on the full balance of $880 (including the GST) that it owes. This discount of $88 means that Uptown Ceramics will only receive $792, but the balance they are owed by Decorators' World is reduced by the total amount of **$880** ($792 plus $88).

Recording: Cash Receipts Journal



Chapter 13 explained how discounts received for early payments to Accounts Payable required some adjustments to the Cash Payments Journal, and the same principle applies to recording cash receipts from Accounts Receivable when discounts are granted. The cash actually received from the Accounts Receivable is recorded in the Bank column in the usual way, but any Discount expense is recorded in its own column, with the amount recorded in the Accounts Receivable column reflecting the total by which the amount owed will decrease (i.e. the cash received *plus* the discount expense).

Study tip

Due to the discount, the amount recorded in the Accounts Receivable column should be larger than the amount recorded in the Bank column.

In this example, $792 cash has been received from Decorators' World, so this amount is recorded in the Bank column. In addition, the discount of $88 is recorded in the Discount expense column. Together, the cash received plus the discount expense ($792 plus $88) means a total reduction in the balance owed by Decorators' World of **$880**, so it is this total that is recorded in the Accounts Receivable column.

Given the discount expense incurred, the amount received from Decorators' World would be recorded in the Cash Receipts Journal as shown in Figure 14.10:

Figure 14.10 Cash Receipts Journal: Receipts from Accounts Receivable with discount

Cash Receipts Journal *

Date	Details	Source Document	Bank	Discount Expense	Accounts Receivable	Sales	Sundries	GST
April 2	Cash sales	Rec. 123	**132**			120		12
5	Decorators' World	EFT 18	**440**		440			
8	Cash sales	Rec. 124	**462**			420		42
17	Stellar Gallery	EFT 19	**1 000**		1 000			
18	Home Junction	EFT 20	**220**		220			
22	Cash sales	Rec. 125	**319**			290		29
26	Capital contribution	Rec. 126	**5 000**				5 000	
28	Stellar Gallery	Rec. 127	**500**		500			
29	Decorators' World	EFT 21	**792**	88	**880**			
	TOTALS	**$**	**8 865**	88	3 040	830	5 000	83

* Other probable entries have been added to show a more complete Cash Receipts Journal.

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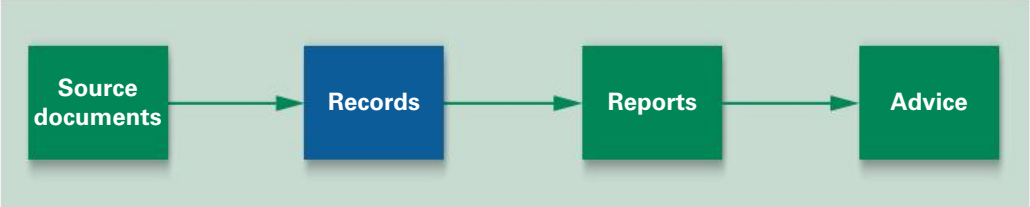
Double-checking mechanism

Similar to the Cash Payments Journal, the total of the Bank column plus the Discount expense column should equal the sum of the totals of the other (classification and Sundries) columns.

Using the figures from the Cash Receipts Journal in Figure 14.10, the double-check would show:

Bank	8865	=	Accounts Receivable	3040
Discount expense	88		+ Sales	830
			+ Sundries	5000
			+ GST	83
Total	**8953**		**Total**	**8953**

Recording: Accounts Receivable record



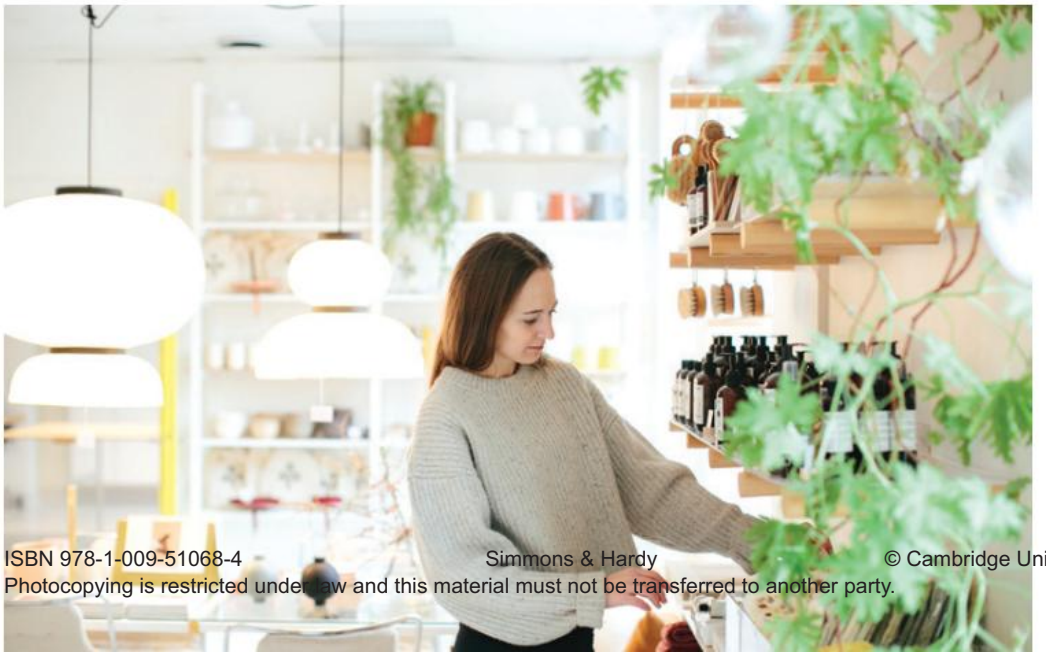
The receipt from Decorators' World involving the discount expense would be recorded in the Accounts Receivable records as shown in Figure 14.11:

Figure 14.11 Accounts Receivable record: Discount expense

Account Receivable – Decorators' World

Date	Details	Document	Amount $	Balance $
April 1	Balance			440
5	Receipt	EFT Rec. 18	(440)	–
20	Sales (incl. GST)	Inv. 91	**880**	880
29	Receipt / Discount expense	EFT Rec. 21	**(880)**	–

Note that the figure of **$880** is the total by which Accounts Receivable decreases, including both the cash received ($792) and the discount expense ($88), as recorded in the Accounts Receivable column in the Cash Receipts Journal.



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Effect on the Accounting equation

A receipt from Accounts Receivable where discount expense is involved will thus have the following effect on the Accounting equation:

	Increase/Decrease/No effect	Amount $
Assets	Decrease (Decrease Accounts Receivable **$880**, increase Bank $792)	88
Liabilities	No effect	
Owner's equity	Decrease (Discount expense decreases Net Profit)	88

Benefits and costs

Granting discounts to Accounts Receivable for early payment comes with both benefits and costs.

Benefits

- Cash is received faster from Accounts Receivable, meaning it can be used to make other payments.
- The possibility of bad debts is reduced (discussed further in Section 14.6).
- Greater sales may be generated (potentially leading to higher profit) as customers are more willing to buy because they can see that if they pay early, they can actually pay less.

Costs

- Less cash is actually received from Accounts Receivable, meaning lower cash on hand to pay make other payments.
- Net Profit is decreased, as the discount incurred is an expense.

Review questions 14.5

1. **Explain** why discounts given to Accounts Receivable are classified as expenses.
2. **Explain** what is meant by the terms '10/10, n/30'.
3. **Identify** the source documents that may be used to verify a receipt from an Account Receivable where a discount is involved.
4. **Explain** why the amounts in the Bank and Accounts Receivable columns are different when recording a receipt from an Account Receivable where a discount is involved.
5. **State** the effect of a receipt from an Account Receivable with discount expense on the Accounting equation.
6. **List** the benefits of offering discounts to Accounts Receivable.
7. **List** the costs of offering discounts to Accounts Receivable.

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14.6 Bad debts

Unfortunately for small business owners, not all Accounts Receivable can be counted on to repay the amounts they owe, and occasionally a debt may need to be written off as uncollectable or 'bad'. These **bad debts** are expenses as they decrease assets (Accounts Receivable) and also decrease owner's equity, and they are usually recognised as being incurred when the debt is deemed to be irrecoverable. This would usually be because the Account Receivable is in liquidation or has been declared bankrupt.

Recording bad debts ensures that the Accounts Receivable records are complete and free from error, and provide a *Faithful representation* of the balances still owing (and likely to be collected). At the same time, reporting the bad debts expense in the Income Statement ensures *Relevance* by providing all the information that is capable of making a difference to decision-making about profit.

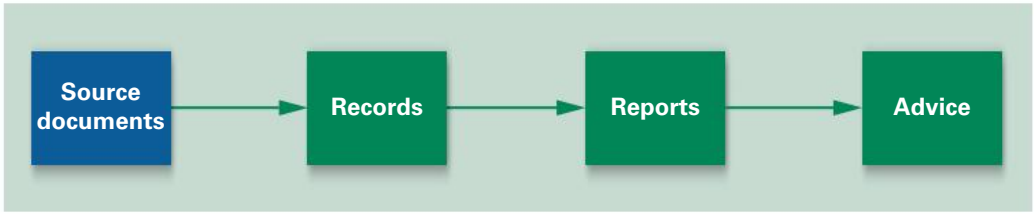
Study tip

A bad debt is a good example of how an expense does not have to involve a cash payment as a bad debt decreases Accounts Receivable not Bank.

Example

On 29 April 2030, Uptown Ceramics was informed that Account Receivable – Home Junction was bankrupt and would only be able to pay $440 of the amount owing. On 30 April 2030, the business received $440 (Rec. 128) and the owner decided to write off the remaining amount as a **bad debt** (Memo 41).

Source document

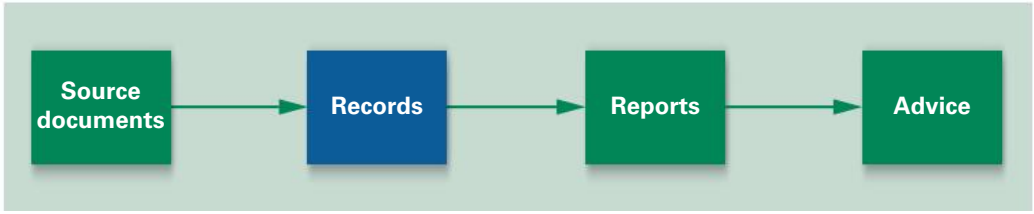


bad debt
an expense incurred when a debt is written off because it is deemed to be irrecoverable

The source document for any cash received is a receipt generated manually or electronically, via EFT or by credit card. In this case the $440 cash received is verified by Receipt 128.

However, the decision to 'write off' the bad debt must be verified by a memo issued by the owner or the Accounting department. In this case, Memo 41 verifies the writing off of the remaining balance of **$550** owed by the Home Junction.

Recording



The $440 cash received from the Account Receivable would be recorded in the Cash Receipts Journal in the usual way. For Uptown Ceramics, the total cash received for April 2030 would increase to $9305 and the cash received from Accounts Receivable would increase to $3392.

However, the remaining **$550** that will **not** be collected must be 'written off' (or deducted from) the balance of the Accounts Receivable. Of this amount, $50 will be

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deducted from the GST payable as it will not be collected from the Accounts Receivable and is therefore no longer owed to the ATO, leaving $500 to be recognised as Bad debts expense.

Figure 14.12 shows how this would be recorded in the Accounts Receivable record for Home Junction:

Figure 14.12 Accounts Receivable record: Bad debt

Account Receivable – Home Junction				
Date	Details	Document	Amount $	Balance $
April 1	Balance			220
9	Sales (incl. GST)	Inv. 92	990	1 210
18	Receipt	EFT Rec. 20	(220)	990
30	Receipt	Rec. 128	(440)	550
	Bad debt (incl. GST)	Memo 41	**(550)**	-

Effect on the Accounting equation

A bad debt has the following effect on the Accounting equation:

	Increase/Decrease/No effect	Amount $
Assets	Decrease (Accounts Receivable)	550
Liabilities	Decrease (GST payable)	50
Owner's equity	Decrease (Bad debts expense decreases Net Profit)	500

Ethical considerations

Ethical considerations

Whether to disclose a bad debt or not is an ethical as well as a financial decision. The Qualitative characteristics of *Relevance* and *Faithful representation* both support the idea that bad debts should be disclosed as soon as they are probable, and it is certainly ethical to make sure that the Income Statement and Balance Sheet include all information that may affect decision-making.

There may be some situations in which it is not clear whether the debt will be written off and in these cases the accountant has to balance whether to include all information with an equal but (in this case) competing need for information that is accurate and free from bias.

Calculating Accounts Receivable balance

With these new transactions in mind, the formula to calculate the balance of Accounts Receivable must be amended. Figure 14.13 shows the formula to calculate the balance of Accounts Receivable, taking into consideration sales returns and discount expense:

Figure 14.13 Accounts Receivable formula: Sales returns, discounts and bad debts

Accounts Receivable balance at start	760	From the *previous* Balance Sheet (as at 1 April 2030)
+ Credit sales including GST	4301	From the Sales Journal
	5061	
– Sales returns including GST	(220)	
– Receipts from Accounts Receivable / Discount expense	(3480)	From the Cash Receipts Journal
– Bad debts including GST	(550)	
Accounts Receivable balance at end	**$811**	**For the *next* Balance Sheet (as at 30 April 2030)**

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This new balance of the total owed by Accounts Receivable (of **$811**) can be checked against the Accounts Receivable Schedule to verify its accuracy. (Use the Accounts Receivable Schedule in Figure 14.7 but deduct $220 from the balance of A. Minty and $880 from the balance of Decorators' World, and record the balance of Home Junction as zero.)

Review questions 14.6

1. **Define** the term 'bad debt'.
2. **Explain** why a bad debt is recognised as an expense.
3. Referring to two Qualitative characteristics, **explain** why bad debts must be recognised in the reports.
4. **Explain** the effect of a bad debt on GST payable.
5. **State** the effect of a bad debt on the Accounting equation.
6. **Explain** how the recognition of a bad debt can involve ethical considerations.
7. **Show** the formula to calculate the balance of Accounts Receivable at the end of the period, taking into account sales returns, discounts and bad debts.

Ethical considerations

Where have we been?

- A credit sale occurs when goods are sold but the cash is not received until a later date.
- A credit sale will be verified by a sales invoice and recorded in the Sales Journal, which summarises all credit sales in a reporting period. (Credit sales are recorded in the OUT column of the appropriate inventory card, and decrease the balance of Inventory on hand.)
- Individual Account Receivable records are maintained to aid in the recording, reporting and management of Accounts Receivable.
- Cash receipts from Accounts Receivable are verified by a receipt and are recorded in the Cash Receipts Journal, which summarises all cash receipts in a period.
- GST is recognised and reported only at the time the sale is made, rather than when cash is received from an Account Receivable.
- Sales returns reduce the balance owed by Accounts Receivable, the balance owed to the ATO and Net Profit.
- Discount expense reduces the cash received, the balance owed by the Account Receivable, and Net Profit.
- In the Cash Receipts Journal, the Accounts Receivable column shows the total amount by which Accounts Receivable will decrease – the cash received plus the discount expense.
- Bad debts expense reduces the balance owed by Accounts Receivable and Net Profit.
- The Accounts Receivable Schedule is used to check the balance at the end of the period.
- The balance of Accounts Receivable at the end of the period can be calculated using either a formula or an Accounts Receivable Schedule.

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Exercises

Please note: asterisks indicate that an answer for that question is available in the Selected Answers section at the end of this book.

Exercise 14.1
Source documents

page 239

Opulence Furniture sells leather lounge suites from a shop in Mornington and has provided the following source document:

Opulence Furniture
ABN: 19 900 016 252
Main St, Mornington, Vic, 3931

Invoice: 901
Terms: Net 30 days
TAX INVOICE Duplicate
5 August 2030

Charge to: Davey Street Clinic
Davey St Frankston Victoria 3199

Item	Description	Qty	Unit cost	$
C3	Chesterfield – 3 seater	3	3600	10800
	GST			1080
	Total		**$**	11880

Additional information:

- Opulence Furniture sells all its inventory at a 100% mark-up.

Required

a. **Identify** the source document above. **Describe** the transaction it verifies.
b. **Explain** why it is important that credit terms are stated on an invoice.
c. Referring to one Accounting assumption, **explain** why this transaction leads to the recognition of revenue.
d. **Record** this transaction in the Sales Journal of Opulence Furniture.
e. **State** the effect of this transaction on the Accounting equation of Opulence Furniture.

Exercise 14.2
Sales Journal

page 240

Oz Business Machines sells photocopiers and fax machines and has provided the following list of its transactions for February 2030:

Feb. 4 Sold 1 photocopier on credit to CS Accounting for $1230 plus $123 GST (Inv. 34)
9 Sold 1 fax machine to Helix Science Lab for $330 plus GST (Inv. 35)
15 Sold 1 fax machine to Finch Property for a total of $270 plus GST (Inv. 36)
22 Sold 2 photocopiers to Wills Conveyancing for $1452 including GST each (Inv. 37)
27 Sold 1 fax machine to CS Accounting for $330 including GST (Inv. 38)

All inventory is sold on credit at a 50% mark-up.

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Required

a. **State** the number that will be used on the next sales invoice issued by Oz Business Machines.

* **b.** **Record** the transactions for February 2030 in the Sales Journal of Oz Business Machines.

c. Referring to your answer to part **b**, **state** two reasons why the total of the Sales Journal is unlikely to be the balance owed by Accounts Receivable as at 28 February 2030.

d. **Explain** the effect of GST charged on credit sales on the GST payable to the ATO.

e. **Calculate** Gross Profit for Oz Business Machines for February 2030.

Exercise 14.3
Sales Journal and Cash Receipts Journal

page 241

Hot Glass sells glass products such as wine glasses, vases and bowls. Credit terms are strictly 30 days. As at 30 September 2030, its Accounts Receivable records showed the following balances:

Zucchets Restaurant	$2 400
Barlington Hotel	4 500
Balance of Accounts Receivable as at 30 September 2030	**$6 900**

During October 2030, the following transactions occurred:

Oct.	1	Received $1 500 cash from Zucchets Restaurant (EFT Rec. 11)
	3	Sold inventory on credit to Zucchets Restaurant for $420 plus GST (Inv. 120)
	4	Cash sales –$180 plus GST (Rec. 30)
	6	Received loan from Fincorp – $10 000 to purchase new display cabinets (BS)
	9	Credit sales to Barlington Hotel of $1 320 including GST (Inv. 121)
	10	Zucchets Restaurant paid $700 cash (EFT Rec. 12)
	13	Sold inventory to Ninos Café for $600 plus GST (Inv. 122)
	16	Sold inventory on credit to Club 84 for $792 including GST (Inv. 123)
	18	Barlington Hotel settled previous months account in full (Rec. 31)
	22	Received full balance owing from Ninos Café (EFT Rec. 13)
	25	Sales of $120 plus $12 GST (Rec. 32)
	27	Sales to Barlington Hotel worth $2 100 plus GST (Inv. 124)
	31	Received $300 cash from Club 84 (Rec. 33)

Required

a. **Explain** why the transaction on 1 October 2030 is *not* classified as revenue.

b. **Explain** why there is no GST to account for when cash is received from an Account Receivable.

* **c.** **Record** the transactions for October 2030 in the journals of Hot Glass.

d. **Calculate** the balance of Accounts Receivable as at 31 October 2030.

e. **Explain** whether all Accounts Receivable have met the credit terms during October 2030.

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Exercise 14.4
Journals and Accounts Receivable

page 243

Loony Letterboxes specialises in the sale of novelty letterboxes, and as at 30 April 2030 its Accounts Receivable records showed the following information:

Harry's Hardware	3400
Trident 20	2800
Balance of Accounts Receivable as at 30 April 2030	**$6200**

Loony Letterboxes uses the Identified Cost method of inventory valuation and as at 30 April 2030 the inventory card for 55 Elvis letterboxes showed the following:

30 letterboxes @ $90	2700
25 letterboxes @ $95	2375
Value of Elvis letterboxes	**$5075**

During May 2030, the following transactions occurred:

May
1 Sold 40 letterboxes on credit to Best Value for $140 plus GST each (Inv. A314). Of the letterboxes, 22 had a cost price of $90 each and 18 had a cost price of $95 each.
4 Cash sales – $1232 including $112 GST (Rec. 390)
6 Received cash from Harry's Hardware in full settlement of April balance (EFT Rec. 91)
10 Sold inventory to Trident 20 for $3500 plus GST (Inv. A315)
11 Owner contributed $12000 cash (Rec. 392)
15 Credit sales to Harry's Hardware worth $6930 including GST (Inv. A316)
18 Sales – $770 including GST (Rec. 393)
21 Best Value paid $3000 cash (Rec. 394)
23 Sold inventory to GlenCo Homes for $10780 including GST (Inv. A317)
27 Received $2000 from Trident 20 (EFT Rec. 95)
31 Harry's Hardware purchased inventory for $3200 plus GST (Inv. A318)

Required

a. **Record** the transaction on 1 May 2030 in the inventory card for Elvis letterboxes.
b. **State** the effect of the transaction on 1 May 2030 on the Accounting equation of Loony Letterboxes.
* c. **Record** the transactions for May 2030 in the journals of Loony Letterboxes.
d. **Record** the transactions for May 2030 in the Accounts Receivable records of Loony Letterboxes.
e. **Prepare** an Accounts Receivable Schedule for Loony Letterboxes as at 31 May 2030.
f. **Explain** why transactions with Accounts Receivable should be recorded in both special journals and Accounts Receivable records.
g. **Calculate** the effect on Net Profit for May 2030 if the transaction on 1 May 2030 had instead been recorded using the FIFO method of inventory valuation.

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Exercise 14.5
Sales returns

page 246

Kaveesha Silva owns Silva Footwear, which sells shoes. As at 31 December 2029, the business had 10 pairs of Angelina shoes on hand valued at $40 each and was owed $500 by Account Receivable – Ryan's Academy.

Silva Footwear values its inventory using the FIFO method and the following transactions occurred during January 2030:

Jan. 1 Purchased 60 pairs of Angelina shoes from Indu La Shoes for $50 plus GST each (Inv. x201)

7 Sold 25 pairs of Angelina shoes to Ryan's Academy for $120 plus GST each (Inv. 93)

29 Ryan's Academy returned 6 pairs of Angelina shoes because they were too small and was given a credit of $720 plus GST (Cr. Note 33). The inventory card showed that the cost price of these shoes was $50 per pair.

Required

a. **Identify** the journals in which the following documents would be recorded:
- Invoice x201
- Invoice 93.

b. **Record** the transactions for January 2030 in the inventory card for Angelina Shoes.

c. **Record** the transactions for January 2030 in the Accounts Receivable record for Ryan's Academy.

d. **Explain** the effect on the Accounting equation of the transaction on 29 January 2030.

e. **Discuss** whether Silva Footwear should have accepted the sales return on 29 January 2030.

f. Referring to the information provided, **explain** why the Identified Cost method of inventory valuation can produce a lower valuation of inventory on hand than the FIFO method when prices are rising.

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Exercise 14.6
Discount expense

page 248

Jules and Loz sells clothing, and as at 1 July 2030 the business was owed $1 200 by Account Receivable – Viv's Boutique. Credit sales are made on terms of 10/7, n/30 and all inventory is marked up 100%.

During July 2030 the following transactions occurred:

July	9	Received $1 200 from Viv's Boutique (EFT Rec. 103)
	14	Sold inventory to Viv's Boutique for $2 800 plus GST (Inv. 63)
	15	Viv's Boutique returned clothing worth $550 including GST as it was damaged (Cr. Note x12)
	20	Received cash from Viv's Boutique in full settlement of account (EFT Rec. 110)
	26	Sold clothing to Viv's Boutique for $2 090 including GST (Inv. 68)

Required

a. **Explain** why Viv's Boutique was **not** entitled to a discount on 9 July 2030.
b. **Explain** why a discount given to Accounts Receivable is recognised as an expense.
c. Referring to the transaction on 20 July 2030, **calculate**:
- the discount expense incurred
- the cash received from Account Receivable – Viv's Boutique.

d. **Explain** the effect of the transaction on 20 July 2030 on the Accounting equation of Jules and Loz.
e. **Record** the transaction on 20 July 2030 in the Cash Receipts Journal of Jules and Loz.
f. **Record** the transactions for July 2030 in the Accounts Receivable record for Viv's Boutique.

Exercise 14.7
Bad debts

page 250

On 14 September 2030, the owner of Dodge Dishwashers went to visit one of his customers – Des T. Chute – to recover a $1 100 debt. Upon arrival, the owner found that Des had moved three months ago and left no forwarding address. He decided to write off the debt as bad (Memo 35).

Required

a. **Explain** how the recognition of a bad debt supports Relevance.
b. **Record** Memo 35 in the Accounts Receivable record for Des. T. Chute.
c. **Explain** the effect of Memo 35 on the GST liability of Dodge Dishwashers.
d. **State** the effect of Memo 35 on the Accounting equation of Dodge Dishwashers.
e. **Explain** why it would be unethical for Dodge Dishwashers to not disclose this bad debt in its reports.

Ethical consideration

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Exercise 14.8
Recording in journals and Accounts Receivable

page 251

Sports Bonanza is owned by Joe Little, and on 30 November 2030 the business had the following balances in its Balance Sheet:

Accounts Receivable:	
– Emerald CC	$1 320
– St. Carl's PS	$1 100

During December 2030 the following transactions occurred:

Dec.	1	Cash sales $132 including GST (Rec. 34)
	3	Received amount outstanding from Emerald CC after discount of 10% (Rec. 35)
	6	Received $70 GST refund from the ATO (EFT Rec. 102)
	7	Credit sale to St. Carl's PS for $1 300 plus GST (Inv. 904)
	9	Received $1 100 from Account Receivable – St. Carl's PS (EFT Rec. 103)
	10	Goods with a cost price of $120 sold for $200 plus GST (Rec. 36)
	13	Received $1 287 from St. Carl's PS; 10% discount given on Invoice 904 (EFT Rec. 104)
	15	Sale of inventory to Emerald CC for $880 including GST (Inv. 905)
	18	Cash sales of $400 plus GST (Rec. 37)
	19	Sale of sporting equipment to East Bunbury SC for $1 000 plus GST (Inv. 906)
	21	Joe Little contributed $5 000 cash (BS)
	22	Credit sale to St. Carl's PS for $990 including GST (Inv. 907)
	25	Emerald CC returned inventory worth $330 including GST – no reason was given (Cr. Note 64)
	26	East Bunbury SC paid for Invoice 906; 10% discount on invoice price (EFT Rec. 105)
	30	Emerald CC was declared bankrupt. Cash was received for 20% of the amount owing (Receipt 38), and the remainder was written off as a bad debt (Memo 13).

Additional information:

- All inventory is marked up 50%.

Required

* **a.** **Record** the transactions for December 2030 in the journals of Sports Bonanza.
* **b.** Using the formula, **calculate** the balance of Accounts Receivable as at 31 December 2030.
c. **Record** the transactions for December 2030 in the Accounts Receivable records of Sports Bonanza.
* **d.** **Prepare** an Accounts Receivable Schedule for Sports Bonanza as at 31 December 2030.
e. **State** two benefits of offering discounts to Accounts Receivable.
f. **Explain** the effect of the transaction on 22 December 2030 on the Accounting equation of Sports Bonanza.
g. **Explain** the effect of the transaction on 25 December 2030 on the GST liability of Sports Bonanza.

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Exercise 14.9
Accounts Receivable

page 254

Max Powers operates a lamp shop called Mojo Pty Ltd, which specialises in the sale of lava lamps. On 31 March 2030, its Balance Sheet showed the following balances:

Accounts Receivable:	
– Far Out Lights	$1 100
– Liquid Lamps	$2 200

The journals for April 2030 showed the following:

Cash Receipts Journal

Date	Details	Source Document	Bank	Discount Expense	Accounts Receivable	Sales	Sundries	GST
April 1	Far Out Lights	EFT 21	1 034	66	1 100			
5	Cash sales	Rec. 772	660			600		60
8	Cash sales	Rec. 773	495			450		45
10	Liquid Lamps	EFT 22	2 200		2 200			
17	Far Out Lights	EFT 23	1 100		1 100			
20	Capital contribution	Rec. 774	5 000				5 000	
22	Cash sales	Rec. 775	935			850		85
25	Liquid Lamps	EFT 24	3 300		3 300			
29	Cash sales	Rec. 776	1 320			1 200		120
	TOTALS	**$**	**16 044**	**66**	**7 700**	**3 100**	**5 000**	**310**

Sales Journal

Date	Account Receivable	Inv. No.	Sales	GST	Accounts Receivable
April 4	Far Out Lights	63	1 600	160	1 760
8	Liquid Lamps	64	2 000	200	2 200
12	Arty Facts	65	1 200	120	1 320
15	Liquid Lamps	66	3 000	300	3 300
21	Arty Facts	67	1 400	140	1 540
28	Liquid Lamps	68	1 800	180	1 980
	TOTALS	**$**	**11 000**	**1 100**	**12 100**

Additional information:

- On 17 April 2030, Arty Facts returned inventory worth $440 including GST (Cr. Note 26). This inventory had been purchased by Mojo Pty Ltd for $200 plus GST.
- On 30 April 2030, Far Out Lights was declared bankrupt and the entire remaining balance was written off as a bad debt (Memo 85).

Required

a. **State** two reasons why the total of the Accounts Receivable column of the Cash Receipts Journal does **not** represent the total by which Accounts Receivable decreased in April 2030.

b. **Calculate** the percentage discount given to Far Out Lights on 1 April 2030.

* **c.** Using the formula, **calculate** the balance of Accounts Receivable as at 30 April 2030.

d. **Explain** the effect of the return of inventory on 17 April 2030 on the Accounting equation of Mojo Pty Ltd.

e. **Record** the transactions for April 2030 in the Accounts Receivable records of Mojo Pty Ltd.

* **f.** **Prepare** an Accounts Receivable Schedule for Mojo Pty Ltd as at 30 April 2030.

g. **Explain** how the use of subsidiary records can improve the management of Accounts Receivable.

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Exercise 14.10
Credit transactions

page 257

Meg Walker operates a sports store called Walker Sports. At 30 June 2030 the firm's subsidiary records showed the following balances:

Accounts Receivable	**$**
Atwell High School	4 100
Jimbaroo	930
South Park Tennis Club	260
Balance of Accounts Receivable as at 30 June 2030	**5 290**

Accounts Payable	**$**
Fitness Regime	2 300
Equipped Gear	1 700
Balance of Accounts Payable as at 30 June 2030	**4 000**

The following transactions occurred during July 2030:

July
1 Paid monthly rent of $700 plus GST (EFT payment 303)
2 Atwell High School paid cash to settle June account receiving a 10% discount (Rec. 59)
4 South Park Tennis Club purchased sporting goods for $385 including GST (Inv. 109)
5 Paid Equipped Gear $1 000 (EFT payment 304)
7 Purchased inventory on credit from Equipped Gear for $2 400 plus GST (Inv. 16X)
Received $500 cash from Jimbaroo (Rec. 60)
8 Paid wages of $620 (EFT Rec. 18)
Purchased goods worth $3 960 including GST from Fitness Regime (Inv. 403)
9 Sold inventory on credit to Atwell High School for $1 650 including GST (Inv. 110)
10 Owner withdrew $300 cash (ATM Ref. 002)
Returned inventory worth $350 plus GST to Equipped Gear as it was damaged (Cr. Note 36X)
11 Credit sale to Filton Rovers Football Club for $320 plus GST (Inv. 111)
12 Cash sales of $473 including GST (EFT Rec. 110)
Paid Fitness Regime balance owing from June receiving a 5% discount (EFT payment 305)
13 South Park Tennis Club paid full amount owing (Rec. 61)
15 Bought inventory from Equipped Gear for $2 500 plus GST (Inv. 17Y)
17 Sold inventory to Atwell High School – total invoice price $880 including GST (Inv. 112)
20 Filton Rovers returned some items worth $110 including GST (Cr. Note 14)
22 Paid wages of $600 (EFT Rec. 19)
Sales of $150 plus GST made to A. Winter (Rec. 62)
23 Purchased sporting goods from Fitness Regime for $1 200 plus GST (Inv. 431)
24 Paid advertising worth $319 including GST (EFT payment 306)
Sold sporting goods to South Park Tennis Club for $495 including GST (Inv. 113)

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26 Paid Equipped Gear $3 000 (EFT payment 307)
28 Received $100 from Jimbaroo (Receipt 63), but after being informed that they would not be able to pay any more, the remainder was written off as a bad debt (Memo 38)
31 Received $15 interest on bank account (BS)

Required

* **a.** **Record** the transactions for July 2030 in the journals of Walker Sports.
b. **State** whether the bank balance of Walker Sports as at 31 July 2030 will be higher, lower or the same as it was as at 30 June 2030. **Justify** your answer.
c. Using the appropriate formula, **calculate** the balances of Accounts Payable and Accounts Receivable as at 31 July 2030.
d. **Record** the transactions for July 2030 in the Accounts Payable and Accounts Receivable records of Walker Sports.
e. **Prepare** an Accounts Payable Schedule and an Accounts Receivable Schedule for Walker Sports as at 31 July 2030.
f. **Explain** how subsidiary records can be used to ensure the Balance Sheet provides a Faithful representation of the firm's Accounts Payable and Accounts Receivable.

Exercise 14.11
Source documents

page 261

Seeing is Believing is a store that sells video surveillance equipment, and it has provided the following source documents:

Document A

Seeing is Believing
ABN: 90 872 221 004
Electronic Security Systems
Laverton Victoria 3026

Tax invoice
Invoice 44
Terms: 5/7, n/30
8 May 2030

Customer: Cullinan's Video Shop (ABN: 34 096 558 391)
Moore St, Moe Victoria 3825

Qty	Item	Unit cost	Sub-total
4	Sensor camera	190	760
1	Hi-definition monitor	140	140
	GST		90
		Total $	990

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Document B

Community Bank	
Transfer number: 00395	
Date	17/05/30 (11.21am)
Pay from	Seeing Is Believing BSB: 325–520 Acc. 23 052 6500
Pay to	Hi Tech Cameras BSB: 193–600 Acc. 45 260 6352
Amount:	$1 400
Description (Optional)	Full settlement of account
EFT ref.	00395

Required

a. **Identify** the journal in which each document would be recorded.
b. **Name** the asset that increases as a result of the transaction in Document A.
c. **Explain** why the transaction in Document A should be reported as revenue for May 2030.
d. **Explain** why Document B does **not** specify a GST amount.
e. **Explain** the effect of Document B on the Balance Sheet of Seeing is Believing.

Exercise 14.12
Journals and subsidiary records

page 262

Alex Micari owns Brought to Book, a shop that sells antique and rare books. All books are purchased on credit from Felix Antiques and Oscar's Books, and sales are made on cash and credit terms. As at 31 July 2030, the Accounts Receivable and Accounts Payable records showed the following balances:

Accounts Receivable	**$**
St. Swithin's University	720
Victoria College	1 000
Balance of Accounts Receivable as at 31 July 2030	**1 720**

Accounts Payable	**$**
Felix Antiques	410
Oscar's Books	260
Balance of Accounts Payable as at 31 July 2030	**670**

The journals for August 2030 showed the following:

Sales Journal

Date	Account Receivable	Inv. No.	Sales	GST	Accounts Receivable
Aug. 2	St. Swithin's University	45	400	40	440
9	Macrae Institute	46	520	52	572
15	Victoria College	47	300	30	330
24	St. Swithin's University	48	390	39	429
29	Victoria College	49	560	56	616
	TOTALS	**$**	**2 170**	**217**	**2 387**

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Purchases Journal

Date	Account Payable	Inv. No.	Inventory	GST	Accounts Payable
Aug. 6	Felix Antiques	054	270	27	297
12	Oscar's Books	1 092	550	55	605
20	Oscar's Books	1105	320	32	352
27	Felix Antiques	Q67	350	35	385
	TOTALS	**$**	**1490**	**149**	**1639**

Cash Receipts Journal

Date	Details	Source Document	Bank	Discount Expense	Accounts Receivable	Sales	Sundries	GST
Aug. 6	Cash sales	Rec. 202	165			150		15
5	St. Swithin's University	EFT 75	684	76	760			
8	Cash sales	Rec. 203	187			170		17
13	Victoria College	EFT 76	1 100		1 100			
18	Macrae Institute	EFT 77	572		572			
22	Cash sales	Rec. 204	132			120		12
26	Loan – Uni Bank	BS	8000				8000	
28	St. Swithin's University	EFT 78	380		380			
	TOTALS	**$**	**11220**	**76**	**2812**	**440**	**8000**	**44**

Cash Payments Journal

Date	Details	Source Document	Bank	Discount Revenue	Accounts Payable	Drawings	Wages	Sundries	GST
Aug. 3	Stationery	EFT 59	132					120	12
4	Oscar's Books	EFT 32	260		260				
7	Drawings	ATM 12	390			390			
11	Wages	EFT 33	510				510		
12	Felix Antiques	EFT 60	350		350				
14	Advertising	EFT 61	198					180	18
17	Oscar's Books	EFT 35	360	40	400				
21	Drawings	EFT 62	320			320			
25	Wages	EFT 36	470				470		
30	Felix Antiques	EFT 63	150		150				
	TOTALS	**$**	**3140**	**40**	**1160**	**710**	**980**	**300**	**30**

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Additional information:

- On 23 August 2030, books worth $110 including GST were returned to Oscar's Books (Cr. Note 54).
- On 26 August 2030, St. Swithin's University returned books worth $80 plus GST (Cr. Note 102).

Required

a. **Explain** the role of special journals in the Accounting process.
b. **Identify** the two subsidiary records in which the transaction on 2 August 2030 would be recorded.
c. **State** two reasons why the transaction on 4 August 2030 should **not** be reported as an expense.
d. Using the appropriate formulae, **calculate** the balances of Accounts Payable and Accounts Receivable as at 31 August 2030.
e. **Complete** the Accounts Payable record for Oscar's Books as at 31 August 2030.
f. **Complete** the Accounts Receivable record for St. Swithin's University as at 31 August 2030.
g. Referring to one Qualitative characteristic, **explain** why the Balance Sheet does **not** list each individual Account Payable.

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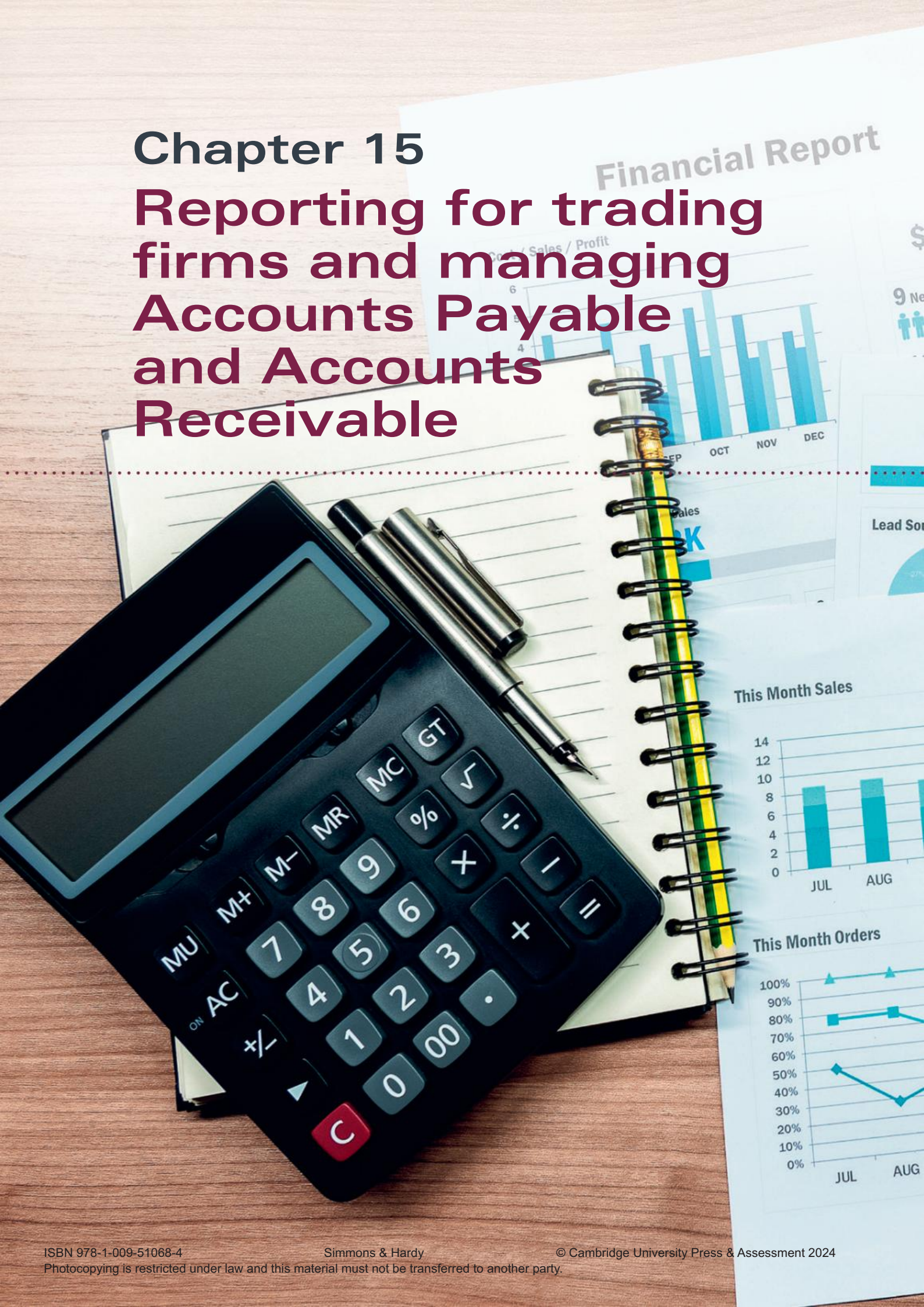
Chapter 15

Reporting for trading firms and managing Accounts Payable and Accounts Receivable



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Learning intentions

After completing this chapter, you should be able to:

- **explain** the effect of credit transactions on the three general-purpose Accounting reports, including reference to appropriate Accounting assumptions and Qualitative characteristics
- **prepare** Accounting reports that show the effect of credit transactions on cash and profit
- **explain** the difference between cash and profit
- **report** for Inventory, Accounts Payable, Accounts Receivable and GST in the Balance Sheet
- **calculate** and **explain** what is measured by Accounts Receivable Turnover and Accounts Payable Turnover
- **explain** the relationship between Inventory Turnover, Accounts Receivable Turnover and Accounts Payable Turnover
- **suggest** and **model** the effect of strategies to manage Accounts Payable and Accounts Receivable
- **discuss** ethical considerations in business decision-making.

Key terms

After completing this chapter, you should be familiar with the following terms:

- Accounts Payable Turnover (APTO)
- Accounts Receivable Turnover (ARTO)
- Accrual Accounting.

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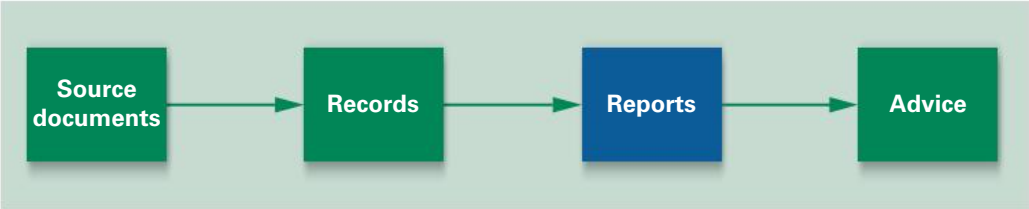
15.1 Accounting reports and credit transactions



The most basic function of an Accounting report is to provide the owner of the business with financial information in order to aid decision-making. So far, we have studied three general-purpose Accounting reports:

- **Cash Flow Statement** reports cash inflows and cash outflows, classified as Operating, Investing or Financing, and the change in the firm's bank balance over a period
- **Income Statement** reports revenue earned and expenses incurred in a particular period
- **Balance Sheet** reports assets, liabilities and owner's equity at a particular point in time.

The information to be presented in these three general-purpose reports is created when transactions are recorded in journals (the Purchases Journal, Sales Journal, Cash Receipts Journal and Cash Payments Journal) and subsidiary records (like inventory cards and Accounts Receivable and Accounts Payable records).

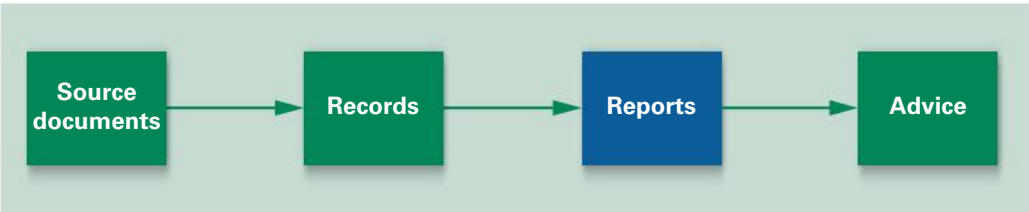
Chapters 13 and 14 pointed out that a credit sale or purchase is in fact two separate (but related) transactions: an exchange of goods, followed by an exchange of cash. Because each transaction will occur on a different day, be verified by a different source document and be recorded in a different journal, each transaction will be reported differently in the Accounting reports.

Whereas Chapters 13 and 14 were concerned with *recording* credit transactions, this chapter concentrates on how to *report* the effects of those credit transactions.

Review questions 15.1

1 **Explain** the role of reports in the Accounting process.
2 **Explain** what is shown in each of the three general-purpose Accounting reports.
3 **Explain** the relationship between Accounting records and Accounting reports.

15.2 The Cash Flow Statement



Although the Cash Flow Statement is concerned only with cash transactions, this does not mean it is unaffected by credit transactions. When goods are sold or purchased on credit there is no cash exchanged, so the actual credit purchase or sale will not be reported in the Cash Flow Statement. However, the payment of cash to an Account Payable or the receipt of cash from an Account Receivable *does* involve cash and so must be reported as a cash inflow or cash outflow in the Cash Flow Statement.

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Example

Chas Windsor owns Full Boards, a shop that sells surfboards and surf gear in Torquay. The firm's assets and liabilities as at 30 September 2030 are listed below:

Assets	$	Equities	$
Bank	3500	Accounts Payable	12600
Inventory	21000	GST payable	310
Accounts Receivable	8300	Loan – QS Finance	30000
Shelving	35000	Capital – Windsor	36890
Office equipment	12000		
Total Assets	**79800**	**Total Equities**	**79800**

Inventory is sold on both cash and credit terms, and the business has provided the following information from its Accounting records for October 2030:

Sales Journal

Date	Account Receivable	Inv. No.	Sales	GST	Accounts Receivable
Oct.	**TOTALS**	**$**	**20000**	**2000**	**22000**

Purchases Journal

Date	Account Payable	Inv. No.	Inventory	GST	Accounts Payable
Oct.	**TOTALS**	**$**	**18000**	**1800**	**19800**

Cash Receipts Journal

Date	Details	Source Document	Bank	Accounts Receivable	Sales	Sundries	GST
Oct.	Capital contribution					1000	
	TOTALS	**$**	**30200**	**16000**	**12000**	**1000**	**1200**

Cash Payments Journal

Date	Details	Source Document	Bank	Accounts Payable	Drawings	Wages	Sundries	GST
Oct.	Freight in						600	
	Loan (principal)						750	
	Interest						150	
	Advertising						1400	
	Rent						2000	
	Shelving						3000	
	TOTALS	**$**	**36200**	**17000**	**3700**	**6900**	**7900**	**700**

Continued

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Additional information:

Inventory on hand as per physical count as at 31 October 2030	$21 880	
Cost of sales for October 2030	16 400	
Inventory loss for October 2030	420	
Sales returns	500	plus GST
Purchase returns	300	plus GST
Discount expense	120	
Discount revenue	100	
Bad debts	220	incl. GST

Figure 15.1 shows the Cash Flow Statement for Full Boards for October 2030:

Figure 15.1 Cash Flow Statement

Study tip

If an item is recorded in a cash journal, it is reported in the Cash Flow Statement – no questions asked!

FULL BOARDS
Cash Flow Statement for October 2030

	$	$
CASH FLOWS FROM OPERATING ACTIVITIES		
Cash sales	12 000	
Receipts from Accounts Receivable	16 000	
GST received	1 200	29 200
Payments to Accounts Payable	(17 000)	
Wages	(6 900)	
GST paid	(700)	
Freight in	(600)	
Interest	(150)	
Advertising	(1 400)	
Rent	(2 000)	(28 750)
Net Cash Flows from Operating Activities		**450**
CASH FLOWS FROM INVESTING ACTIVITIES		
Shelving		(3 000)
Net Cash Flows from Investing activities		**(3 000)**
CASH FLOWS FROM FINANCING ACTIVITIES		
Capital contribution		1 000
Drawings	(3 700)	
Loan principal	(750)	(4 450)
Net Cash Flows from Financing activities		**(3 450)**
Net Increase (Decrease) in cash position		**(6 000)**
Add Bank Balance at start (1 October 2030)		**3 500**
Bank Balance at end (31 October 2030)		**(2 500)**

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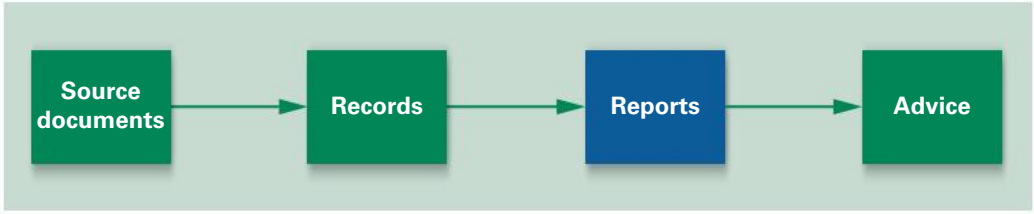
The Purchases Journal and Sales Journal only record sales and purchases made on credit, so the information they contain will **not** be included in the Cash Flow Statement. The same applies to sales returns, purchase returns, discount expense, discount revenue and bad debts. Note also that Cost of Sales and inventory loss – as determined in the inventory cards – are omitted from the Cash Flow Statement because they represent an outflow of inventory, not cash.

In fact, the Cash Flow Statement will report only the information contained in the Cash Receipts Journal and Cash Payments Journal, as these cash journals record all cash received and paid in a period.

Review questions 15.2

1 **Explain** the role of the Cash Flow Statement.
2 **Explain** the role of the cash journals in the preparation of a Cash Flow Statement.
3 **Explain** how the following items are reported in the Cash Flow Statement:
- capital contribution
- credit sales
- payments to Accounts Payable
- Cost of Sales.

15.3 The Income Statement



Whereas the Cash Flow Statement reports on cash received and paid in a period, the Income Statement reports revenue earned and expenses incurred in that period.

Recall the definitions of revenue and expenses from Chapter 10:

- **revenue** is an increase in assets or decrease in liabilities that leads to an increase in owner's equity
- **expense** is a decrease in assets or increase in liabilities that leads to a decrease in owner's equity.

Under these definitions cash *may* be involved, but it does not have to be received or paid for a revenue or expense to be recognised. Some revenue – like cash sales – will involve a receipt of cash and some expenses – like wages – will involve a payment of cash, but this is not a requirement.

In fact, applying the *Accrual basis assumption* means that revenue and expenses (and all other items for that matter) are recognised simply when the definition is satisfied. Revenues are recognised when they are earned (usually when the goods are provided to the customer) and expenses are recognised when they are incurred (when the goods or services are consumed). As a result, profit under the *Accrual basis assumption* is calculated by comparing the revenue earned against the expenses incurred in the current period. This is sometimes abbreviated to **Accrual Accounting**.

Accrual Accounting calculating profit by comparing revenue earned against expenses incurred in a particular reporting period

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Recognising revenue

Let's apply this definition of revenue to credit sales.

When a credit sale is made (and the goods are provided to the customer) an *increase in assets* (Accounts Receivable) occurs, and this *increases owner's equity*, so it is at this point that the revenue has been earned. Despite the fact that no cash is received on the day the sale is made, credit sales fit the definition of revenue perfectly, so it must be reported in the Income Statement as revenue.

Failing to include credit sales as revenue would understate Net Profit and thus undermine the *Relevance* of the Income Statement, making it less useful for decision-making (which is its primary purpose).

Sales returns

Sales returns must also be reported in the Income Statement as they are *negative* revenue and reduce the amount actually earned from sales.

Receipts from Accounts Receivable

Study tip

Recognising receipts from Accounts Receivable as revenue would be counting it twice – once when the inventory is sold, and a second time when the cash is received.

Receipts from Accounts Receivable on the other hand are not reported in the Income Statement. When cash is received from an Account Receivable, assets (Bank) increase but there is no *increase in assets* (*overall*) because Accounts Receivable decreases by the same amount. A receipt from an Account Receivable is in fact just swapping one asset (Accounts Receivable) for another (Bank); there is no increase in owner's equity, so it cannot be reported as revenue and should be omitted from the Income Statement.

Recognising expenses

A similar concept applies to expenses that must be recognised when the change in the Balance Sheet occurs, as this is when it is incurred. For instance, Cost of Sales and Inventory loss are recognised as expenses when the inventory leaves the shop, even though no cash is involved.

Credit purchases

Study tip

Credit purchases are not actually reported in any of the reports, but the information is used to determine the balance owing to Accounts Payable. (For more information, see section titled Payments to Accounts Payable.)

Even though credit purchases lead to an overall *increase in liabilities* (Accounts Payable increases more than GST payable decreases), they also lead to an *increase in assets* (Inventory). The fact that there is no effect on owner's equity, as is demanded by the definition, means credit purchases cannot be reported as an expense and must be omitted from the Income Statement.

Payments to Accounts Payable

Payments to Accounts Payable have a different effect on the Accounting equation, but they does not fit the definition of an expense either. Cash paid to an Account Payable will decrease assets (Bank) but will also decrease liabilities (in the form of Accounts Payable) meaning there is no effect on owner's equity. Therefore, payments to Accounts Payable fail to meet the definition of an expense and so must be omitted from the Income Statement.

An expense is recorded in relation to inventory, but it is represented in the Cost of Sales figure, which shows the *decrease in assets* (Inventory), which decreases *owner's equity*. Cost of Sales is of course recorded and reported when the inventory is sold, not when it is purchased (credit purchases) or paid for (payments to Accounts Payable).

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Using the same data provided earlier, Figure 15.2 shows the Income Statement for Full Boards for October 2030:

Figure 15.2 Income Statement

FULL BOARDS Income Statement for October 2030		
	$	$
Revenue[1]		
Cash sales	12 000	
Credit sales	20 000	
Less Sales returns	(500)	31 500
Less Cost of Goods Sold[2]		
Cost of Sales	16 400	
Freight in	600	17 000
Gross Profit[3]		**14 500**
Less Inventory loss		420
Adjusted Gross Profit[4]		**14 080**
Add Other revenue[5]		
Discount revenue		100
		14 180
Less Other expenses[6]		
Interest on loan	150	
Wages	6 900	
Advertising	1 400	
Rent	2 000	
Discount expense	120	
Bad debts	200	10 770
Net Profit[7]		$3 410

Study tip

Presentation matters in Accounting reports; items must be reported under the correct headings for the statement to be correct.

The information within the report is classified under the following headings:

1 Revenue

This section lists only those revenue earned as a *direct result of selling inventory*, namely, Sales revenue. In this case Cash sales (from the Sales column in the Cash Receipts Journal) and Credit sales (from the Sales column in the Sales Journal) are listed separately, but in other cases these figures may be combined.

Reporting Sales returns (from the Additional information) separately allows the owner to assess the quality of the firm's inventory and customer service. As a negative revenue, Sales returns is reported as a deduction from Sales, leaving Net Sales of $31 500 – the overall Sales revenue earned after the deduction of Sales returns.

2 Cost of Goods Sold

As explained in Chapter 12, **Cost of Goods Sold** is a heading referring to all costs incurred in getting goods into a condition and location ready for sale. Cost of Sales (from the Additional information) is simply one of the items that may be reported under this heading, with other costs, like Freight in, also included.

Study tip

Cost of Sales is determined in the inventory cards and will include inventory sold on cash and credit (from the OUT column) less any Sales returns (from the IN column)

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3 Gross Profit

As the difference between Net Sales ($31 500) and Cost of Goods Sold ($17 000), Gross Profit (**$14 500**) reflects the profit earned directly from the sale of inventory.

Further, as both Net Sales and Cost of Sales are the result of the same sales volume (or quantity of sales), the difference between them reflects the difference between the firm's selling and cost prices, so identifying this figure (with its own heading) allows the owner to assess the adequacy of the firm's mark-up.

4 Adjusted Gross Profit

Inventory losses (from the Additional information) must be deducted from Gross Profit, while Inventory gains must be added in order to determine **Adjusted Gross Profit ($14 080)**. These items do not occur as a direct result of the sale of inventory, but they are related to holding inventory and are therefore reported separately to allow the owner to make decisions about managing inventory.

5 Other revenue

Any revenue other than Sales is reported after Adjusted Gross Profit in order to protect Gross Profit as a measure of the mark-up.

Like Sales, Discount revenue will therefore increase profit; however, it is not earned at the time of the sale: it actually occurs from paying Accounts Payable early, so it is only earned when the payment is made. As a result, it must be reported as **Other revenue**, after Gross Profit has been calculated. Interest revenue and Commission revenue would also be reported here.

The figure derived by adding Other revenue to Adjusted Gross Profit (**$14 180** in Figure 15.2) has no title, but it must be shown nonetheless. Leaving out this total may result in failing to account for Other revenue when Net Profit is calculated.

6 Other expenses

Other expenses refers to all expenses generally not related to inventory, including day-to-day expenses such as Interest expense, Wages, Advertising and Rent (from the Cash Payments Journal) but also Discount expense and Bad debts (from the Additional information). If an expense is not reported in the calculation of Adjusted Gross Profit, it is reported here.

Note that this is where Freight *out* (the cost of delivery *to customers*) would be reported, as this is incurred *after* the sale. Freight *in* (the cost of delivery *from the supplier*) is incurred in the process of getting goods ready for sale, and so is reported as part of Cost of Goods Sold.

7 Net Profit

This is the 'bottom line' so frequently talked about in business circles: the overall profit or loss earned by the business in the current period. It is calculated by deducting Other expenses from the previous total (in this case, **$14 180** less $10 770) or by deducting Total expenses from Total revenue. It is this Net Profit figure of $3 410, which represents the net increase (or decrease) in owner's equity as a result of the firm's trading activities for the period.

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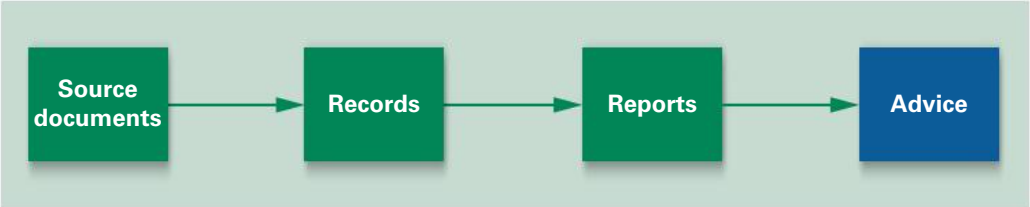
Review questions 15.3

1 **Define** the term 'Accrual Accounting'.
2 **Explain** why credit sales are classified as revenue.
3 **Explain** why GST charged on credit sales is **not** reported in the Income Statement.
4 Referring to one Qualitative characteristic, **explain** why Sales returns must be included in the Income Statement.
5 **Explain** why receipts from Accounts Receivable is **not** reported in the Income Statement.
6 **Explain** why credit purchases and payments to Accounts Payable are **not** classified as expenses.
7 **Explain** the difference between Cost of Sales and Cost of Goods Sold.
8 **Explain** why Discount revenue is reported after Adjusted Gross Profit.
9 **Explain** why Bad debts is reported as an Other expense.

15.4 Uses of the Income Statement



By reporting what has already happened as a result of the firm's trading activities, the Income Statement allows the owner to:

- **Assess the firm's performance**
  This is so that areas of improvement can be identified and corrective action taken to improve profit in the next period.
  Comparing revenue and expenses against targets (budgeted figures) will highlight where performance was better or worse than expected. Strategies can then be implemented to generate more revenue and/or control expenses more effectively. (See the next section.)
- **Plan for future trading activities by helping to set targets for the future**
  This may include sales levels and advertising expenditure, or even inventory levels and staffing requirements.
- **Calculate financial indicators to support analysis and interpretation.**
  Financial indicators such as Gross Profit Margin (GPM) and Net Profit Margin (NPM) can be used not only to uncover what has happened, but to help explain why. (This is covered in the following sections and in more detail in Chapter 18.)

Strategies to earn profit

In basic terms, earning profit involves two simple yet complex activities:

1 earning revenue
2 controlling expenses.

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Earning revenue

To generate more revenue, the owner may perform one of the following tasks.

- **Change selling prices** to generate a higher volume of sales (by decreasing prices) or greater revenue per sale (by increasing prices). Modelling various courses of action can help the owner make this decision in an informed manner.
- **Market strategically and effectively** by increasing or targeting advertising more accurately. This can start with how inventory is displayed for sale within the store.
- **Implement strategies to manage inventory** such as:
  - maintaining an appropriate inventory mix
  - promoting the sale of complementary goods
  - ensuring inventory is up to date
  - rotating inventory.
- **Move to a better location** that is more visible, closer to customers or close to a new potential market.
- **Improve customer service** through staff training, extra services (such as deliveries, wrapping, internet/phone access and product advice) or improving procedures (such as ordering).

Study tip

See Chapter 11 for a more detailed discussion of strategies to manage inventory.

Controlling expenses

In order to improve its ability to control expenses, a business might perform the following tasks.

- **Change inventory management practices** to find a cheaper supplier or better quality inventory or change handling procedures to reduce delivery and storage costs and inventory losses.
- **Change staff management practices**, such as rosters, incentives and training, to generate greater efficiency.
- **Change non-current asset management practices** by adopting energy-saving practices and devices or researching lower prices from different suppliers.

Non-financial information

Choosing between options for improvement must always be done with knowledge of the individual business in mind, and to this end non-financial information – any information that cannot be found in the financial statements, and is not expressed in dollars and cents, or reliant on dollars and cents for its calculation – is also critical. For example:

- the number of competitors in the area
- the number of repeat sales
- the number of sales returns
- the number of customer complaints
- the number of website hits
- the predicted weather for the next month

can all influence which strategies are implemented.

Ethical considerations

All of these decisions must still be made with **ethical considerations** in mind, and a business owner may for ethical reasons decide to choose a more expensive option because it is more socially or environmentally responsible.

Inventory from suppliers who pay their employees fairly, electricity and gas generated through 'green power', or assets that produce less waste and fewer greenhouse emissions may each be chosen in spite of higher short-term costs from their use. Advertising can be persuasive, but it cannot be dishonest. Also, staff management practices must be ethical and responsible as well as legal.

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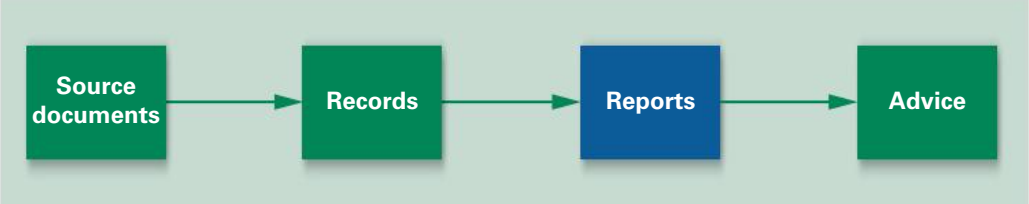
Unethical businesses may generate gains in the short term but in the longer term may find that customers are unwilling to buy from a business that puts its own immediate profit before the longer-term considerations of society and the environment.

Review questions 15.4

1 **Explain** how an Income Statement can be used by a business to assess its trading performance.
2 **Explain** how an Income Statement can be used by a business to plan for future trading activities.
3 **List** five strategies that might be used to generate more revenue.
4 **List** five strategies that might be used to improve expense control.
5 **Explain** the importance of non-financial information in decision-making to improve profit.
6 **Explain** why ethical considerations must be taken into account by business owners when choosing strategies to improve profitability.

Ethical considerations

15.5 The Balance Sheet



The rules of double-entry Accounting dictate that every transaction – cash, credit or anything else – must affect the Accounting equation (and the Balance Sheet on which it is based) in *at least* two ways, and those effects must balance. How does this apply to credit transactions?

In terms of Accounts Payable, Credit purchases increase Accounts Payable and Inventory, while decreasing the GST payable, and Purchase returns have the opposite effect. Payments to Accounts Payable simply decrease both Bank and Accounts Payable, but Discount revenue increases Net Profit and decreases Accounts Payable.

For Accounts Receivable, Credit sales increase Net Profit, Accounts Receivable and GST payable, while Sales returns have the opposite effect. Receipts from Accounts Receivable increase Bank and decrease Accounts Receivable, but Discount expense and Bad debts decrease Net Profit and Accounts Receivable.

This seems like a fairly complicated set of changes to remember! In practice it is much simpler. Any transaction that affects cash is already reported in the Cash Flow Statement, where all effects on Bank are summarised. Similarly, any transaction that affects profit is already reported in the Income Statement, where all the effects on Net Profit (and therefore owner's equity) are summarised.

As a result, all that must be considered is the *other* effect of these transactions on the Balance Sheet, and this is summarised by use of formulas for:

- Accounts Payable
- Accounts Receivable
- GST balance.

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Accounts Payable formula

Chapter 13 discussed the use of the Accounts Payable formula to check the balance of the Accounts Payable Schedule. By bringing together all of the transactions that affect Accounts Payable, the formula also allows the business to calculate the balance of Accounts Payable at the end of the period.

Figure 15.3 shows the Accounts Payable formula for Full Boards as at 31 October 2030:

Figure 15.3 Accounts Payable formula

Accounts Payable balance at start	12600	From the *previous* Balance Sheet (30 Sept. 2030)
+ Credit purchases (including GST)	19800	From the Purchases Journal
	32400	
– Purchase returns (including GST)	(330)	From the Additional Information
– Payments to Accounts Payable	(17000)	From the Cash Payments Journal
– Discount revenue	(100)	From the Additional Information / Income Statement
Accounts Payable balance at end	**$14970**	**For the *next* Balance Sheet (31 Oct. 2030)**

Study tip

Choose between the formula and schedule to calculate Accounts Receivable or Accounts Payable based on the available information.

This **$14970** balance of Accounts Payable will be reported in the Balance Sheet as a Current liability.

Accounts Receivable formula

Exactly the same approach can be taken with Accounts Receivable; both the Accounts Receivable Schedule and the Accounts Receivable formula should calculate the same balance owing at the end of the period.

Figure 15.4 shows the Accounts Receivable formula for Full Boards as at 31 October 2030:

Figure 15.4 Accounts Receivable formula

Accounts Receivable balance at start	8300	From the previous Balance Sheet (30 Sept. 2030)
+ Credit sales (including GST)	22000	From the Sales Journal
	30300	
– Sales returns (including GST)	(550)	From the Additional Information / Income Statement
– Receipts from Accounts Receivable	(16000)	From the Cash Receipts Journal
– Discount expense	(120)	From the Additional Information / Income Statement
– Bad debts (including GST)	(220)	From the Additional Information / Income Statement
Accounts Receivable balance at end	**$13410**	**For the *next* Balance Sheet (31 Oct. 2030)**

This **$13410** balance of Accounts Receivable will be reported in the Balance Sheet as a Current asset.

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GST balance

As we have noted before, businesses charge and collect the GST on behalf of the ATO, so any GST on Cash sales (from the Cash Receipts Journal) or Credit sales (from the Sales Journal) will increase GST payable. However, any GST on Sales returns or Bad debts – amounts that will not be collected from Accounts Receivable – will decrease that liability.

At the same time, GST on Cash purchases (from the Cash Payments Journal) or Credit purchases (from the Purchases Journal) will be forwarded to the ATO by the supplier, and so both are deducted from any GST liability. By contrast, GST on Purchase returns increases the liability as it will not be paid to the supplier.

Figure 15.5 shows the formula to calculate the GST balance, using the data from Full Boards for October 2030:

Figure 15.5 GST formula

GST balance at start	310	From the *previous* Balance Sheet (30 Sept. 2030)
+ GST on Cash sales	1 200	From the Cash Receipts Journal
+ GST on Credit sales	2 000	From the Sales Journal
– GST on Sales returns	(50)	From the Additional information
– GST on Bad debts	(20)	
– GST on Cash purchases	(700)	From the Cash Payments Journal
– GST on Credit purchases	(1 800)	From the Purchases Journal
+ GST on Purchase returns	30	From the Additional information
GST balance at end	**$970**	**For the *next* Balance Sheet (31 Oct. 2030)**

This **$970** balance is a debt owed to the ATO and will be reported as a Current liability – GST payable – in the Balance Sheet.

GST payable/receivable

If the GST on sales is greater than GST on purchases, the business will have a debt to the ATO, and the GST will be reported in the Balance Sheet as a Current liability called **GST payable**. That is, the GST will be a present obligation to transfer an economic resource (by paying the ATO a GST settlement) in the next 12 months.

Given that selling prices are usually higher than cost prices, GST on sales will usually be higher than GST on purchases, so GST payable will be the most likely GST outcome.

However, if the GST on purchases is greater than the GST on sales, the business will end up being owed GST by the ATO. This **GST receivable** will be reported in the Balance Sheet as a Current asset because it is a present economic resource controlled by the business that will produce economic benefits (when the refund is received) in the next 12 months.

Although this is less likely than GST payable, GST receivable could occur if the business has purchased inventory that has not yet sold or has made large outlays to purchase non-current assets.

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The Balance Sheet that incorporates these effects is shown in Figure 15.6:

Figure 15.6 Balance Sheet

FULL BOARDS
Balance Sheet as at 31 October 2030

	$	$		$	$
Current Assets			**Current Liabilities**		
Inventory[2]	21 880		Bank[1]	**2 500**	
Accounts Receivable[3]	**13 410**	35 290	Accounts Payable[6]	**14 970**	
Non-Current Assets			GST Payable[7]	**970**	
Shelving[4]	38 000		Loan – QS Finance[8]	9 000	27 440
Office Equipment[5]	12 000	50 000	**Non-Current Liabilities**		
			Loan – QS Finance[8]		20 250
			Owner's equity		
			Capital – Windsor[9]	37 890	
			Add Net Profit[10]	3 410	
				41 300	
			Less Drawings[11]	3 700	37 600
Total Assets		**85 290**	**Total Equities**		**85 290**

Notes to the Balance Sheet

1	Bank	Cash Flow Statement (Figure 15.1): closing balance
2	Inventory	Additional information; determined by the physical inventory count
3	Accounts Receivable	Accounts Receivable formula (Figure 15.4): Balance at end
4	Shelving	Previous Balance Sheet *plus* $3000 new shelving *
5	Office equipment	Previous Balance Sheet (no change)
6	Accounts Payable	Accounts Payable formula (Figure 15.3): Balance at end
7	GST Payable	GST formula (Figure 15.5): Balance at end
8	Loan – QS Finance	Previous Balance Sheet: Current: $750 per month ×12 months Non-current: remainder ($30 000 – $750 repayment *– $9 000)
9	Capital	Previous Balance Sheet *plus* $1000 capital contribution *
10	Net Profit	Income Statement (Figure 15.2)
11	Drawings	Cash Flow Statement (Figure 15.1)

* From the Cash Flow Statement (Figure 15.1).

Review questions 15.5

1. **Show** the formula to calculate the balance of Accounts Payable at the end of the period.
2. **Show** the formula to calculate the balance of Accounts Receivable at the end of the period.
3. **Show** the formula to calculate the GST balance at the end of the period.
4. **Explain** the circumstances in which the GST balance would be classified as a Current liability.
5. **Explain** the circumstances in which the GST balance would be classified as a Current asset.

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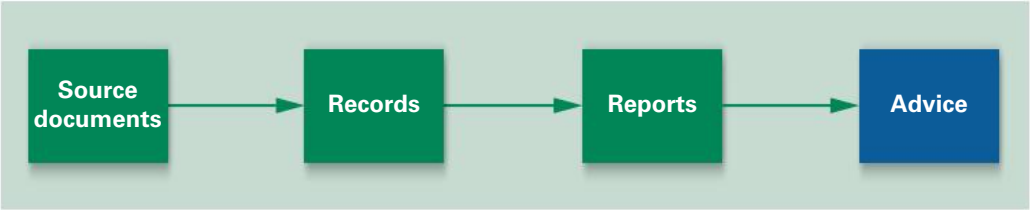
15.6 Managing Accounts Payable



The main benefit of purchasing inventory using credit is that it gives the business time to sell the inventory, and collect the cash from the customer, before payment for the inventory must be made. However, it is still important that Accounts Payable are paid on time. **Accounts Payable Turnover (APTO)** measures the average number of days taken to pay Accounts Payable.

The Accounts Payable Turnover is calculated as shown in Figure 15.7:

Accounts Payable Turnover (APTO) an efficiency indicator that measures the average number of days it takes for a business to pay its Accounts Payable

Figure 15.7 Formula: Accounts Payable Turnover

$$\text{Accounts Payable Turnover (APTO)} = \frac{\text{Average Accounts Payable}}{\text{Net Credit Purchases (plus GST)}} \times 365$$

$$= \text{Average number of days}$$

The formula uses the average balance of Accounts Payable (derived by adding the starting and ending balances, and then dividing by 2) to accommodate for any changes in that balance over the period, and multiplies by 365 so that the answer is expressed in terms of days. It also uses 'Net' Credit purchases (plus GST) to account for any returns of inventory, as these will reduce the amount that must be paid.

Example

Fulton Furniture has provided the following information relating to its Accounts Payable for the year ended 30 June 2030:

Credit purchases incl. GST	$203 500
Purchase returns incl. GST	$2 750
Accounts Payable as at 1 July 2029	$23 000
Accounts Payable as at 30 June 2030	$17 000
Credit terms offered by suppliers	45 days

Calculating Accounts Payable Turnover (APTO)

The Accounts Payable Turnover for Fulton Furniture would be calculated as is shown in Figure 15.8:

Figure 15.8 Calculation: Accounts Payable Turnover

$$\text{APTO} = \frac{(\$23\,000 + \$17\,000) / 2}{\$203\,500 - \$2\,750} \times 365$$

$$= \frac{\$20\,000}{\$200\,750} \times 365$$

$$= 37^{*} \text{ days (36.36 rounded up to the nearest day)}$$

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Study tip

Changes in APTO should be described as faster or slower than previous periods; than budgeted; than similar businesses; than credit terms.

The Accounts Payable Turnover indicates that for the year ended 30 June 2030, it took an average of 37 days to pay Accounts Payable – eight days before the credit terms required payment.

Analysing Accounts Payable Turnover

When assessing any aspect of business performance, it can be useful to compare results against some type of 'benchmark' or 'standard'. In the case of Accounts Payable Turnover, these benchmarks allow the owner to assess whether the business is paying its Accounts Payable *faster* or *slower* than:

- last year (performance in **previous periods**)
- expected (**budgeted** performance)
- its competitors (performance of **similar businesses**, sometimes reflected in an *industry average*).

However, the credit terms offered by suppliers is the main determinant of whether Accounts Payable Turnover is satisfactory or not. Paying Accounts Payable early may be beneficial if discounts are involved, but generally a business should try to pay its Accounts Payable as close to the credit terms as is possible without exceeding them. This will allow the business to maximise the time it has available to generate cash from its sales. It will also mean it retains its cash longer so it can be used to meet other payments as they fall due.

However, exceeding the credit terms can lead to a variety of consequences, such as:

- a loss of any possible discount for early repayment
- a reduction in the firm's credit rating (which may jeopardise future borrowing)
- a refusal of credit facilities by the supplier, meaning the business must pay cash up-front or purchase from a new supplier (who may not provide the same price, quality or range).

Inventory Turnover, Accounts Receivable Turnover and Accounts Payable Turnover

The firm's ability to pay its Accounts Payable will rely heavily on its ability to generate cash from its inventory. This means Accounts Payable Turnover is reliant on Inventory Turnover and (if the business deals mainly on credit) Accounts Receivable Turnover. If inventory is sold and cash collected from customers quickly, then Accounts Payable can be paid on time. If not, debts may become overdue, and a whole variety of liquidity problems may result.

Strategies for managing Accounts Payable

Using the credit provided by Accounts Payable, businesses are more able to manage when they pay for their inventory, and this gives them an important resource for managing their **liquidity** – their ability to meet short-term debts as they fall due.

Having access to credit makes it critical that Accounts Payable are managed effectively, and this can be done by following some broad principles:

- **Develop a strong relationship with each supplier** to access better prices, better credit terms or even better quality inventory.
- **Pay within, but as close as possible to, the credit terms** so that the supplier will continue to provide ongoing access to credit, but the business has time to generate the cash and retain cash to meet other payments as they fall due.
- **Pay early to earn discount revenue** (if available, and affordable)

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- **Check each Statement of Account against the Accounts Payable record** to ensure each account is accurate and complete as this reduces the possibility of overpayment.
- **Appoint an Accounts Payable OfficerClerk** to take responsibility for record keeping (including checking the Statements of Account), liaising with each Account Payable and ensuring that accounts are paid on time (and with appropriate discounts).
- **Communicate in a timely fashion** especially at times where it may be difficult to pay by the deadline as other payment arrangements may be possible.

In all of these dealings, **acting in an ethical manner** – particularly by acting with integrity and being honest (and open, within the bounds of commercial confidentiality) – remains essential if the relationship with the supplier is to continue.

Review questions 15.6

1. **State** what is measured by Accounts Payable Turnover.
2. **Show** the formula to calculate Accounts Payable Turnover.
3. **List** three benchmarks that can be used to assess Accounts Payable Turnover.
4. **State** three negative consequences of exceeding the credit terms offered by suppliers.
5. **Explain** the relationship between Accounts Payable Turnover, Inventory Turnover and Accounts Receivable Turnover.
6. **List** five strategies for managing Accounts Payable effectively.
7. **Explain** how ethical considerations and personal relationships can be useful in the effective management of Accounts Payable.

Ethical considerations

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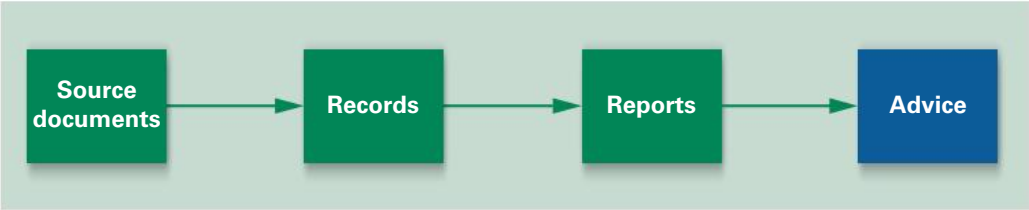
15.7 Managing Accounts Receivable



As we have seen, credit sales are classified as revenue because when the sale is made, a future economic benefit – in the form of Accounts Receivable – is created. If credit sales are significant, then so too will be the amount owed by Accounts Receivable, making the management of Accounts Receivable vital to the success of a small business. After all, there is little point in generating high credit sales if the cash is never received from Accounts Receivable.

Primarily, management of Accounts Receivable involves ensuring that debts are collected from Accounts Receivable in full and on time, so that cash is available when needed, and bad debts are minimised. Management of this kind requires detailed Accounting information – information that should be generated by the Accounting system. The system we have developed provides information about Accounts Receivable via:

- Accounts Receivable records
- Accounts Receivable Turnover.

Accounts Receivable records

As was explained in Chapter 14, Accounts Receivable records detail each individual transaction with each individual Account Receivable. By examining these records, the owner can identify slow-paying Accounts Receivable and then take steps to recover the cash.

Some larger (but still small) businesses may even employ an accounts clerk whose sole job is to manage Accounts Receivable by issuing invoices, collecting cash and making reminder calls to those who are overdue. Using the Accounts Receivable records to give this type of attention to individual Accounts Receivable can be a very effective approach to managing Accounts Receivable.

Accounts Receivable Turnover (ARTO) an efficiency indicator that measures the average number of days it takes for a business to collect cash from its Accounts Receivable

Accounts Receivable Turnover

Examining the Accounts Receivable records will give specific and detailed information about individual Accounts Receivable but will not give an overview of the effectiveness of the firm's Account Receivable management policies. These general principles should be applied to all Accounts Receivable and should ensure that the vast bulk of Accounts Receivable meet the credit terms offered.

The overall effectiveness of Account Receivable management policies can be assessed by calculating **Accounts Receivable Turnover (ARTO)** – the average number of days it takes to collect cash from Accounts Receivable.

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The Accounts Receivable Turnover is calculated as shown in Figure 15.9:

Figure 15.9 Formula: Accounts Receivable Turnover

$$\textbf{Accounts Receivable Turnover (ARTO)} = \frac{\textbf{Average Accounts Receivable}}{\textbf{Net Credit Sales (plus GST)}} \times 365$$

$$= \textbf{Average number of days}$$

Like its Accounts Payable equivalent, Accounts Receivable Turnover uses the average balance of Accounts Receivable (derived by adding the starting and ending balances, and then dividing by 2) to accommodate for any changes in that balance over the period, and multiplies by 365 so that the answer is expressed in terms of days. It also uses 'Net' credit sales (plus GST) to account for any sales returns, as these will reduce the amount that will be received.

Example

Fulton Furniture has provided the following information relating to its Accounts Receivable for the year ended 30 June 2030 :

Credit sales incl. GST	$220 000
Sales returns incl. GST	$19 800
Accounts Receivable as at 1 July 2029	$35 000
Accounts Receivable as at 30 June 2030	$45 000
Credit terms offered to customers	60 days
Accounts Payable Turnover	37 days

Calculating Accounts Receivable Turnover (ARTO)

The Accounts Receivable Turnover for Fulton Furniture would be calculated as is shown in Figure 15.10:

Figure 15.10 Calculation: Accounts Receivable Turnover

$$\textbf{ARTO} = \frac{(\$35\,000 + \$45\,000)/2}{\$220\,000 - \$19\,800} \times 365$$

$$= \frac{\$40\,000}{\$200\,200} \times 365$$

$$= 73^{*} \text{ days (72.9 rounded up to the nearest day)}$$

Study tip

When entering these figures in your calculator, press = before dividing by 2, or your answer will be incorrect.

The Accounts Receivable Turnover indicates that in the year ended 30 June 2030, it took an average of 73 days to collect cash from Accounts Receivable.

Analysing Accounts Receivable Turnover

This Accounts Receivable Turnover should be assessed against 'benchmarks' or 'standards' including:

- last year (performance in **previous periods**)
- expected (**budgeted** performance)
- its competitors (performance of **similar businesses**, sometimes reflected in an industry average).

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These benchmarks are useful, but it is the credit terms offered to customers that should be used to determine whether or not Accounts Receivable Turnover is satisfactory. In this example, customers were offered 60 days credit, so an Accounts Receivable Turnover of 73 days indicates poor Account Receivable management. If Accounts Receivable are taking 13 days longer than allowed to repay their debts, the business is being forced to wait longer to collect its cash, which may place a strain on its ability to meet its other debts.

Because it is an average, the Accounts Receivable Turnover could conceal the fact that some Accounts Receivable took much more than 73 days to pay (because some took less than 73 days), so it must be read in conjunction with the Accounts Receivable records to identify which Accounts Receivable are overdue. However, it does identify that there is a problem with the firm's Account Receivable management techniques.

Strategies for managing Accounts Receivable

If a significant proportion of sales are made on credit, the business will have to wait not only until the inventory is sold, but also wait again until the cash is collected from its Accounts Receivable (as measured by Accounts Receivable Turnover) for the cash to pay its Accounts Payable, wages and other expenses. Conversely, fast Accounts Receivable Turnover will mean cash is collected quickly and can then be used to meet debts as they fall due. This means the firm's ability to manage its Accounts Receivable effectively is crucial to its liquidity.

Given the importance of receiving cash from Accounts Receivable on a timely basis, the owner may consider implementing some, or all, of the following strategies to manage its Accounts Receivable:

- **Offer discounts for quick settlement** to encourage Accounts Receivable to pay well within the credit terms. (Note that this is a strategy to encourage early payment of debts that are not already late: discounts should not be offered on overdue debts!)
- **Send invoices promptly** so that the customer is immediately aware of the amount owing and the repayment date.
- **Conduct extensive credit checks** so that sales are only made to customers who have a proven record of paying on time.
- **Send reminder notices** to remind Accounts Receivable that their payment is overdue. Reminders may take the form of a copy of the invoice or a Statement of Account that has the outstanding amount clearly shown as overdue.
- **Threaten legal action** but only as a last resort as it expensive and signals the end of the relationship with the customer.
- **Employ a debt collection agency** to employ practices ranging from annoying a late payer by persistent telephone contact to embarrassment at their place of work.
- **Deny access to credit facilities** to Accounts Receivable who have not paid their current debts until the amount outstanding is received.
- **Appoint an Accounts Receivable OfficerClerk** to take responsibility for record keeping (including checking the Statements of Account) and liaising with each Account Receivable to ensure that they pay on time.
- **Consider non-financial information** such as the customer's current business (or even personal) circumstances or the significance (importance or length) of the relationship with the customer, which might prompt a more 'flexible' approach.

Ethical considerations

When managing debts owed by Accounts Receivable, acting in an ethical manner remains essential, as it underpins the financial and personal relationships between the business and its customers, which can sustain both through difficult periods. Collecting debts should never descend into unethical – or illegal – practices.

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Review questions 15.7

1 **Explain** how Accounts Receivable records can be used to aid Account Receivable management.
2 **State** what is measured by Accounts Receivable Turnover.
3 **Show** the formula to calculate Accounts Receivable Turnover.
4 **List** three benchmarks that can be used to assess Accounts Receivable Turnover.
5 **Explain** the importance of credit terms offered to customers in assessing Accounts Receivable Turnover.
6 **Explain** why Accounts Receivable records and Accounts Receivable Turnover should both be used to assess the management of Accounts Receivable.
7 **Explain** why Account Receivable management is vital to ensuring adequate liquidity.
8 **List** the strategies a business could use to improve its Accounts Receivable Turnover, in the order in which they should be implemented.
9 **Explain** how ethical considerations and non-financial information can inform the management of Accounts Receivable.

Ethical considerations

Where have we been?

- Credit sales is reported as revenue in the Income Statement because it increases assets and owner's equity, but receipts from Accounts Receivable is not revenue because it does not increase assets overall and there is no increase in owner's equity.
- Credit purchases is not reported in any of the reports, but the information is used to determine the balance owing to Accounts Payable and the balance of Inventory and GST.
- Payments to Accounts Payable is not reported as an expense because it will decrease both assets and liabilities with no effect on owner's equity.
- Accrual Accounting determines profit by comparing the revenue earned in the current reporting period against the expenses incurred in the current reporting period.
- Accounts Payable Turnover (APTO) measures the average number of days taken to pay Accounts Payable.
- Accounts Receivable Turnover (ARTO) measures the average number of days it takes to collect cash from Accounts Receivable.
- Accounts Payable Turnover is reliant on Inventory Turnover and Accounts Receivable Turnover.
- Businesses can use a variety of strategies to manage Accounts Payable/Accounts Receivable but must do so in an ethical manner.

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Exercises

Please note: asterisks indicate that an answer for that question is available in the Selected Answers section at the end of this book.

Exercise 15.1
Reporting credit transactions

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Larkham Interiors sells office furniture and has provided the following information about its activities for April 2030:

LARKHAM INTERIORS
Balance Sheet (unclassified) as at 31 March 2030

Assets	$	Equities	$
Accounts Receivable	1 600	Accounts Payable	2 400
Inventory	32 000	Bank overdraft	1 000
Equipment	7 000	GST payable	520
Premises	80 000	Capital – Larkham	116 680
Total Assets	**120 600**	**Total Equities**	**120 600**

The transactions for April 2030 have been summarised in the journals below:

Sales Journal

Date	Account Receivable	Inv. No.	Sales	GST	Accounts Receivable
April	**TOTALS**	**$**	**4 500**	**450**	**4 950**

Purchases Journal

Date	Account Payable	Inv. No.	Inventory	GST	Accounts Payable
April	**TOTALS**	**$**	**5 000**	**500**	**5 500**

Cash Receipts Journal

Date	Details	Source Document	Bank	Discount Expense	Accounts Receivable	Sales	Sundries	GST
April	Loan – nab						15 000	
	TOTALS	**$**	**30 500**	**nil**	**5 600**	**9 000**	**15 000**	**900**

Cash Payments Journal

Date	Details	Source Document	Bank	Discount Revenue	Accounts Payable	Drawings	Wages	Sundries	GST
April	Advertising							2 000	200
	Van							15 000	1 500
	Electricity							500	50
	Stationery							100	10
	TOTALS	**$**	**27 760**	**nil**	**4 900**	**1 500**	**2 000**	**17 600**	**1 760**

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Additional information:

- Inventory on hand as at 30 April 2030 (physical count) was $30 500.
- Cost of Sales for April 2030 was $6 500.
- Loan – nab is repayable in instalments of $5 000 per year.

Required

* **a.** **Prepare** a Cash Flow Statement for Larkham Interiors for April 2030.
* **b.** **Prepare** an Income Statement for Larkham Interiors for April 2030.
c. Referring to one Accounting assumption, **explain** why credit sales are classified as revenue.
d. **Calculate** the balance of Accounts Receivable and Accounts Payable as at 30 April 2030.
e. **Calculate** the GST balance as at 30 April 2030.
* **f.** **Prepare** a Balance Sheet for Larkham Interiors as at 30 April 2030.
g. Referring to your answer to part **f**, **explain** your treatment of GST.

Exercise 15.2
Reporting credit transactions

page 268

Smith's Hardware has provided the following information about its activities for 2030:

SMITH'S HARDWARE
Balance Sheet (unclassified) as at 31 December 2030

Assets	$	Equities	$
Bank	5 000	Accounts Payable	16 500
Inventory	21 000	Loan – ANZ	15 000
Accounts Receivable	12 500	GST payable	2 350
Delivery van	15 000	Capital – Smith	27 650
Office equipment	8 000		
Total Assets	**61 500**	**Total Equities**	**61 500**

The transactions for 2030 have been summarised in the journals below:

Sales Journal

Date	Account Receivable	Inv. No.	Sales	GST	Accounts Receivable
	TOTALS	**$**	**46 000**	**4 600**	**50 600**

Purchases Journal

Date	Account Payable	Inv. No.	Inventory	GST	Accounts Payable
	TOTALS	**$**	**36 000**	**3 600**	**39 600**

Cash Receipts Journal

Date	Details	Source Document	Bank	Discount Expense	Accounts Receivable	Sales	Sundries	GST
	Capital contribution						5 000	
	TOTALS	**$**	**92 600**	**460**	**33 060**	**50 000**	**5 000**	**5 000**

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Cash Payments Journal

Date	Details	Source Document	Bank	Discount Revenue	Accounts Payable	Drawings	Wages	Sundries	GST
2030	Advertising							2 000	200
	Loan – ANZ							3 000	
	Interest on loan							1 000	
	Rent							9 000	900
	TOTALS	**$**	**94 100**	**190**	**19 190**	**35 000**	**24 000**	**15 000**	**1 100**

Additional information:

- Sales returns for 2030 were $1 000 plus GST.
- Purchase returns for 2030 were $330 including GST.
- Cost of Sales for 2030 was $34 000.
- As at 31 December 2030, the inventory cards showed Inventory on hand worth $22 700.
- A physical count on 31 December 2030 showed Inventory on hand of $22 200.
- The loan is repayable in instalments of $3 000, due on 1 January every year.
- Smith's Hardware is thinking of changing to a cheaper supplier for 2031, but there have been discussions in the media about poisonous lead in their paint.

Required

* **a.** **Prepare** a Cash Flow Statement for Smith's Hardware for 2030.
* **b.** **Prepare** an Income Statement for Smith's Hardware for 2030.
c. Referring to one Qualitative characteristic, **explain** why receipts from Accounts Receivable are not reported in the Income Statement.
d. **Explain** two reasons why Smith's Hardware suffered a net decrease in cash position despite earning a profit for 2030.
e. Referring to financial and ethical considerations, **discuss** whether Smith's Hardware should change to the cheaper supplier in 2031.
f. **Calculate** the balance of Accounts Receivable and Accounts Payable as at 31 December 2030.
g. **Calculate** the GST balance as at 31 December 2030.
* **h.** **Prepare** a Balance Sheet for Smith's Hardware as at 31 December 2030.
i. **Explain** one technique Smith's Hardware is using to ensure its Balance Sheet provides a Faithful representation of its financial position.

Ethical considerations

Exercise 15.3
Reporting credit transactions

W B page 272

Cozy Imij sells home decorations and furnishings, and has provided the following information about its activities for August 2030:

COZY IMIJ
Balance Sheet (unclassified) as at 31 July 2030

Assets	$	Equities	$
Accounts Receivable	18 400	Bank	2 000
Inventory	12 600	Accounts Payable	700
Shop fittings	5 000	GST payable	390
		Loan – nab	9 000
		Capital – Baird	23 910
Total Assets	**36 000**	**Total Equities**	**36 000**

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COZY IMIJ
Cash Flow Statement for August 2030

	$	$
CASH FLOWS FROM OPERATING ACTIVITIES		
Cash sales	5 000	
Receipts from Accounts Receivable	4 400	
GST received	500	9 900
Payments to Accounts Payable	(2 500)	
Wages	(1 950)	
GST paid	(160)	
Interest on loan	(150)	
GST settlement	(390)	(5 150)
Net Cash Flows from Operating Activities		**4 750**
CASH FLOWS FROM INVESTING ACTIVITIES		
Computer equipment		(1 600)
Net Cash Flows from Investing activities		**(1 600)**
CASH FLOWS FROM FINANCING ACTIVITIES		
Capital contribution		3 000
Drawings		(1 400)
Net Cash Flows from Financing activities		**1 600**
Net Increase (Decrease) in cash position		**4 750**
Add Bank Balance at start (1 August 2030)		**(2 000)**
Bank Balance at end (31 August 2030)		**2 750**

Additional information:

- Credit sales for August 2030 were $4 200 plus GST.
- Sales returns for August 2030 were $330 including GST.
- Credit purchases for August 2030 were $8 700 plus GST.
- Purchase returns for August 2030 were $110 including GST.
- Cost of Sales for August 2030 was $7 500.
- Inventory balance as per inventory cards as at 31 August 2030 was $13 700.
- Physical inventory count as at 31 August 2030 was $13 900.
- Discount granted to customers $140.
- Discount received from suppliers $80.
- During August 2030, a balance of $220 owed by an Account Receivable was written off as a bad debt. The owner has not received formal notification of bankruptcy but has read in the newspaper that the customer has fled the country.
- The loan is repayable in instalments of $3 000 every six months.

Required

* **a.** **Prepare** an Income Statement for Cozy Imij for August 2030.

b. **Explain** why payments to Accounts Payable are not reported as an expense in the Income Statement.

c. **Discuss** the ethical considerations involved in the owner's decision to report the bad debt.

Ethical considerations

d. **Explain** two reasons why Cozy Imij made a Net Loss yet generated a net increase in cash for August 2030.

e. **Calculate** the balance of Accounts Receivable, Accounts Payable and GST as at 31 August 2030.

* **f.** **Prepare** a Balance Sheet for Cozy Imij as at 31 August 2030.

g. Referring to your answer to part **f**, **explain** your treatment of GST.

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Exercise 15.4
Managing Accounts Payable

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Pennington Prints purchases all of its inventory on credit. The following information relates to the year ended 30 November 2030:

Credit purchases	$71 900	plus GST
Purchase returns	$2 600	plus GST
Accounts Payable (1 December 2029)	$13 600	
Accounts Payable (30 November 2030)	$12 400	
Credit terms offered by suppliers	60 days	

Required

a. **Calculate** Accounts Payable Turnover for Pennington Prints for the year ended 30 November 2030.
b. Referring to your answer to part **a**, **state** whether the Accounts Payable Turnover is satisfactory. **Justify** your answer.
c. **Suggest** two strategies the owner could implement to improve the firm's Accounts Payable Turnover.
d. **State** two possible consequences of exceeding the terms offered by the supplier.

Exercise 15.5
Managing Accounts Payable

page 276

Mildura Fashions makes all its sales and purchases on credit and has provided the following information relating to the year ended 31 March 2030:

Credit purchases	$91 250	plus GST
Purchase returns	$6 600	including GST
Average Accounts Payable	$12 000	
Credit terms offered by suppliers	7/10, n/45	
Inventory Turnover for the year ended 31 March 2030	42 days	

Required

a. **Calculate** Accounts Payable Turnover for the year ended 31 March 2030.
b. Referring to your answer to part **a**, **state** whether the Accounts Payable Turnover is satisfactory. **Justify** your answer.
c. **State** one positive consequence of exceeding the credit terms offered by suppliers.
d. **Explain** how paying early could improve the liquidity and profitability of Mildura Fashions.
e. **Explain** why Mildura Fashions must analyse its inventory management strategies.

Exercise 15.6
Managing Accounts Receivable

page 277

Wainwright HiFi sells all its inventory on credit. The following information relates to the year ended 30 September 2030:

Credit sales	$155 000	plus GST
Sales returns	$10 000	plus GST
Accounts Receivable (1 October 2029)	$16 700	
Accounts Receivable (30 September 2030)	$17 300	
Credit terms offered to customers	5/10, n/30 days	
Inventory Turnover	17 days	
Inventory Turnover (Industry average)	20 days	
Credit terms offered by suppliers	45 days	

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Required

a. **Calculate** Accounts Receivable Turnover for Wainwright HiFi for the year ended 30 September 2030.
b. Referring to your answer to part **a**, **state** whether the Accounts Receivable Turnover is satisfactory. **Justify** your answer.
c. **Suggest** two strategies the owner could implement to improve the firm's Accounts Receivable Turnover.
d. **Explain** why Wainwright HiFi may have difficulty in meeting the terms offered by its suppliers.

Exercise 15.7
Managing Accounts Receivable

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Bendigo Bikes has provided the following information regarding its activities for the year ended 31 May 2030:

BENDIGO BIKES
Income Statement for the year ended 31 May 2030

	$	$
Cash sales	990 000	
Credit sales	11 000	
Less Sales returns	1 000	1 000 000
Less Cost of Goods Sold		750 000
Gross Profit		**250 000**
Less Other expenses		150 000
Net Profit		**100 000**

Additional information:

- Average Accounts Receivable for the year ended 31 May 2030 was $2 000.
- Credit sales are made on terms of 2/7, n/60, but due to concerns over the Accounts Receivable Turnover, the owner has decided to make credit more difficult to obtain.
- All inventory is purchased on credit terms of 60 days.

Required

a. **Calculate** Accounts Receivable Turnover for the year ended 31 May 2030.
b. Referring to your answer to part **a**, **state** whether the Accounts Receivable Turnover is satisfactory. **Justify** your answer.
c. **Explain** the likely effect on Accounts Receivable Turnover of the owner's decision to make credit more difficult to obtain.
d. **Explain** why the firm's Accounts Receivable Turnover will **not** have a significant effect on its ability to meet its short-term debts.
e. **Explain** how the Accounts Receivable records could be used to improve the management of Accounts Receivable.

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Exercise 15.8
Managing Accounts Payable and Accounts Receivable

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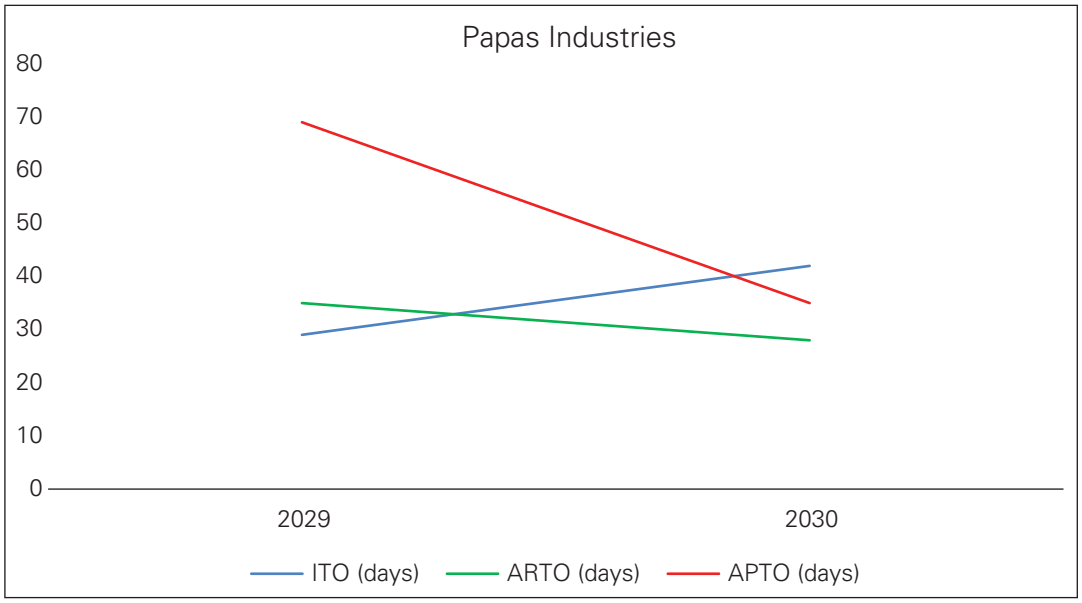
Papas Industries sells calculators and other business machines and has provided the following information for 2029 and 2030:



Video 15.1
Interpreting graphs

Additional information:

- Papas Industries offers credit terms of 10/7, n30 and all sales are made on credit.
- Accounts Payable provide credit terms of n60.

Required

a. **Suggest** two actions Papas Industries may have taken that led to the change in Accounts Receivable Turnover in 2030.

b. **Discuss** the performance of Papas Industries in managing its inventory, Accounts Receivable and Accounts Payable in 2030 and the likely effect on the firm's liquidity.

c. **Explain** three actions Papas Industries could take to improve its management of inventory, Accounts Receivable and Accounts Payable in the future.

Exercise 15.9
Reporting credit transactions

page 280

Hattie Madding is the owner and operator of Madding Hatters, a hat retailer. Inventory is purchased on credit. Credit sales are offered to sporting clubs, but some cash sales are also made over the counter. Hattie has provided the following information regarding the firm's activities for July 2030:

MADDING HATTERS
Balance Sheet (unclassified) as at 30 June 2030

Assets	$	Equities	$
Bank	1 500	Accounts Payable	35 000
Accounts Receivable	41 000	Loan – QuickFin	28 000
Inventory	9 000	GST payable	500
Office equipment	14 000	Capital – Madding	22 000
Shop fittings	20 000		
Total Assets	**85 500**	**Total Equities**	**85 500**

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The transactions for July 2030 have been summarised in the journals below:

Sales Journal

Date	Accounts Receivable	Inv. No.	Sales	GST	Accounts Receivable
July	**TOTALS**	**$**	**47 000**	**4 700**	**51 700**

Cash Receipts Journal

Date	Details	Source Document	Bank	Accounts Receivable	Sales	Sundries	GST
July	**TOTALS**	**$**	**54 400**	**32 400**	**20 000**	**nil**	**2 000**

Cash Payments Journal

Date	Details	Source Document	Bank	Discount revenue	Accounts Payable	Drawings	Wages	Sundries	GST
July	Protective spray							6 200	
	Rent							3 000	
	Interest on loan							300	
	Delivery to customers							2 000	
	TOTALS	**$**	**57 920**	**250**	**26 750**	**7 800**	**11 000**	**11 500**	**1 120**

Additional information:

- Cost of Sales $27 600
- Sales returns $600 plus GST
- Purchase returns $220 including GST
- Accounts Receivable as at 31 July 2030 $58 540
- Accounts Payable as at 31 July 2030 $40 150
- Inventory on hand as at 31 July 2030 (inventory cards) $10 400
- Inventory on hand as at 31 July 2030 (physical count) $10 200
- Loan – QuickFin repayments $4 000 p.a.
- Discounts were granted to Accounts Receivable, but the owner did not keep a record of how much.
- All inventory is treated with a special protective spray before it is offered for sale to customers.

Required

a. **Calculate** the bank balance of Madding Hatters as at 31 July 2030.
b. Use the Accounts Receivable formula to **calculate** discount expense for July 2030.
* **c.** **Prepare** an Income Statement for Madding Hatters for July 2030.
d. **Explain**, giving two examples from the information provided, how Madding Hatters generated a Net Profit despite suffering a net decrease in cash position for July 2030.
e. **Calculate** the GST balance as at 31 July 2030.
* **f.** **Prepare** a Balance Sheet for Madding Hatters as at 31 July 2030.
g. **Explain** why most businesses will end up with GST payable at the end of the period.

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Exercise 15.10
Reporting credit transactions

page 284

Josh Houston runs a paint shop called Painter's Choice. All inventory is purchased on credit, but sales are made on both cash and credit terms. Josh has provided the following information regarding the firm's activities for June 2030:

PAINTER'S CHOICE
Balance Sheet (unclassified) as at 31 May 2030

Assets	$	Equities	$
Accounts Receivable	3500	Bank	2000
Inventory	29500	Accounts Payable	3000
GST receivable	200	Loan – ANZ	12000
Shop fittings	13500	Capital – Houston	29700
Total Assets	**46700**	**Total Equities**	**46700**

PAINTER'S CHOICE
Cash Flow Statement for June 2030

	$	$
CASH FLOWS FROM OPERATING ACTIVITIES		
Cash sales	2000	
Receipts from Accounts Receivable	10390	
GST received	200	12590
Payments to Accounts Payable	(7700)	
Wages	(1750)	
GST paid	(70)	
Freight in	(200)	
Interest	(100)	
Rent	(500)	(10320)
Net Cash Flows from Operating Activities		**2270**
CASH FLOWS FROM FINANCING ACTIVITIES		
Capital contribution		5000
Drawings		(3400)
Net Cash Flows from Financing activities		**1600**
Net Increase (Decrease) in cash position		**3870**
Bank Balance at start (1 June 2030)		**(2000)**
Bank Balance at end (30 June 2030)		**1870**

Additional information:

- Credit sales $8900 plus $890 GST
- Sales returns $330 including GST
- Cost of Sales $8300
- Inventory on hand as at 30 June 2030 (inventory cards) $30590
- Inventory on hand as at 30 June 2030 (physical count) $30400
- Accounts Receivable were granted discounts of $140 during June 2030, but a bad debt worth $165 (including GST) was also written off.
- Discount revenue for June 2030 was $90.
- As at 30 June 2030, Painter's Choice had a GST liability.

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Required

a. **Suggest** one possible reason to explain how Painter's Choice generated a GST receivable as at 31 May 2030.

* **b.** **Prepare** an Income Statement for Painter's Choice for June 2030.

c. **Explain**, giving two examples from the information provided, how Painter's Choice generated a net increase in cash position despite suffering a Net Loss for June 2030.

d. **Calculate** the balance of Accounts Receivable as at 30 June 2030.

e. Referring to your answer to part **d**, **state** one method Josh could use to check the accuracy of this calculation.

f. **State** two strategies that Josh could implement to encourage late Accounts Receivable to pay.

* **g.** **Prepare** an extract of the Balance Sheet to show the Current assets of Painter's Choice as at 30 June 2030.

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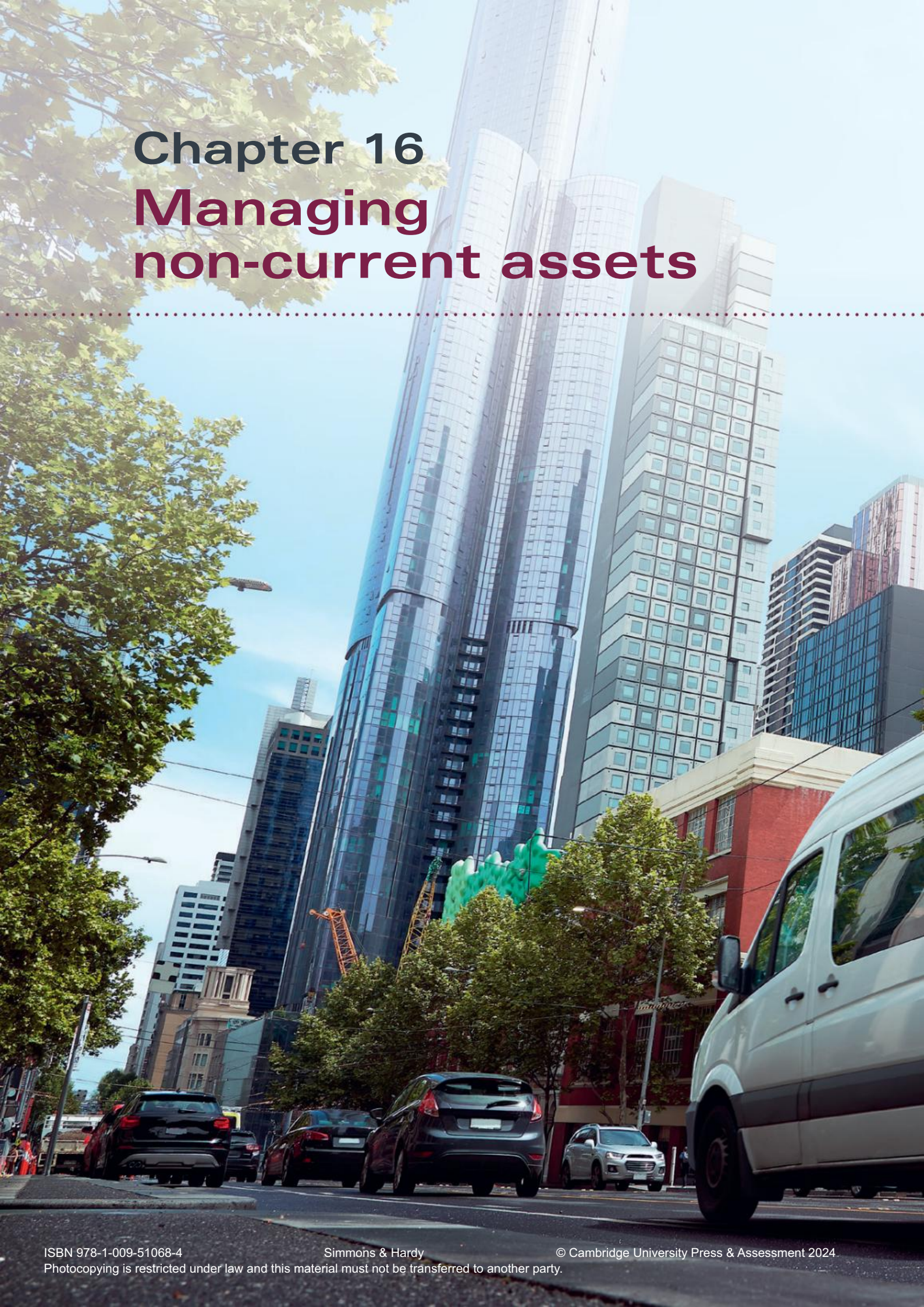

Chapter 16
Managing non-current assets

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Learning intentions

After completing this chapter, you should be able to:

- **determine** the value of a non-current asset
- **distinguish** between Historical cost and fair value
- **define** depreciation, and other related terms
- **calculate** depreciation expense using the straight-line method and the reducing balance method
- **make** balance day adjustments for depreciation expense
- **state** the effect of depreciation on the Accounting equation
- **report** accumulated depreciation in the Income Statement and Balance Sheet
- **explain** how the Period assumption and Qualitative characteristic of Relevance affect the calculation of profit
- **state** ethical considerations faced by owners.

Key terms

After completing this chapter, you should be familiar with the following terms:

- tangible assets
- intangible assets
- Historical cost
- fair value
- finite life
- market value
- asset register – depreciable asset
- depreciation
- depreciable value
- depreciation expense
- Accumulated depreciation
- Carrying value
- Asset Turnover (ATO)
- Return on Assets (ROA)
- straight-line method
- reducing balance method.

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16.1 Non-current assets

A non-current asset is a present economic resource controlled by the entity as a result of past events that is expected to be used by the business for a number of years and is not held for the purpose of resale. Items such as vehicles, office equipment and shop fittings will provide a *potential future economic benefit* for more than 12 months and so should be recorded as non-current assets when they are purchased. These assets are different in nature and serve a different purpose within the business to current assets. These are cash and other types of assets held primarily for the purpose of sale and are reasonably expected to be sold, consumed or converted into cash within 12 months after the end of the reporting period such as inventory, Accounts Receivable and stationery supplies.

Assets themselves can be either current or non-current depending on how the business treats them. For example, a vehicle to a business in most circumstances would be considered a non-current asset; however, to a business that sells cars, the majority of its vehicles would be considered inventory and therefore a current asset.

tangible assets
assets that have a physical form that can be touched or held

intangible assets
assets that do not have a physical form

Tangible and intangible non-current assets

Most forms of non-current assets that we think of are **tangible assets**; that is, they have a physical form that can be touched or held such as office furniture, buildings and computer equipment. However, there are non-current assets that a business can control that do not have a physical form such as goodwill, copyrights, patents and trademarks. These are known as **intangible assets**.

Review questions 16.1

1 **Explain** the difference between a current and non-current asset. **Provide** examples.
2 **Explain** the difference between a tangible and intangible asset. **Provide** examples.

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16.2 Valuation of a non-current asset

The value of a non-current asset depends on how the business acquired the non-current asset. If the business purchased it, then it would be valued at Historical cost (original purchase price excluding GST); however, if the non-current asset was contributed to the business by the owner, then it would be valued at its fair value.

Historical cost

The value of a non-current asset, if purchased, is guided by the Qualitative characteristic *Verifiability*, which ensures that its cost can be evidenced by a source document and that an independent observer would come to the same conclusion regarding its cost. Therefore, the cost of the non-current asset would be a Faithful representation, free from error and without bias. This value is referred to as **Historical cost**.

Historical cost
the cost of the asset when purchased

In determining the value of a non-current asset, the initial cost of purchase (excluding GST) is what is recorded in the business's records. However, if there was a material cost involved in getting the non-current asset into a location (e.g. transit costs) and/or condition (e.g. adding a refrigeration unit to a truck) so it can be used as the business intends, then all these costs can be included and will be recorded as part of the non-current asset's cost (excluding GST).

Fair value

When a *non-current asset* is contributed to the business by the owner, it must be valued at what it is worth *to the business* at the time it is acquired *by the business*. In the records of the business, this non-current asset cannot be valued at the original price paid by the owner because the *owner* is assumed to be a separate entity. This is set out clearly by the *Accounting entity* assumption.

fair value
the price received when selling an asset if it was sold at the time it was acquired by the business

market value
the price an asset can be sold for

When a non-current asset is contributed by the owner to the business, there is no 'sale' from the owner to the business and there is no 'sale' document to verify its cost. The non-current asset must be valued at its **fair value** – the price that would be received if the asset was sold at the time it was acquired by the business. In effect, this means the fair value of an asset is an estimate of its **market value** at the time it is contributed by the owner.

The fair value amount that is recorded will be in all cases an estimate, and therefore not *Verifiable* in the same way as other assets that have been *purchased* by the business. There is potential for conflict: how can we be sure that the fair value recorded provides a *Faithful representation* of the asset's value? If the owner ensures that the fair value chosen reflects research that references current market valuations of other comparable assets (of a similar age and/or in a similar condition), this will help to ensure that the fair value chosen is as neutral (without bias) as possible. In this case the importance of *Relevance*, having relevant information for decision making, would outweigh *Verifiability*.

Review questions 16.2

1 **Explain** how the cost of a non-current asset is determined.
2 **Distinguish** between Historical cost and fair value.
3 Referring to two Qualitative characteristics, **explain** how a non-current asset's value can be recorded in the records of a business.
4 **Explain** the potential conflict between Qualitative characteristics when using fair value.

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16.3 Non-current asset management

asset register
a document that shows the assets that a business owns

Non-current assets are significant to a business not only because they make up a large portion of total assets due to their value but also because of the role they play in ensuring the successful operation of a business. Imagine a store with no shelves, fixtures or fittings, office furniture or equipment, cash registers – it would be impossible to successfully operate. Therefore, these assets need to be carefully managed. The use of an **asset register** is vital to maintain an overview of the non-current assets of the business. An asset register is a document that shows the assets that a business owns and usually contains the following information:

- Date of purchase
- Description of the asset
- Serial number(s)
- Acquisition cost
- Estimated Useful life
- Rate of depreciation
- Usage for relevant assets such as kilometres travelled for vehicles or units produced for machinery
- Disposal details – date the non-current asset was sold and for how much.

The use of an asset register is important to a business for a number of reasons:

1. *It assists planning* – as it will highlight the need for any scheduled maintenance or draw attention to the fact that a particular asset may be approaching the end of its Useful life and may require replacement.
2. *It protects assets* – if a business conducts regular audits of its assets against its register, it has the potential to prevent fraud, theft and loss. If an asset is stolen, then the correct records are in place, such as serial numbers, to assist recovery or with insurance claims.
3. *It assists with the calculation of depreciation* – as all details relevant to these calculations are recorded within the register.

Many Accounting software programs have asset registers contained in their packages; however, if a business is not using Accounting software they are easily set up in a spreadsheet. An example is shown in Figure 16.1:

Figure 16.1 Example of an asset register

Asset register

Business name: XYZ Pty Ltd

Asset code	Asset name	Asset description	Serial number	Purchase date	Purchase price	Useful life	Estimated disposal	Depreciation type	Dep. rate	Disposal date	Disposal reason	Disposal amount
V101	Car	Holden Calais	C49362X	1/06/2025	$56 000	5 years	$6 000	Straight line	20%			

Review questions 16.3

1. **Describe** an asset register. **Explain** what it records.
2. **Explain** the importance of an asset register to a business.

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16.4 Ethical considerations

Ethical considerations

As stated previously, non-current assets play a significant role in business operations and are engaged with and utilised regularly. Businesses should always consider buying locally produced non-current assets where possible to support the Australian economy. Also, business owners have the ability to purchase assets that are efficient in nature and have a minimal environmental impact.

The use of an asset register with regular audits would help ensure that the assets of a business are used appropriately and not subject to fraud or theft. Also, because owners and employees would be using these assets on a regular basis, the importance of ensuring up-to-date maintenance and safety for users is paramount. Machinery must have all safety features in place to protect workers and electrical equipment must have regular safety checks to ensure it is compliant and safe to use. It is the law for owners/managers to ensure that they provide a safe working environment by making sure the non-current assets within their business are not potentially dangerous.

Financially, the business needs to consider ethically:

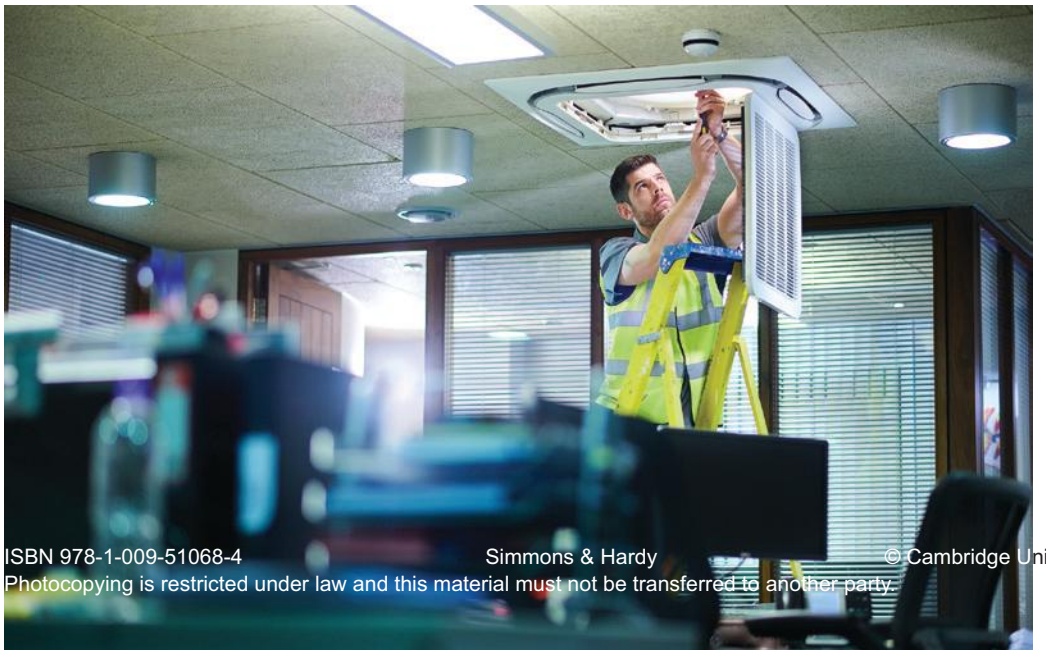
- *fair value* – if an owner contributes a non-current asset to the business, that they determine a responsible and considered fair value to ensure a *Faithful representation* of the non-current asset's value.
- *depreciation rate* – a depreciation rate that provides an expense figure that gives the best matching of revenue earned with expenses incurred. It must also give the best reflection of the non-current asset's Useful life and provides a Carrying value that is reflective of the non-current asset's useful value to the business.

This will ensure that the financial reports provide the most relevant information for decision makers and will provide a Faithful representation of the economic situation of the business.

Review questions 16.4

Ethical considerations

1 **Explain** three ethical considerations a business owner has in regards to their non-current assets.
2 **Explain** why the valuation of non-current assets and depreciation must be carefully considered by owners/management.



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16.5 Depreciation of non-current assets

Depreciable non-current assets

Items such as vehicles, office equipment and shop fittings have the *potential* to provide a *future economic benefit* for more than 12 months and so should be recorded as non-current assets when they are purchased.

finite life
the limited period of time (usually measured in years) for which a non-current asset will exist

depreciable asset
a non-current asset that has a finite life, and thus must be depreciated over that life

At the same time, just because assets like these will last for more than 12 months does not mean they will last forever – almost all will have a **finite life**, meaning they will be useful for a fixed period of time but at some point will no longer be able to earn revenue. Assets that have a finite life are known as **depreciable assets**. (This would include the vast majority of non-current assets on the Balance Sheet of a typical business, such as vehicles, shop fittings, office equipment and furniture.)

Why do depreciable assets have a finite life? Put simply, as they age, they wear out, or as with technology it becomes out of date, and as their life expires, so too does their ability to earn revenue. In effect, they are consumed over time. Every year, part of the value of the asset is consumed, until – at the end of its life – it is no longer able to earn revenue. The value of the non-current asset that is consumed in each reporting period is reported as the depreciation expense.

Depreciation

depreciation
the allocation of the cost of a non-current asset over its Useful life

depreciation expense
the part of the cost of a non-current asset that has been consumed in the current reporting period

Although the term **depreciation** is frequently used to describe the expense, it actually refers to the *process* – the Accounting procedure – that creates depreciation expense. In terms of the process, depreciation is the allocation of the cost of a non-current asset over its Useful life.

Because a non-current asset is not consumed entirely within one reporting period, depreciation is an attempt to calculate how much of the asset's value has been consumed in the *current* reporting period. It therefore *spreads out* or *allocates* the cost of the asset over the years in which it is useful for earning revenue, rather than treating all of the cost as an expense in any one year.

As a result of this process, **depreciation expense** is created, representing that part of the cost of a non-current asset that has been consumed in the current reporting period.

By recognising as an expense only that part of the cost of a non-current asset that is consumed/incurred in the *current* reporting period, depreciation (which is a balance day adjustment) ensures that profit will be calculated accurately, as directed by the *Period assumption* and that *Relevance* is upheld because the reports will include all information that is useful for decision-making. Thus, when we speak of determining profit, we are actually comparing the revenue earned in the current reporting period against the expenses incurred in the same reporting period. This is the essence of Accrual Accounting.

(Depreciation does *not* involve any payment of cash. The cash payment relating to each non-current asset will be recorded only at the time when the asset is purchased. Depreciation affects only the Income Statement and the Balance Sheet.)

Example

On 1 July 2029, Mickleson Books paid $16 000 (plus $1 600 GST) for new shelving that is expected to last for four years.

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How should this shelving be reported?

At purchase date, **1 July 2029**, the shelving is clearly a non-current asset: none of the economic benefit has been consumed, so the entire $16 000 is a *potential future economic benefit* (in terms of the books it can display), and that benefit will be provided for more than *12 months* (four years).

But how should the shelving be reported at **30 June 2030**? Because the business still has the shelving, it would be inaccurate to report the entire $16 000 as an expense for the year as it has not been consumed. Indeed, the shelving still has three years of life left and so should still be reported as a non-current asset.

However, the shelving will not last forever, and by **30 June 2030** one year of its life has been consumed. Given the shelving is expected to last for four years, in one year the business will have consumed $\frac{1}{4}$ of its life, and therefore $\frac{1}{4}$ of its value. Thus, of the $16 000 of future economic benefit, $4 000 ($\frac{1}{4}$ of $16 000) has been consumed and should be reported as depreciation expense. The remaining $12 000 remains a future economic benefit and should be reported as a non-current asset.

Study tip

Depreciation does not mean there is less shelving; it means the same shelving is worth less to the business because some of its value has been consumed.

Review questions 16.5

1 **Explain** why the entire cost of a non-current asset should **not** be reported as an expense in one reporting period.
2 **Define** the following terms:
- finite life
- depreciable asset
- depreciation
- depreciation expense.

3 Referring to one Accounting assumption, **explain** the purpose of depreciating a non-current asset.
4 **Explain** the effect of depreciation on a firm's bank balance.
5 **Explain** what is meant by 'Accrual Accounting'.

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16.6 Methods of depreciation

Straight-line depreciation

The *straight-line method of depreciation* assumes that non-current assets *contribute evenly to revenue*. As a result, it assumes that the value of a non-current asset is *consumed evenly over its life* and that the depreciation expense will be the same every year. (If this depreciation expense was plotted on a graph, the line would be a straight line, giving the method its name.)

Calculating depreciation expense: Straight-line formula

The formula for calculating depreciation expense under the straight-line method is given in Figure 16.2:

Figure 16.2 Calculating depreciation expense: Straight-line formula

$$\textbf{Depreciation expense (\$ per annum)} = \frac{\textbf{HC less RV}}{\textbf{Life}}$$

Where:

HC = Historical cost: the original purchase price of the non-current asset (excluding GST)

RV = Residual value: the estimated value of the non-current asset at the end of its Useful life

Life = Useful life: the estimated period of time for which the non-current asset will be used (by the current entity) to earn revenue. (This is usually measured in years.)

The basic premise is to divide the cost of the asset by the number of years for which it is used, thus determining how much of that cost is consumed per year. (Because each non-current depreciable asset is different in terms of its Useful life and Residual value, each must be depreciated individually.)

Example

On 1 July 2029, Dells Luggage purchased shop fittings for $8 000 (plus GST). The fittings will be kept for five years, at which time they are estimated to have a Residual value of $500.

$$\textbf{Depreciation expense} = \frac{\text{HC less RV}}{\text{Life}}$$

$$= \frac{\$8\,000 - 500}{5 \text{ years}}$$

$$= \frac{\textbf{\$7 500}}{\textbf{5}}$$

$$= \$1\,500 \text{ per annum}$$

depreciable value the total value of the asset that will be consumed by the current entity, and so must be allocated over its Useful life

The top line of the formula shows that of the $8 000 paid for the shop fittings, $500 of its value will remain unused at the end of its Useful life: this amount will not be consumed by Dells Luggage, but rather by the next owner. As a result, the **depreciable value** of the shop fittings – the amount that will be consumed by Dells Luggage – is only **$7 500**. (If the asset has no value at all at the end of its Useful life, its Residual value will be zero.)

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However, this $7 500 will not be consumed in one year, but over *five* years. Thus, the depreciation process calculates that Dells Luggage will consume $1 500 worth of the value of the shop fittings each year. This amount would be reported as depreciation expense in the Income Statement and would also decrease the value at which the shop fittings are valued in the Balance Sheet.

Reducing balance depreciation

Not all assets contribute to revenue evenly over their lives. An asset with moving parts (such as a photocopier or a vehicle) or one that is technologically based (computers) is likely to be more efficient and productive when it is new, and therefore *contribute more to revenue at the start of its useful life* than at its end.

The reducing balance method of depreciation assumes that the asset will contribute *more* to revenue at the start of its life, when it is new, efficient and productive. Therefore, more depreciation is allocated at at the start of the asset's life than at its end. As the asset ages, its contribution to revenue decreases and so too does the depreciation expense.

Using the reducing balance method ensures that the depreciation expense and the revenue the asset earns are matched in each reporting period. Both are higher at the start; however, they reduce over the life of the asset.

Calculating depreciation expense: Reducing balance formula

Under the straight-line method, depreciation expense is the same each year because it is calculated as a percentage of the **Historical cost** of the asset. By contrast, the reducing balance method calculates depreciation expense as a percentage of the **Carrying value**.

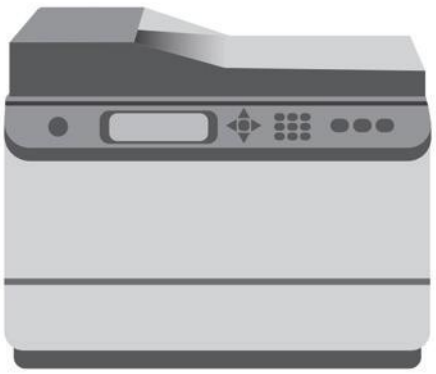
The formula for calculating depreciation expense under the straight-line method is given in Figure 16.3:

Figure 16.3 Calculating depreciation expense: Reducing balance formula

Depreciation expense: reducing balance formula

Depreciation expense ($ per annum) = Carying value × Depreciation rate

where carrying value = Historical cost – accumulated depereciation



On 1 July 2029, Dells Luggage purchased a photocopier for $10 000 plus $1 000 GST. The asset is expected to have a useful life of five years and a residual value of $2 000, It is to be depreciated at 27.52% per annum using the reducing balance method.

Example

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The reducing balance formula calculates depreciation expense as a percentage of the carrying value, and as the carrying value reduces every period, so too will the depreciation expense.

Depreciation expense for the year ended 30 June 2030

Using the reducing balance formula, the depreciation expense for the photocopier for the year ended 30 June 2030 would be calculated as shown:

Depreciation expense = carrying value × depreciation rate
= $10 000 × 27.52%
= $2 752

For the first year of the asset's life, the carrying value will be the same as the **Historical cost** (that is, $10 000) as no depreciation has been accumulated yet, and depreciation expense will be $2 752. As it is the first year of the asset's life, its depreciation expense would then become its Accumulated depreciation at the end of the year.

Depreciation expense for the year ended 30 June 2031

For the *second* year of the asset's life, we need to determine the carrying value of the photocopier **before** we can calculate the depreciation expense.

Carrying value = Historical cost – Accumulated depreciation
= $10 000 – $2 752
= $7 248

Therefore for the second year, depreciation expense would be:

Depreciation expense = carrying value × depreciation rate
= $7 248 × 27.52%
= $1 995

Because of the Accumulated depreciation from 2030 ($2 752), the carrying value for 2031 has decreased (from $10 000 to $7 248), resulting in a decrease in depreciation expense (from $2 752 to $1 995). Thus, the reducing balance method allocates more depreciation expense at the start of the asset's life, and less as it ages. This pattern will continue for the life of the asset.

Review questions 16.6

1. **Explain** the assumption that underlies the straight-line method of depreciation in relation to how assets contribute to revenue.
2. **Show** the formula for calculating depreciation expense using the straight-line method.
3. **Define** the following terms:
   - Historical cost
   - Residual value
   - Useful life.
4. **Explain** why each non-current asset must be depreciated individually (rather than as a total).
5. Referring to one Accounting assumption, **explain** why Residual value is deducted from Historical cost when calculating depreciation using the straight-line method.
6. **State** the assumption that underlies the reducing balance method of depreciation in relation to how assets contribute to revenue.
7. **Identify** three non-current assets that should be depreciated using the reducing balance method of depreciation.
8. **Explain** how the reducing balance method of depreciation allocates depreciation expense.
9. **Explain** how the straight-line and reducing balance methods differ in their calculation of depreciation expense.

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16.7 Reporting depreciation

Income Statement

Regardless of which depreciation method is used, only the amount consumed in the current reporting period is reported in the Income Statement as depreciation expense. In the example, the Income Statement of Dells Luggage for the year ended 30 June 2030 would report the $1 500 that has been consumed as Depreciation of Shop fittings and the $2 752 that has been consumed as Depreciation of Photocopier under the heading 'Other expenses'.

Balance Sheet

The first effect of depreciation on the Balance Sheet is via owner's equity. As we have already seen, depreciation expense decreases Net Profit, which in turn decreases owner's equity.

At the same time, depreciation also decreases the value at which the asset is valued in the Balance Sheet. After all, the non-current asset is a *future economic benefit,* but by depreciating the asset we are recognising that some of this benefit has now been consumed. This reduction in the value of an asset is reported as a new item called **Accumulated depreciation**, which is a negative asset.

Whereas depreciation expense refers to the amount consumed in the current reporting period (and is reported in the Income Statement), Accumulated depreciation refers to depreciation that has accumulated (or built up) *over the life of the asset so far* (and is reported in the Balance Sheet). That is, Accumulated depreciation will grow every year as the depreciation expense for each reporting period is added to it.

Figure 16.4 shows how the firm's non-current assets would be reported in the Balance Sheet as at 30 June 2030:

Figure 16.4 Balance Sheet: Accumulated depreciation

DELLS LUGGAGE
Balance Sheet (extract) as at 30 June 2030

Non-current assets	$	$
Shop fittings	8 000[1]	
Less Accumulated depreciation	1 500[2]	6 500[3]
Photocopier	10 000[1]	
Less Accumulated depreciation	2 752[2]	7 248[3]

Instead of just reporting the asset as one figure, three are now involved:

1 Historical cost of $8 000 (shop fittings) and $10 000 (photocopier)
To ensure the reports remain as *free from bias* as possible, the asset must always be reported at its Historical cost – its original purchase price – as this amount is verifiable by reference to the source document.

2 Accumulated depreciation of $1 500 (shop fittings) and $2 752 (photocopier)
Accumulated depreciation represents the total value of the asset that has been consumed over its life so far. This negative asset must be reported in the Balance Sheet to show that some of the asset's value has been consumed.

Study tip

Exam tip: Depreciation and partial periods: BE AWARE – partial periods are the easiest way to get a depreciation question wrong. When doing a depreciation question' take particular note of the dates, the length of the Accounting period and the date the asset was acquired.

Study tip

Depreciation is reported along with all the 'Other expenses' such as Wages, Advertising and Rent.

Accumulated depreciation
the value of a non-current asset that has been consumed over its life so far

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Carrying value
the value of a non-current asset that is yet to be consumed/allocated as an expense, plus any Residual value

3 Carrying value of $6500 (shop fittings) and $7248 (photocopier)

The **Carrying value** is calculated by deducting any Accumulated depreciation from the Historical cost of the asset. It represents the value of the asset that is *yet to be consumed* – and thus yet to be allocated as Depreciation expense – plus any Residual value. Once the asset is depreciated, the Historical cost of the asset is less useful for decision-making than the Carrying value, which is thus a more *Relevant* valuation to report in the Balance Sheet.

Effect on the Accounting equation

Depreciation thus has the following effect on the Accounting equation:

	Increase/Decrease/No effect	Amount $
Assets	Decrease (increase Accumulated depreciation)	4252
Liabilities	No effect	
Owner's equity	Decrease (Depreciation expense decreases Net Profit)	4252

Like all balance day adjustments, depreciation does not involve any payment of cash and only affects the Income Statement and the Balance Sheet.

Study tip

Carrying value is also known as carrying cost, written down value, unallocated cost and book value.

Successive periods

Depreciation expense using the straight-line method will be the same amount each year ($1500 in this example), Accumulated depreciation will increase every year as the Depreciation expense for each reporting period is added to it.

The shop fittings owned by Dells Luggage (which will be depreciated at $1500 per year for every year of their life) would appear in successive Balance Sheets and end at their Residual value.

Depreciation expense using the reducing balance method will have a reducing amount of depreciation each year; however, the accumulated depreciation will still increase every year as the depreciation expense for each reporting period is added to it. The value of the shop fittings and photocopier have both been allocated over the life of each asset, leaving just the Residual values of $500 and $2000 respectively, as shown in Figure 16.5:

Figure 16.5 Successive Balance Sheets: Accumulated depreciation

DELLS LUGGAGE
Balance Sheet (extract) as at 30 June

Non-current assets	2030	2031	2032	2033	2034
Shop fittings	8000	8000	8000	8000	8000
Less Accumulated depreciation	1500	3000	4500	6000	7500
Carrying value	**6500**	**5000**	**3500**	**2000**	**500**
Photocopier	10000	10000	10000	10000	10000
Less Accumulated depreciation	2752	4747	6193	7241	8000
Carrying value	**7248**	**5253**	**3807**	**2759**	**2000**

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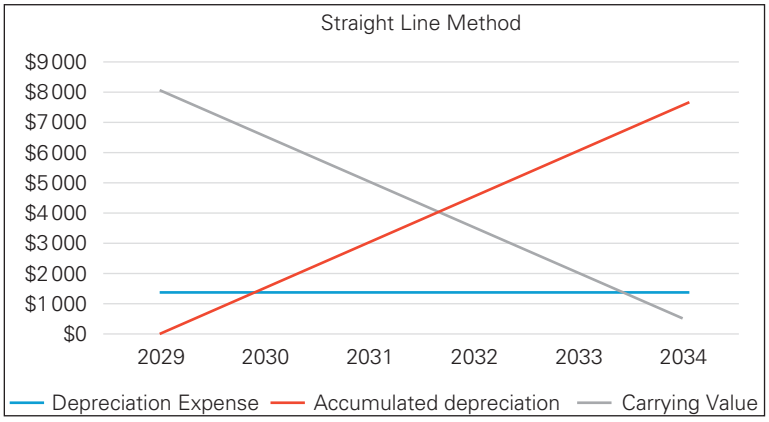
Representing depreciation graphically

In order to satisfy *Understandability,* reports must be prepared in a manner that is readily understandable by the user, with the preparation of graphs one simple strategy that can be employed. Preparing a graph can make it easier for the owner to understand both the idea of depreciation and its effect on the Accounting reports.

For example, Figure 16.6 shows how the Depreciation expense, Accumulated depreciation and Carrying value could be represented graphically:

Figure 16.6 Graphing depreciation using the straight-line method



This graph clearly shows why it is called the 'straight-line' method, as the amount of Depreciation expense is constant every year ($1 500), creating a straight-line across the life of the asset.

The Accumulated depreciation starts at zero and grows at a constant rate (increased by the Depreciation expense). At the same time, the Carrying value starts at the Historical cost and moves in exactly the opposite direction, decreasing every year by the amount of the Deprecation expense), ending at the Residual value (if the graph shows the asset's entire Useful life).

Figure 16.7 Graphing depreciation using the reducing balance method

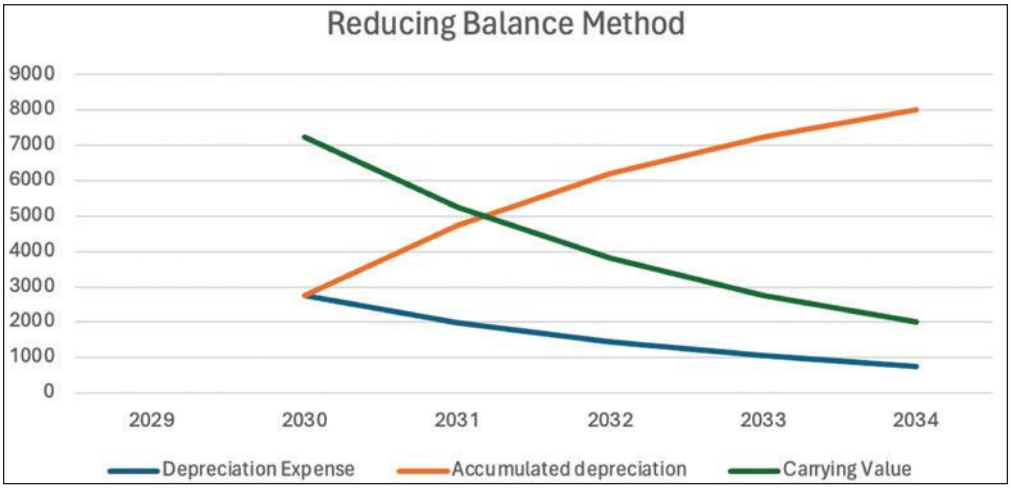


Figure 16.7 shows the reducing balance method. It is clear to see the amount of Depreciation expense is declining every year as the Depreciation expense line is on a downward trend. The Accumulated depreciation starts at zero and grows at a reducing rate as it slowly becomes flatter. At the same time, the Carrying value starts at the Historical cost and moves in exactly the opposite direction, decreasing every year by a smaller amount ending close to the photocopier's Residual value.

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Selecting a depreciation method

Regardless of which method is chosen, both methods end up at the same point, which is allocating the cost of the non-current asset against the revenue it has earned until it reaches the Carrying value at the end of its life, which is its Residual value (a non-current asset can have a residual value of 0). This is because although each method gives a different depreciation expense in each reporting period, both methods will (if the rates have been calculated accurately) calculate the same total depreciation expense *over the life of the asset*.

The key factor to consider in choosing a depreciation method is the revenue-earning pattern of the asset:

- If the asset contributes evenly to revenue, and its cost is consumed evenly, over its life, the straight-line method should be used. This relates to non-current assets that are not mechanical in nature or involve technology such as office furniture, shelving, premises, and fixtures and fittings.
- If the asset contributes more to revenue, and its cost is consumed more, at the start of its life and less as it ages, the reducing balance method should be used. This relates to non-current assets that are mechanical in nature or involve technology such as photocopiers, computers, machinery and vehicles.

It is the asset itself, and how it contributes to revenue, that determines which method of depreciation is appropriate. Therefore, a business may use the straight-line method for some assets, and the reducing balance method for others.

While this choice exists, once a method is chosen, that method should be used from one period to the next, upholding *Comparability*. Changing depreciation methods is possible, but the change must be clearly disclosed in the reports.

Review questions 16.7

1 **Explain** how depreciation is reported in the Income Statement.
2 **Define** the term 'Accumulated depreciation'.
3 Referring to one Accounting assumption, **explain** the difference between Depreciation expense and Accumulated depreciation.
4 Referring to one Qualitative characteristic, **explain** why the original purchase price of a non-current asset must be disclosed in the Balance Sheet.
5 **Define** the term 'Carrying value'.
6 Referring to one Qualitative characteristic, **explain** why non-current assets must be reported at their Carrying value in the Balance Sheet.
7 **State** the effect of depreciation on the Accounting equation.
8 Referring to one Qualitative characteristic, **explain** why it may be useful to represent depreciation graphically.
9 **State** three ways in which the effect of depreciation is the same under both the straight-line and reducing balance methods.
10 Compared with the straight-line method, **explain** how the reducing balance method of depreciation will affect Net Profit during each period.
11 **Explain** how the method of depreciation affects total depreciation over the life of the asset.
12 **Explain** the main factor to be considered in selecting a method of depreciation.
13 Referring to one Qualitative characteristic, **explain** why depreciation methods should **not** be changed from one period to the next.

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16.8 Depreciation: calculation issues

Rate of depreciation

The reducing balance method always provides a percentage rate that is applied to the Carrying value to determine the Depreciation expense amount for that period.

The straight-line method formula in Figure 16.2 calculates the *amount* of Depreciation expense, expressed in dollar terms. However, depreciation under this method can also be expressed as a rate – a percentage of the cost.

Depreciation rate formula for the straight-line method

Figure 16.8 Formula: Depreciation rate

$$\textbf{Depreciation rate (\% per annum)} = \frac{\textbf{Depreciation expense}}{\textbf{Historical cost}} \times \textbf{100}$$

The figures from the earlier example were:

Historical cost = $8000
Residual value = $500
Useful life = 5 years
Depreciation expense = $1500 per year

The rate of depreciation would thus be calculated as is shown in Figure 16.9:

Figure 16.9 Calculation: Depreciation rate

$$\textbf{Depreciation rate (\% per annum)} = \frac{\text{Depreciation expense}}{\text{Historical cost}} \times 100$$
$$= \frac{\$1500}{\$8000} \times 100$$
$$= 18.75\% \text{ per annum}$$

Example

On 1 July 2029, Jiggles Clothing purchased a delivery vehicle for $25300 (including GST). The vehicle is to be depreciated at 12% per annum. Balance day is 30 June 2030.

This means 18.75% of the asset's cost will be consumed for each of the five years of its life. (This will leave 6.25% unconsumed as Residual value.)

If the rate is known, the Depreciation expense (in dollar terms) for the straight-line method can be calculated by simply multiplying the rate by the Historical cost as is shown in Figure 16.10:

Figure 16.10 Calculation: Depreciation expense

$$\textbf{Depreciation expense (\% per annum)} = \text{Depreciation rate} \times \text{Historical cost}$$
$$= 12\% \times \$23000$$
$$= \$2760 \text{ per annum}$$

Be sure to pay attention as to what depreciation method you are asked to use when provided with a depreciation rate as it will affect the calculation. If a question asks you to depreciate a non-current asset at 15% p.a. using the straight-line method, then you will be calculating 15% of the Historical cost; however, if the question asks you to depreciate a non-current asset at 15% p.a. using the reducing balance method, then you will be calculating 15% of the Carrying value.

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Depreciation for less than a year

Because the life of the asset is usually measured in years, the depreciation formulas will calculate Depreciation expense *per annum*. However, if at the time the reports are prepared the firm has had control of the asset for *less than a year,* the Depreciation expense figure will need to be applied on a *pro-rata basis;* if the business has had the asset for only one month, then only one month's worth of depreciation ($\frac{1}{12}$ of a year) should be charged as an expense.

Referring to the previous example, if Jiggles Clothing had purchased the vehicle on 1 February 2030 (rather than 1 July 2029), then by balance day – 30 June 2030 – it would have been under business control for only five months (February to June inclusive), so only five months worth of depreciation should be charged as an expense for the year ending 30 June 2030. This is shown in Figure 16.11:

Study tip

Note when the asset is purchased to calculate how many month's worth of depreciation should be reported.

Figure 16.11 Calculating depreciation: Less than a year

$$\textbf{Depreciation expense} = \$2\,760 \text{ per annum} \times \frac{5}{12}$$

$$= \$1\,150$$

Thus, the Depreciation expense for the five months from purchase until balance day is $1 150, and only this amount should be reported in the Income Statement for the year ending 30 June 2030. The following year, the firm will have had control of the vehicle for the full 12 months, and so for the year ending 30 June 2031 should report Depreciation expense as $2 760.

Study tip

Rather than multiply by fractions like $\frac{1}{4}$ or $\frac{1}{2}$, it is safer to multiply by the number of months out of 12, e.g. $\frac{3}{12}$ or $\frac{6}{12}$.

Estimates

One of the key issues in calculating depreciation is estimating the asset's Residual value and Useful life; without these estimates, depreciation cannot be calculated. However, because the Residual value and Useful life are *estimates*, using them in the calculation of depreciation means that the reports will not be free from bias, and to some extent this will undermine the *Verifiability* of the Accounting reports.

The obvious question then arises: why depreciate non-current assets if we are undermining a key Qualitative characteristic? The answer lies in a different Qualitative characteristic: *Relevance*. Depreciation ensures that the Income Statement includes all information that is useful for decision-making (about profit) by showing the consumption of non-current assets in the current reporting period. Similarly, by showing Accumulated depreciation in the Balance Sheet, it ensures that assets are shown at their Carrying value, which is more useful for decision-making about their replacement. In this sense, Relevance overrides *Verifiability* so that the Accounting reports fulfil their function of providing useful financial information.

Study tip

Although the depreciation figure may be inaccurate, not reporting any depreciation at all is certain to be inaccurate.

Review questions 16.8

1. **Show** the formula for calculating the rate of depreciation.
2. Referring to one Accounting assumption, **explain** why it is not always accurate to report Depreciation expense per annum.
3. **Explain** the process for calculating depreciation when the firm has had control of the asset for less than a year.
4. **Explain** how depreciation can undermine the Verifiability of Accounting reports.
5. **Explain** how depreciation ensures Relevance in the Accounting reports.

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16.9 Comprehensive example

To summarise how depreciation is reported, consider the following example.

Example

Kingsmill Music has provided the following information relating to its trading activities for the year ending 30 June 2030:

Cash sales	$63 000	
Cost of Sales	$28 000	
Wages incurred	$14 700	
Advertising incurred	$800	(plus GST)
Rent incurred	$1 320	(including GST)

Additional information:

- Office furniture of $18 000 was purchased on 1 January 2030 and is to be depreciated at 10% p.a. using the straight-line method.
- The van was purchased for $28 000, and as at 1 July 2029, Accumulated depreciation on the van amounted to $7 000. The van is to be depreciated at 25% p.a. using the reducing balance method.

Study tip

The expense must be titled 'Depreciation of van' rather than just 'Depreciation', because it is likely that more than one non-current asset will be depreciated.

Depreciation calculation: Office furniture (straight-line method)
= Historical cost × rate
= $18 000 × 10%
= $1 800

However, this figure relates to a years' worth of depreciation, when the business has only held the office furniture for 6 months. The $1 800 must therefore be multiplied by 6/12 to calculate the expense for the period.

The Depreciation of Office Furniture expense for the period is $900.

Depreciation calculation: Van (reducing balance method)
Carrying value = Historical cost – Accumulated depreciation
$28 000 – $7 000 = $21 000
= $21 000 × 25%
= $5 250

The Depreciation of Van expense for the period is $5 250.

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The Income Statement for Kingsmill Music is shown in Figure 16.12:

Figure 16.12 Income Statement: Depreciation

KINGSMILL MUSIC Income Statement for the year ending 30 June 2030		
	$	$
Revenue		
Cash sales		63 000
Less Cost of Goods Sold		
Cost of Sales		28 000
Gross Profit		**35 000**
Less Other expenses		
Wages	14 700	
Advertising	800	
Rent	1 200	
Depreciation of Office Furniture	900	
Depreciation of Van	5 250	22 850
Net Profit		**12 150**

The Balance Sheet for Kingsmill Music as at 30 June 2030 is shown in Figure 16.13:

Figure 16.13 Balance Sheet: Depreciation

KINGSMILL MUSIC Balance Sheet as at 30 June 2030					
	$	**$**		**$**	**$**
Current Assets			**Current Liabilities**		
Bank	* 1 200		Accounts Payable	* 15 400	
Inventory	* 60 500		GST payable	* 1 300	
Accounts Receivable	* 21 600	83 300	Loan – Qs Finance	* 9 700	26 400
Non-Current Assets			**Non-Current Liabilities**		
Office Equiment	18 000		Loan – Qs Finance		* 21 000
Less Accumulated depreciation	900	17 100			
Van	28 000		**Owner's equity**		
Less Accumulated depreciation	12 250	15 750	Capital – Kingsmill	* 60 600	
			Add Net Profit	12 150	
				72 750	
			Less Drawings	* 4 000	68 750
Total Assets		**116 150**	**Total Equities**		**116 150**

*Additional figures have been made up to create a realistic Balance Sheet.

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16.10 Financial indicators and non-current assets

Non-current assets will be used by a business for many years or at least more than 12 months. They are a significant investment by the business and, like all investments, an adequate return needs to be earned by them, not only to justify their retention within the business but to ensure the business remains a *Going concern*.

The first indicator we will examine looks at the assets, ability to generate revenue. **Asset Turnover (ATO)** is an efficiency indicator, and it assesses how efficiently the firm has used it assets to generate revenue. Earning revenue is crucial to earning profit: no revenue means no profit! Therefore, assessing a firm's Asset Turnover is integral to assessing its profitability.

Asset Turnover (ATO)
an efficiency indicator that assesses how productively a business has used its assets to earn revenue

Asset Turnover formula

The formula for calculating Asset Turnover is given in Figure 16.14:

Figure 16.14 Formula: Asset Turnover

$$\text{Asset Turnover (ATO)} = \frac{\text{Net Sales}}{\text{Average Total Assets}}$$

The higher the Asset Turnover, the better the business is utilising its asset base. A high Asset Turnover means that a business is using its assets efficiently as each dollar of assets is generating more revenue.

The Asset Turnover of Kingsmill Music would be calculated as shown in Figure 16.15:

Example

For the year ended 30 June 2031, Kingsmill Music had earned $63 000 in Net Sales and had an Average Total Assets of $104 150.

Figure 16.15 Calculation: Asset Turnover

$$\text{ATO} = \frac{\text{Net Sales}}{\text{Average Total Assets}}$$
$$= \frac{\$63\,000}{\$104\,150}$$
$$= 0.60 \text{ times}$$

Specifically, this indicator measures the number of times in a period the value of the firm's assets is earned as sales revenue: the higher the Asset Turnover, the more capable the firm is of using its assets to earn revenue. Kingsmill Music's ATO of 0.60 times indicates that for every dollar of assets in the business it earned revenue of 60 cents. A low ATO indicates the assets of the business are not being used productively and that there may be idle assets in the business that need to be disposed of (sold).

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Assessing Asset Turnover

Asset Turnover can be used to assess revenue-earning ability *independent of the level of assets* involved. This means it can be used not only to assess different businesses, but also the same business over time. Therefore, the owner can identify if there were any improvements – or deteriorations – in how productively those assets were used.

A benchmark is required to determine the performance of Kingsmill Music's ATO. Past figures, budgeted figures and indicators from similar businesses or an industry average would provide a point of comparison to assess the adequacy of the result achieved.

Return on Assets (ROA) a profitability indicator that assesses how effectively a business has used its assets to earn profit

Whereas Asset Turnover assesses profitability from how effectively the assets have been used to generate *revenue*, **Return on Assets (ROA)** assesses how effectively the business has used its assets to earn profit.

Return on Assets formula

The formula for calculating Return of Assets is given in Figure 16.16:

Figure 16.16 Formula: Return on Assets

$$\textbf{Return on Assets (ROA)} = \frac{\textbf{Net Profit}}{\textbf{Average Total Assets}} \times 100$$

$$\textbf{Average Total Assets} = \frac{\textbf{(Total Assets at start + Total Assets at end)}}{\textbf{2}}$$

The higher the Return on Assets, the better the business is utilising its asset base. A high Return on Assets means that a business is using its assets effectively to generate profit and that the business is maintaining good expense control.

Example

For the year ended 30 June 2031, Kingsmill Music had achieved $18 150 in Net Profit and had Average Total Assets of $104 150.

The Return on Assets of Kingsmill Music would be calculated as shown in Figure 16.17:

Figure 16.17 Calculation: Return on Assets

$$\textbf{ROA} = \frac{\text{Net Profit}}{\text{Average Total Assets}} \times 100$$

$$= \frac{\$18\,150}{\$104\,150} \times 100$$

$$= 17.43\%$$

Return on Assets measures Net Profit earned per dollar of assets controlled by the business. A Return on Assets of 17.43% means that for every dollar of assets under the control of Kingsmill Music, it has earned 17 cents profit.

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Assessing Return on Assets

Because it expresses profit *relative to assets*, the Return on Assets can be used to compare the profitability of businesses of different sizes to ascertain which has used its assets more effectively to earn profit. It also allows for the comparison of one business's profitability over time. For example, if a business increased its asset base, it would expect both its revenue and profit to increase, making an assessment of the reasons for the change in its profitability difficult to identify. Was the business more profitable, or just bigger? By calculating the Return on Assets, the effect of changes in assets can be isolated from changes in its profitability.

Net Profit and Return on Assets

Assuming assets do not change, a change in the Return on Assets will be solely the result of a change in profit, which may itself be the result of a change in the firm's ability to earn revenue or control its expenses (or both). As a result, the Return on Assets will depend heavily on the firm's ability to earn revenue and control its expenses. Thus, the Return on Assets is dependent on two other profitability indicators:

- Asset Turnover (which measures revenue-earning ability)
- Net Profit Margin (which measures expense control).

Review questions 16.10

1 **State** what is measured by Asset Turnover.
2 **Show** the formula to calculate Asset Turnover.
3 **State** what is measured by Return on Assets.
4 **Show** the formula to calculate Return on Assets.
5 **List** three benchmarks that could be used to assess the adequacy of Asset Turnover and Return on Assets.
6 **Explain** the relationship between Net Profit Margin, Asset Turnover and Return on Assets.

Where have we been?

- A non-current asset is a present economic resource controlled by the entity as a result of past events and is expected to be used by the business for a number of years and is not held for the purpose of resale.
- Non-current assets can be tangible or intangible.
- Non-current assets are valued at Historical cost if purchased or fair value if contributed to the business.
- An asset register helps to manage a business's non-current assets.
- Depreciation is the allocation of the cost of a non-current asset over its Useful life.
- Depreciation is calculated using the straight-line method or the reducing balance method.
- The straight-line depreciation rate is applied to the Historical cost of the non-current asset.
- The reducing balance depreciation rate is applied to the Carrying value of the non-current asset.
- Depreciation is reported in the Income Statement (Depreciation expense) and the Balance Sheet (Accumulated depreciation).
- Depreciation is calculated for a year; however, it can also be determined for partial reporting periods.

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Exercises

Please note: asterisks indicate that an answer for that question is available in the Selected Answers section at the end of this book.

Exercise 16.1
Asset register and depreciation

page 287

On 1 July 2029, Restoration Doors purchased a new Fiju photocopier C506X for $6 000 (plus $600 GST). It is expected that the photocopier will have a Useful life of four years and will be disposed of at this time for $300. Its serial number is 003782357. It is to be depreciated using the straight-line method.

Required

a. **Define** the term 'depreciation'.
b. **Calculate** depreciation of the photocopier for the year ending 30 June 2030.
c. **Calculate** the rate of depreciation.
d. **Create** an asset register in Microsoft Excel to record the purchase of the non-current asset.
e. **Explain** why Residual value is deducted from the Historical cost when calculating depreciation.
f. **Explain** the effect of Depreciation of Photocopier on the Net Profit of Restoration Doors for the year ending 30 June 2030.
g. **Model** the potential outcomes on the financial statements of Restoration Doors for 2030 if they chose to lease the photocopier instead at a cost of $1 200 plus GST per year.
h. **Explain** two benefits of leasing this particular asset.
i. **Explain** whether the straight-line method is the best method of depreciation for the photocopier.

Exercise 16.2
Depreciation

page 290

On 1 January 2030, Aroma World purchased office furniture for $12 000 (plus GST). The office furniture has an estimated Useful life of five years, with a Residual value of $2 000.

Required

a. Referring to one Accounting assumption, **explain** why it is necessary to depreciate non-current assets.
b. **Calculate** Depreciation of Office furniture for 2030.
c. **Show** how office furniture would be reported in the Balance Sheet of Aroma World as at 31 December 2030.
d. **Explain** the effect of Depreciation of office furniture on the Balance Sheet of Aroma World as at 31 December 2030.
e. **Model** the potential outcomes on the financial statements of Aroma World if they chose to depreciate the office furniture over 10 years with a Residual value of $1 000.
f. **Explain** why Aroma World may choose a longer useful life for this asset.

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Exercise 16.3
Depreciation rate comparison

page 292

On 1 July 2029, Finnigan's Wave Boards purchased new polishing equipment, paying $17 600 cash (including GST). The equipment is expected to last for five years, at which time it will have a Residual value of $1 000.

Required

a. **Calculate** Depreciation of Equipment for the year ending 30 June 2030 using the straight-line method.
b. **Calculate** the rate of depreciation applied to the equipment.
c. **Show** how equipment would appear in the Balance Sheet of Finnigan's Wave Boards as at 30 June 2030, 2031 and 2032.
d. Referring to one Qualitative characteristic, **explain** why the equipment must be shown in the Balance Sheet at its Carrying value.
e. Assuming that the business instead chose to use the reducing balance method at a rate of 25% p.a., **show** how the equipment would appear in the Balance Sheet as at 30 June 2030, 2031 and 2032.
f. **Model** the potential outcomes on the financial statements of Finnigan's Wave Boards for the year ended 30 June 2030 if they chose to depreciate the equipment using the reducing balance method at a rate of 25% p.a.
g. **Explain** which depreciation method Finnigan's Wave Boards should use. **Justify** your response.

Exercise 16.4
Depreciation – less than 12 months

page 295

On 1 October 2029, Lukin Motors purchased a new computer for $2 400 (plus GST). The computer will be depreciated at a rate of 15% per annum using the reducing balance method.

Required

a. **Calculate** depreciation of the computer for the year ending 30 June 2030.
b. **State** the effect on the Accounting equation of Lukin Motors as at 30 June 2030 if the adjustment for depreciation was not made.
c. **Show** how the computer would appear in the Balance Sheet of Lukin Motors as at 30 June 2030, 2031 and 2032.

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Exercise 16.5
Depreciation – less than 12 months

page 296

Wangaratta Watches has provided the following extract from its Balance Sheet as at 1 July 2029:

WANGARATTA WATCHES
Balance Sheet (extract) as at 1 July 2029

Non-Current Assets	$	$
Display cases	32 000	
Less Accumulated depreciation	8000	24 000

Additional information:

- A new display case was purchased on 30 November 2029 for $3600 (plus $360 GST).
- Display cases are depreciated at 10% per annum using the straight-line method.

Required

a. **Calculate** Depreciation of display cases for the year ending 30 June 2030.
b. **Show** how display cases would appear in the Balance Sheet of Wangaratta Watches as at 30 June 2030.
c. **Explain** the effect on the Balance Sheet of Wangaratta Watches as at 30 June 2030 if the adjustment for depreciation had not been made.

Exercise 16.6
Reporting depreciation

page 297

Wayne's Fountains sells fountains and other garden ornaments. Its assets and equities as at 1 October 2029 were as follows:

WAYNE'S FOUNTAINS
Assets and Equities as at 1 October 2029

Assets	$	$	Equities	$	$
Inventory		127 000	Bank overdraft		2800
Accounts Receivable		4900	Accounts Payable		64 000
Premises	265 000		GST payable		2700
Less Accumulated depreciation	120 000	145 000	Capital – Wayne		207 400
Total Assets		**276 900**	**Total Equities**		**276 900**

The business has provided the following information for the year ending 30 September 2030:

Sales Journal

Date	Account Receivable	Inv. No.	Sales	GST	Accounts Receivable
	TOTALS	**$**	**18 000**	**1800**	**19 800**

Purchases Journal

Date	Account Payable	Inv. No.	Inventory	GST	Accounts Payable
	TOTALS	**$**	**16 000**	**1600**	**17 600**

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Cash Receipts Journal

Date	Details	Source Document	Bank	Accounts Receivable	Sales	Sundries	GST
	Loan – FIX Finance					20 000	
	TOTALS	**$**	**97 100**	**21 000**	**51 000**	**20 000**	**5 100**

Cash Payments Journal

Date	Details	Source Document	Bank	Accounts Payable	Drawings	Wages	Sundries	GST
	Electricity						6 300	
	Advertising						4 000	
	Insurance						2 400	
	GST Settlement						2 700	
	TOTALS	**$**	**89 270**	**14 100**	**26 000**	**32 500**	**15 400**	**1 270**

Additional information:

- The premises are depreciated at a rate of 5% p.a. using the straight-line method
- Due to effective inventory management techniques, both the inventory cards and the physical count as at 30 September 2030 showed $124 000 Inventory on hand.
- Cost of Sales for the year was $19 000.
- The principal of the loan – FIX Finance is due to be repaid in monthly instalments of $500.

Required

a. Referring to one Accounting assumption, **explain** the purpose of recording depreciation.

b. **Calculate** Depreciation of Premises for the year ending 30 September 2030.

* **c.** **Prepare** a Cash Flow Statement for Wayne's Fountains for the year ending 30 September 2030.

* **d.** **Prepare** an Income Statement for Wayne's Fountains for the year ending 30 September 2030.

e. **State** three reasons why Wayne's Fountains was able to generate a Net increase in cash position despite incurring a Net Loss for the year ending 30 September 2030.

f. **Calculate** the following balances as at 30 September 2030:

- Accounts Receivable
- Accounts Payable
- GST payable.

* **g.** **Prepare** a classified Balance Sheet for Wayne's Fountains as at 30 September 2030.

h. **Calculate** Asset Turnover and Return on Assets for Wayne's Fountains. **Comment** on the performance of Wayne's Fountains given that last year's Asset Turnover was 0.86 times and Return on Assets was 5%.

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Exercise 16.7
Reporting depreciation

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That Bike Shop sells bikes and riding gear and has provided the following information relating to its trading activities for June 2030:

THAT BIKE SHOP
Assets and equities as at 31 May 2030

Assets	$	$	Equities	$	$
Bank		1 650	Accounts Payable		18 650
Inventory		69 700	GST payable		1 900
Accounts Receivable		40 500	Loan – GH Bank		27 000
Delivery van	50 000		Capital – Melven		97 200
Less Accumulated depreciation	17 100	32 900			
Total Assets		**144 750**	**Total Equities**		**144 750**

THAT BIKE SHOP
Cash Flow Statement for June 2030

	$	$
CASH FLOWS FROM OPERATING ACTIVITIES		
Cash sales	8 000	
Receipts from Accounts Receivable	36 000	
GST received	800	**44 800**
Payments to Accounts Payable	(20 000)	
Wages	(18 600)	
Interest	(100)	
Advertising	(800)	
Rent	(600)	
GST paid	(140)	(**40 240**)
Net Cash Flows from Operating Activities		**4 560**
CASH FLOW FROM FINANCING ACTIVITIES		
Capital contribution	1 000	1 000
Drawings	(6 200)	
Loan principal	(1 500)	(7 700)
Net Cash Flows from Financing activities		**(6 700)**
Net Increase (Decrease) in cash position		**(2 140)**
Bank Balance at start (1 June 2030)		**1 650**
Bank Balance at end (30 June 2030)		**(490)**

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Additional information:

- The credit journals for June 2030 showed:

Credit sales	$40 000 plus GST
Credit purchases	$15 000 plus GST

- The inventory cards for June 2030 showed:

Cost of Sales	$18 000
Inventory on hand as at 30 June 2030	$66 700
Sales returns	$1 200 (excluding GST)

- A physical count on 30 June 2030 revealed an inventory loss of $200.
- The delivery van is depreciated at 20% p.a. using the reducing balance method.
- The principal of the loan – GH Bank is repayable at $3 000 per annum by two six-monthly payments.

Required

a. **Explain** how depreciation ensures Relevance in the financial reports.
b. **Calculate** depreciation of the delivery van for June 2030.
* **c.** **Prepare** an Income Statement for That Bike Shop for June 2030.
d. **Explain** two reasons why That Bike Shop was able to earn a profit despite suffering a net decrease in cash position in June 2030.
e. **Calculate** the Accounts Receivable and Accounts Payable balances as at 30 June 2030.
f. **Calculate** the GST balance as at 30 June 2030.
* **g.** **Prepare** a classified Balance Sheet for That Bike Shop as at 30 June 2030.
h. **Calculate** Asset Turnover and Return on Assets for That Bike Shop. **Comment** on That Bike Shop's performance given that the industry average for Asset Turnover was 0.28 times and Return on Assets was 4%.

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Exercise 16.8
Reporting depreciation

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Bronwyn Devitt is the owner/operator of Between the Lines, a small bookshop in Hillside. Reports are prepared quarterly, with the next balance day on 31 March 2030:

BETWEEN THE LINES
Assets and Equities as at 31 December 2029

Assets	$	$	Equities	$	$
Bank		2400	Accounts Payable		9000
Inventory		32000	GST payable		1500
Accounts Receivable		5000	Loan – ANZ		28000
Shelving	48000		Capital – Devitt		34500
Less Accumulated depreciation	14400	33600			
Total Assets		**73000**	**Total Equities**		**73000**

BETWEEN THE LINES
Cash Flow Statement for the quarter ending 31 March 2030

	$	$
CASH FLOWS FROM OPERATING ACTIVITIES		
Cash sales	42000	
Receipts from Accounts Receivable	14000	
GST received	4200	**60200**
Payments to Accounts Payable	(31500)	
Wages	(18000)	
Freight in	(250)	
Interest	(280)	
Advertising	(3000)	
GST paid	(325)	**(53355)**
Net Cash Flows from Operating Activities		**6845**
CASH FLOW FROM FINANCING ACTIVITIES		
Drawings	(3900)	
Loan principal	(1200)	(5100)
Net Cash Flows from Financing activities		**(5100)**
Net Increase (Decrease) in cash position		**1745**
Bank Balance at start (1 January 2030)		**2400**
Bank Balance at end (31 March 2030)		**4145**

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Additional information:

- The Purchases Journal showed credit purchases of $30 000 plus $3 000 GST, but the Sales Journal is missing.
- The inventory cards for the quarter ending 31 March 2030 showed:

Cost of Sales	$40 000
Drawings of inventory	$300
Inventory on hand as at 31 March 2030	$21 700

- A physical count on 31 March 2030 revealed inventory on hand of $21 410.
- Depreciation of shelving is charged at 15% p.a. using the straight-line method.
- The principal of the loan – ANZ is repayable at $400 per month.
- Selected balances as at 31 March 2030:

Accounts Payable	$10 500
Accounts Receivable	$7 500
GST payable	$3 875

Required

a. **Calculate** Depreciation of Shelving for the quarter ending 31 March 2030.

b. **Calculate** Credit sales for the quarter ending 31 March 2030.

* **c.** **Prepare** an Income Statement for Between the Lines for the quarter ending 31 March 2030.

d. **Explain** two reasons why Between the Lines was able to generate a net increase in cash position despite suffering a Net Loss for the quarter ending 31 March 2030.

* **e.** **Prepare** a Balance Sheet for Between the Lines as at 31 March 2030.

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Chapter 17
Budgets

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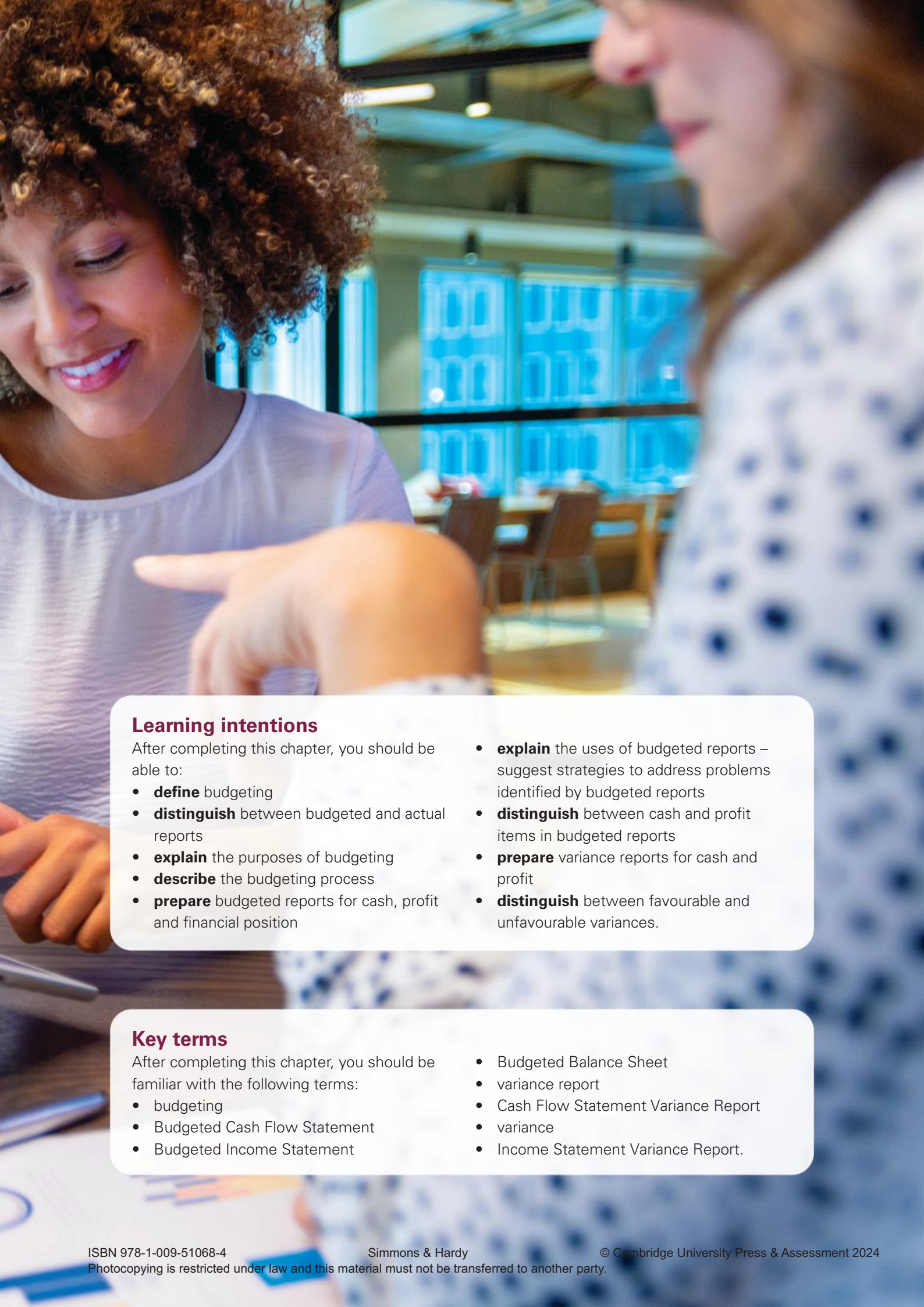

Learning intentions

After completing this chapter, you should be able to:

- **define** budgeting
- **distinguish** between budgeted and actual reports
- **explain** the purposes of budgeting
- **describe** the budgeting process
- **prepare** budgeted reports for cash, profit and financial position
- **explain** the uses of budgeted reports – suggest strategies to address problems identified by budgeted reports
- **distinguish** between cash and profit items in budgeted reports
- **prepare** variance reports for cash and profit
- **distinguish** between favourable and unfavourable variances.

Key terms

After completing this chapter, you should be familiar with the following terms:

- budgeting
- Budgeted Cash Flow Statement
- Budgeted Income Statement
- Budgeted Balance Sheet
- variance report
- Cash Flow Statement Variance Report
- variance
- Income Statement Variance Report.

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17.1 Budgeting

budgeting
the process of predicting/estimating the financial consequences of future events

There is a saying in business circles that 'failing to plan is planning to fail'. At its heart is the idea that a business cannot be successful if it does not prepare early for what it may face in the future. Of course, business owners must analyse what has already happened so that they can identify where they need to improve, and this has been the focus of most of what we have studied so far. However, owners must also attempt to predict what will happen in the future, so that they can plan ahead and be prepared for what is likely to occur. This is the focus of **budgeting**.

Budgeting is the process of preparing reports that estimate or predict the financial consequences of likely future events. These reports look almost the same as the reports we have already prepared, but are different in two key ways:

1 Budgets report *future events* rather than historical events; they focus on what might happen rather than what has already happened.
2 As a consequence, budgets use *estimates or predictions* rather than actual, verifiable data.

In all other ways, budgeted reports resemble actual reports: they use the same headings and include the same items.

Budgeted reports

In practice, the owner of a small trading business will be engaging in a form of budgeting every day, ranging from estimating the number of sales that will be made in a week, to the amount of inventory needed to meet those sales, the number of hours staff will be expected to work and how much the cost of electricity is likely to be. However, it is only via the preparation of budgeted reports that the owner can assess how these estimates affect the firm's expected performance overall.

Study tip

If you can prepare actual reports, you can prepare budgeted reports as they contain the same types of items.

In this course, we will concentrate on the three general-purpose budgets:

1 **Budgeted Cash Flow Statement**, which shows all expected cash inflows and outflows, the expected increase or decrease in cash for the budget period and the expected bank balance at the end of the budget period.
2 **Budgeted Income Statement**, which shows all expected revenue and expenses, and thus the firm's expected Net Profit or Loss for the budget period.
3 **Budgeted Balance Sheet**, which shows expected assets and liabilities at the end of the budget period.

The purpose of budgeting

Like all Accounting reports, budgeted reports have a role in both planning and decision-making:

1 Budgeting **assists planning** by predicting what is likely to occur in the future. This allows the owner to prepare in advance so that possible problems may be managed, and possible opportunities may be taken.
2 Budgeting **aids decision-making** by providing a standard (a benchmark or yardstick) against which actual performance can be measured. This allows the owner to identify areas in which performance is unsatisfactory, so that remedial action can be taken.

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Qualitative characteristics and ethical considerations

Because budgeted reports use estimates, the information they contain is not *Verifiable* by reference to a source document. As a result, they do not provide the same level of *Faithful representation* as historical reports because the information they contain may not be complete or free from error. Indeed, the very fact that budgeted reports are based on estimates means that they *cannot* be neutral or free from bias.

Nonetheless, budgeted reports remain important. The estimates they contain are the best available information about future activities and thus *Relevant* in that they are most capable of making a difference to decision-making about those future activities.

It is therefore important that budgeted reports are prepared in an ethical manner (that is, as impartially and objectively as possible) as the owner and other users will rely on them to make decisions. Budgets should not be prepared to make the firm's future look 'good' or 'bad', rather they should include all information that might affect decision-making and present this information as faithfully as possible.

Review questions 17.1

1 **Define** the term 'budgeting'.
2 **State** two differences between the information presented in budgeted and actual reports.
3 **Explain** what types of information are reported in a:
   - Budgeted Cash Flow Statement
   - Budgeted Income Statement
   - Budgeted Balance Sheet.
4 **Explain** how budgets assist planning.
5 **Explain** how budgets assist decision-making.
6 **Explain** why budgeted reports are not always *Verifiable*.
7 **Explain** the relationship between ethical considerations and *Relevance* in budgeted reports.

Ethical considerations

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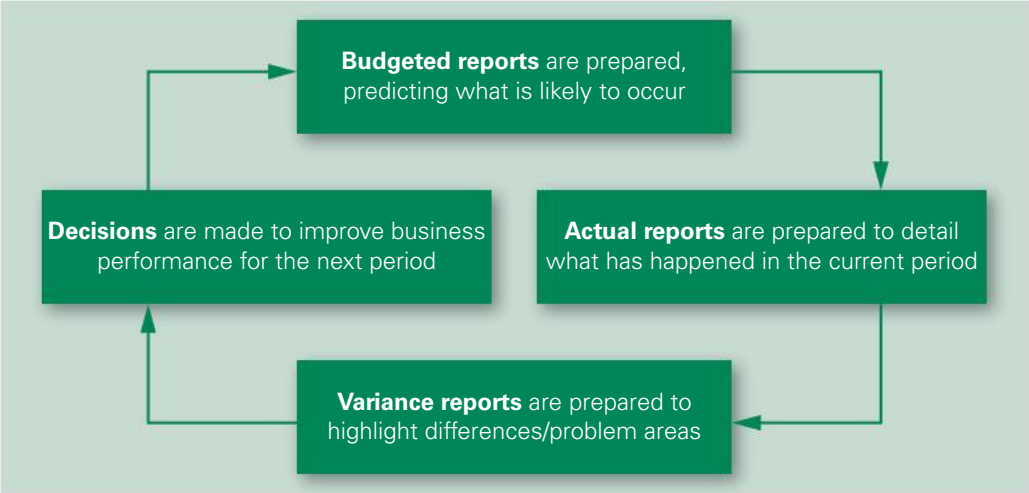
17.2 The budgeting process

We are studying budgeting almost at the *end* of the Accounting process, but budgeting should be one of the *first* steps in starting a new business. After all, a budget is part of the plan the business will use to guide its future, so it must be prepared before operations begin. However, the information in a budget relies largely on what has happened before: what we expect to happen this year will depend on what happened last year.

In this way, budgeting is part of a *continuous process*: budgets should be prepared, compared against actual reports to allow problems to be identified; decisions should be made based on that assessment, and then new budgets should be prepared for the next period. This budgeting process is shown in Figure 17.1:

Figure 17.1 The budgeting process



The information presented in the budgeted reports should be based on the historical data, but allowances must be made for changes and the effects of new business decisions. (Obviously, a new business will not have any historical data on which to rely – this makes budgeting harder for new businesses, but no less important.)

Review questions 17.2

1 **Explain** why budgeting is described as a 'process'.
2 **Describe** the various stages in the budgeting process.
3 **Explain** the role of historical data in the preparation of budgeted reports.

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17.3 Budgeted Cash Flow Statement

In order to survive into the future, a small business must have sufficient cash to meet its obligations. These obligations will include paying Accounts Payable, paying for expenses (such as wages, rent or advertising), meeting loan repayments and providing cash drawings for the owner. In order to do this, it must generate sufficient cash, chiefly through the cash it generates from its sales, either as cash sales or receipts from Accounts Receivable. The **Budgeted Cash Flow Statement** attempts to estimate all future cash inflows and cash outflows, and thus predict the firm's cash balance at the end of the budgeted period.

Budgeted Cash Flow Statement
an Accounting report that predicts future cash inflows and outflows, determines the expected cash increase or decrease, and thus estimates the bank balance at the end of the budget period

Expected cash receipts

The Budgeted Cash Flow Statement should report all cash the business expects to receive in the budget period. Typical cash inflows a trading firm could expect to see in its Budgeted Cash Flow Statement might include:

- cash sales
- receipts from Accounts Receivable
- GST received
- GST refund
- other revenue received (such as interest or commission revenue)
- cash contributions by the owner
- loans received.

Expected cash payments

Similar to cash inflows, the Budgeted Cash Flow Statement should report all cash the business expects to pay in the budget period. Typical cash outflows a trading firm could expect to see in its Budgeted Cash Flow Statement might include:

- cash purchases of inventory
- payments to Accounts Payable
- expenses paid (such as wages, rent or advertising)
- GST paid
- GST settlement
- cash drawings by the owner
- loan repayments
- cash paid for non-current assets.

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Example

Perfect Portraits is run by Karl Rubens and sells photography equipment. As at 30 September 2030, the business had the following assets and equities:

Assets	$	Equities	$
Bank	1800	GST payable	450
Inventory	52000	Accounts Payable	14300
Accounts Receivable	10000	Capital	249050
Premises	200000		
Total Assets	**263800**	**Total Equities**	**263800**

Karl has predicted the following transactions for October 2030:

- Sales are estimated to be $30000 (plus GST), and of these, 40% are expected to be on credit. Sales returns are usually 2% of credit sales.
- Accounts Receivable usually pay in the month following sale, earning a discount of 10%. As at 30 September 2030, the balance of Accounts Receivable was $10000.
- All inventory is marked up 100%, but an inventory loss of 1% of sales is usual.
- As at 30 September 2030, Accounts Payable was $14300 and this will be paid for in October 2030, earning a 5% discount. Credit purchases for October 2030 are expected to be $14000 plus GST. No purchase returns are expected.
- The following expenses will be paid during October 2030:

Supplies	$700	(plus $70 GST)
Wages	25%	of Sales revenue
Advertising	$600	(plus $60 GST)
Interest expense	$150	

- A GST settlement will be paid at the start of October.
- Cash drawings will be $900. Drawings of inventory is expected to be $140.
- New office equipment costing $2640 (including $240 GST) will be purchased using cash on 1 October 2030 and depreciated at 10% p.a. using the straight-line method.
- During October 2030, Karl plans to take out a loan from Dollard Finance (DolFin) for $20000 to help finance the purchase of a new company car later in the year. Monthly loan repayments of $850 will begin on 12 November 2030.

Video 17.1
Finding what you need

Study tip

Reading skills are essential in budgeting questions: you will find most of the answers in the question itself – if you look carefully enough.

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The Budgeted Cash Flow Statement for Perfect Portraits for October 2030 is shown in Figure 17.2:

Figure 17.2 Budgeted Cash Flow Statement

PERFECT PORTRAITS
Budgeted Cash Flow Statement for October 2030

	$	$
CASH FLOWS FROM OPERATING ACTIVITIES		
Cash sales [1]	18 000	
GST received [2]	1 800	
Receipts from Accounts Receivable [3]	9 000	28 800
Payments to Accounts Payable [4]	(13 585)	
Supplies	(700)	
Wages [5]	(7 500)	
Advertising	(600)	
Interest	(150)	
GST settlement	(450)	
GST paid [6]	(370)	(23 355)
Net Cash Flows from Operating Activities		**5 445**
CASH FLOWS FROM INVESTING ACTIVITIES		
Office equipment		(2 400)
Net Cash Flows from Investing activities		**(2 400)**
CASH FLOWS FROM FINANCING ACTIVITIES		
Loan – DolFin		20 000
Drawings		(900)
Net Cash Flows from Financing activities		19 100
Net Increase (Decrease) in cash position		**22 145**
Add Bank Balance at start (1 October 2030)		**1 800**
Bank Balance at end (31 October 2030)		**23 945**

Notes to the Budgeted Cash Flow Statement

1	Cash sales	$30 000 sales × 60% cash sales
2	GST received	$18 000 cash sales × 10%
3	Receipts from Accounts Receivable	$10 000 owing less 10% ($1 000) discount expense
4	Payments to Accounts Payable	$14 300 owing less 5% ($715) discount revenue
5	Wages	$30 000 sales × 25%
6	GST paid	$70 (Supplies) +$60 (Advertising) +$240 (Office equipment)

In this example, Perfect Portraits is expecting to generate an increase in cash of **$22 145** for October 2030. As a result, its bank balance as at 31 October 2030 will increase to **$23 945** (provided all goes according to budget).

Compared with the Cash Flow Statement, the only differences are those outlined earlier: rather than actual historical data, the Budgeted Cash Flow Statement uses *estimates of future* transactions. The only actual figure in the Budgeted Cash Flow Statement is the Bank Balance at start (as this figure is already known when the budget is prepared).

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Further, although there is revenue and expense information given, only cash inflows and cash outflows are reported in the Budgeted Cash Flow Statement. For example, Total sales is $30 000, but only 60% of this is cash sales. The Receipts from Accounts Receivable amount is actually based on the credit sales made last period.

Indeed, many of the transactions listed in the example are not reported in the Budgeted Cash Flow Statement for October 2030, because they do not involve cash. Among others, Credit sales, Sales returns, Credit purchases and Drawings of inventory have all been excluded as they are *non-cash transactions*.

Using the Budgeted Cash Flow Statement

Decision-making

The Budgeted Cash Flow Statement **aids decision-making** about the effectiveness of the firm's cash management by setting a standard (a target or benchmark) that can be used to assess actual cash receipts and payments. Comparing actual cash flows against the budgeted figures allows the owner to identify problem areas (where performance was below expectation) and then act to correct the situation.

For example, Figure 17.2 set a target for Cash sales of $18 000: should actual Cash sales not meet this expectation, corrective action (in the form of more/better advertising or a review of prices) can be taken. Similarly, should payments to Accounts Payable exceed the budgeted figure of $13 585, the owner may wish to review the amount of inventory that is being purchased or the frequency of payment, or even change suppliers (for a cheaper price).

Planning

The Budgeted Cash Flow Statement **aids planning** by allowing the owner to prepare in advance for an expected increase or decrease in cash. That is, the owner will be forewarned if the business is not generating enough cash or if excess funds will be available and will then be able to take steps to prepare for (or perhaps even prevent) that outcome.

The Budgeted Cash Flow Statement in Figure 17.2 predicted a cash increase of **$22 145**), so the owner can start planning how this extra cash can be used. (In this example, the owner had already made plans to use $20 000 to purchase a company car later in the year.)

Responding to a net decrease in cash

Where the Budgeted Cash Flow Statement warns of a *cash decrease*, the owner may be able to respond by taking corrective action to:

- increase sales
- increase receipts from Accounts Receivable
- reduce cash payments for expenses
- make a cash capital contribution
- defer the purchase of non-current assets, or use a loan for their purchase
- defer loan repayments (on existing loans)
- take less cash drawings
- organise (or extend) an overdraft facility.

Although cutting expenses is an obvious (and frequently appropriate) response to a predicted cash decrease, the owner must be particularly mindful of which expenses are cut, as the benefits

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the expenses provide may be vital in the earning of sales. For example, reducing advertising may mean less exposure, whereas reducing hours worked by employees might not only decrease service (and thus sales) but undermine commitment to the business.

Responding to a net increase in cash

Should the Budgeted Cash Flow Statement predict an overall cash increase, the owner might plan to use the extra cash to:

- purchase more or newer non-current assets
- increase loan repayments
- increase cash drawings
- expand operating activities by increasing advertising or employing more staff.

Alternatively, a business that starts a period with a bank overdraft may choose to do nothing and let the expected cash surplus bring their bank balance back into surplus.

Ethical considerations

Ethical considerations

Further, each business needs to consider the ethical as well as financial consequences of its decisions. Lower wages (which increase social inequality), cheaper inventory (which is poorly made or even dangerous), cheaper packaging (which creates waste or causes damage to the environment) or misleading or even exploitative advertising may generate short-term financial gain, but the negative consequences are, in the longer term, harmful to the interests of society and/or the environment, and therefore to the business as well.

Review questions 17.3

1 **Explain** the role of a Budgeted Cash Flow Statement.
2 **List** three typical cash inflows for a trading firm.
3 **List** three typical cash outflows for a trading firm.
4 **Explain** how a Budgeted Cash Flow Statement can aid decision-making.
5 **Explain** how a Budgeted Cash Flow Statement can assist in planning.
6 **State** three actions the owner could take to prepare for a budgeted cash decrease.
7 **State** three actions the owner could take to use a budgeted cash increase.
8 **Explain** the importance of ethical considerations when making business decisions.

17.4 Budgeted Cash Flow Statement: consecutive periods

In general, more frequent budgets will be more accurate, and therefore more useful as benchmarks for comparison. In addition, they will allow for the earlier detection of problems, so that corrective action can be taken in a timely fashion (and can perhaps stop a small problem from becoming large).

However, Figure 17.2 relates only to one month taken in isolation. To show the effect of monthly variations, it would be wise for a business to prepare budgets for consecutive months. That is, separate budgets for October, November and December 2030 could be prepared and presented side by side to show trends in receipts and payments from month to month.

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Such a budget may appear as is shown in Figure 17.3:

Figure 17.3 Budgeted Cash Flow Statement – consecutive periods

PERFECT PORTRAITS
Budgeted Cash Flow Statement for October – December 2030

	$	$	$
CASH FLOWS FROM OPERATING ACTIVITIES			
Cash sales	18000	15000	21000
GST received	1800	1500	2100
Receipts from Accounts Receivable	9000	10584	8820
Total Operating Cash Inflows	**28800**	**27084**	**31920**
Payments to Accounts Payable	(13585)	(14630)	(12540)
Supplies	(700)	(500)	(900)
Wages	(7500)	(6250)	(8750)
Advertising	(600)	(600)	(1200)
Interest	(150)	(150)	(150)
GST settlement	(450)		
GST paid	(370)	(3610)	(210)
Total Operating Cash Outflows	**(23355)**	**(25740)**	**(13585)**
Net Cash Flows from Operating Activities	**544**	**1344**	**8170**
CASH FLOWS FROM INVESTING ACTIVITIES			
Office equipment	(2400)		
Company car		(35000)	
Net Cash Flows from Investing activities	**(2400)**	**(35000)**	
CASH FLOWS FROM FINANCING ACTIVITIES			–
Loan – DolFin	20000		
Capital contribution			10000
Loan principal		(850)	(850)
Drawings	(900)	(900)	(900)
Net Cash Flows from Financing activities	**19100**	**(1750)**	**8250**
Net Increase (Decrease) in cash position	**22145**	**(35406)**	**16420**
Add Bank Balance at start	**1800**	**23945**	**(11461)**
Bank Balance at end	**23945**	**(11461)**	4959

Note how the balance at the end of October ($**23945**) is then transferred to become the balance at the start of November; November's closing balance ($**11461**) becomes the opening balance for December, and so on.

This type of budget allows the owner to assess when to undertake a particular cash activity (such as the purchase of a non-current asset or repayment of a loan). In this example, the budgeted cash balance at the end of October 2030 (**$23945**) is healthy, but is expected to fall into overdraft (of **$11461**) by the end of November 2030 due to the purchase of the company car. Armed with this information, the owner can decide to defer the purchase of the car until December 2030 (when he is able to make a capital contribution for the remainder). However, if the car is necessary to support the increase in sales predicted for December 2030, he may elect to bring the capital contribution forward into November 2030.

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Review questions 17.4

1 **Explain** two reasons why budgets should be prepared more frequently than once per year.
2 **Explain** the relationship between the bank balances shown in Budgeted Cash Flow Statements prepared over consecutive periods.
3 **Explain** how preparing Budgeted Cash Flow Statements over consecutive periods can aid planning.

17.5 Budgeted Income Statement

Whereas the Budgeted Cash Flow Statement reports the effect of expected cash transactions, the **Budgeted Income Statement** reports the effect of expected revenue earned and expenses incurred for the budget period. In many cases, these revenue and expenses will be the same as the cash receipts and payments. However, because cash and profit relate to different areas of business performance, it is likely that the firm's budgeted cash surplus (or deficit) will be different to its budgeted Net Profit (or Loss).

Let's use the same information that was used to generate the Budgeted Cash Flow Statement in Figure 17.2 to illustrate how the Budgeted Income Statement will appear, but this time with the revenue and expenses highlighted:

Budgeted Income Statement
an Accounting report that predicts revenue earned and expenses incurred, and thus the expected Net Profit (or Loss) for the budget period

Example

Perfect Portraits is run by Karl Rubens and sells photography equipment. As at 30 September 2030, the business had the following assets and equities:

Assets	$	Equities	$
Bank	1 800	GST payable	450
Inventory	52 000	Accounts Payable	14 300
Accounts Receivable	10 000	Capital	249 050
Premises	200 000		
Total Assets	**263 800**	**Total Equities**	**263 800**

Karl has predicted the following transactions for October 2030:

- Sales are estimated to be $30 000 (plus GST), and of these, 40% are expected to be on credit. Sales returns are usually 2% of credit sales.
- Accounts Receivable usually pay in the month following a sale, earning a discount of 10%. As at 30 September 2030, the balance of Accounts Receivable was $10 000.
- All inventory is marked up 100%, but an Inventory loss of 1% of sales is usual.
- As at 30 September 2030, Accounts Payable was $14 300, and this will be paid for in October 2030, earning a 5% discount. Credit purchases for October 2030 are expected to be $14 000 plus GST. No purchase returns are expected.
- The following expenses will be paid during October 2030:

Supplies	$700	(plus $70 GST)
Wages	25%	of Sales revenue
Advertising	$600	(plus $60 GST)
Interest expense	$150	

- A GST settlement will be paid at the start of October.
- Cash drawings will be $900. Drawings of inventory is expected to be $140.
- New office equipment costing $2 640 (including $240 GST) will be purchased using cash on 1 October 2030 and depreciated at 10% p.a. using the straight-line method.
- During October 2030, Karl plans to take out a loan from Dollard Finance (DolFin) for $20 000 to help finance the purchase of a new company car later in the year. Monthly loan repayments of $850 will begin on 12 November 2030.

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The budgeted Income Statement for Perfect Portraits for October 2030 is shown in Figure 17.4:

Figure 17.4 Budgeted Income Statement

PERFECT PORTRAITS
Budgeted Income Statement for October 2030

	$	$
Revenue		
Sales	30 000	
Less Sales returns[1]	240	29 760
Less Cost of Goods Sold		
Cost of Sales [2]		14 880
Gross Profit		**14 880**
Less Inventory loss [3]		300
Adjusted Gross Profit		**14 580**
Add Other revenue		
Discount revenue [4]		715
		15 295
Less Other expenses		
Discount expense [5]	1 000	
Supplies	700	
Wages [6]	7 500	
Advertising	600	
Interest	150	
Depreciation of Office equipment [7]	20	9 970
Net Profit		**5 325**

Notes to the Budgeted Income Statement

1	Sales returns	$12 000 Credit sales × 2%
2	Cost of Sales	$29 760 Net sales × 50% (100% mark-up)
3	Inventory loss	$30 000 Sales × 1%
4	Discount revenue	$14 300 owing to Accounts Payable x 5%
5	Discount expense	$10 000 owing from Accounts Receivable × 10%
6	Wages	$30 000 Sales × 25%
7	Depreciation of Office equipment	$2 400 Office equipment × 10% Depreciation × $^{1}/_{12}$

As with the Budgeted Cash Flow Statement, the Budgeted Income Statement closely resembles the actual Income Statement but uses budgeted rather than actual historical data. In this example, Perfect Portraits is expecting to earn a Gross Profit of $14 880 and a Net Profit of $5 325 for October 2030.

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Cash versus profit

Video 17.2
Cash versus profit

Note that not all the items reported in the Budgeted Cash Flow Statement (in Figure 17.2) are reported in the Budgeted Income Statement (in Figure 17.4), and as a consequence the budgeted Net Profit for October 2030 (of $5 325) is **not** the same as the budgeted increase in cash (of **$22 145**). This is because:

- some items are cash flows but are not revenue and expenses so do not affect profit
- some revenue and expenses that affect profit are not cash flows so do not affect cash
- some items affect cash and profit, but by differing amounts.

Cash flows that are not revenue or expenses

The Budgeted Income Statement only includes expected revenue and expenses, meaning it excludes some cash flows reported in the Budgeted Cash Flow Statement:

Cash inflows that are **not** revenue	These cash inflows will increase budgeted cash but are **not** revenue and so will **not** affect budgeted Net Profit. They may explain why cash has increased even though the business has suffered a loss.
GST received GST refund Capital contribution of cash Receipt of loan	
Cash outflows that are **not** expenses	These cash outflows will decrease budgeted cash but are **not** expenses and so will not affect budgeted Net Profit. They may explain why cash has decreased even though the business has earned a profit.
GST paid GST settlement Cash payment for a non-current asset Cash drawings Repayment of loan principal	

Revenue and expenses that are not cash flows

At the same time, the Budgeted Income Statement will include some revenue and expenses that are not reported as cash flows in the Budgeted Cash Flow Statement:

Inventory gain	This revenue will increase budgeted Net Profit but is not a cash flow so will **not** affect budgeted cash. It may explain why the business has earned a profit even when cash has decreased.
Revenue that is **not** a cash inflow	
Expenses that are **not** cash outflows	These expenses will decrease budgeted Net Profit but are **not** cash flows so will not affect budgeted cash. They may explain why the business has suffered a loss even though cash has increased.
Inventory loss Bad debts expense Depreciation expense	

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Items that affect cash and profit by differing amounts

Finally, some items will affect both budgets, but the amounts may differ:

Revenue/Expense	Cash inflow/Cash outflow	
Credit sales	Receipts from Accounts Receivable	If Credit sales is greater than Receipts from Accounts Receivable, profit will increase more than cash. *
Cost of Sales	Cash payments for Inventory/ Payments to Accounts Payable	If Cost of Sales is greater than Payments to Accounts Payable, profit will decrease more than cash. *

Opposites apply here: if Credit sales is lower than Receipts from Accounts Receivable, cash will increase more than profit; if Cost of Sales is lower than Payments to Accounts Payable, cash will decrease more than profit.

Using the Budgeted Income Statement

Just as the Budgeted Cash Flow Statement can be used to assist both planning and decision-making, so too can the Budgeted Income Statement.

As an **aid to decision-making**, the Budgeted Income Statement provides a standard against which actual trading performance can be measured, allowing problems to be identified and corrective action taken. This benchmark can also act as a target or goal to motivate staff and management. Specifically, the owner could assess:

- revenue-earning performance (and the effectiveness of advertising)
- expense control
- staff performance.

The Budgeted Income Statement also **aids planning** by reporting expected revenue and expenses and thus indicating the firm's future requirements relating to issues like purchasing inventory, staffing (which may require hiring or firing) or the need for advertising campaigns. Where a Net Loss is predicted, the owner can respond by:

- changing prices, advertising or the inventory offered for sale
- seeking cheaper suppliers
- examining rosters to ensure staffing levels are appropriate.

Review questions 17.5

1 **Explain** the role of a Budgeted Income Statement.
2 **State** three examples of:
   - cash inflows that are **not** revenue
   - cash outflows that are **not** expenses.
3 **Explain** how an inventory gain will affect both cash and profit.
4 **State** three examples of expenses that are not cash outflows.
5 **Explain** what will happen to cash and profit if:
   - Credit sales is greater than receipts from Accounts Receivable
   - Cost of Sales is greater than payments to Accounts Payable.
6 **Explain** how a Budgeted Income Statement can be used to assist decision-making.
7 **Explain** how a Budgeted Income Statement can be used to assist planning.

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17.6 Budgeted Balance Sheet

Having prepared budgeted reports for cash (the Budgeted Cash Flow Statement) and profit (the Budgeted Income Statement), the business can prepare a **Budgeted Balance Sheet** to show expected assets, liabilities and owner's equity at some point in the future.

Using the same information for Perfect Portraits (as shown earlier in this chapter), the Budgeted Balance Sheet as at 31 October 2030 would appear as shown in Figure 17.5:

Budgeted Balance Sheet
an Accounting report that predicts assets, liabilities and owner's equity at the end of the budget period

Figure 17.5 Budgeted Balance Sheet

PERFECT PORTRAITS
Budgeted Balance Sheet as at 31 October 2030

	$	$		$	$
Current Assets			**Current Liabilities**		
Bank [1]	23 945		Accounts Payable [5]	15 400	
Inventory [2]	50 680		GST Payable [3]	1 206	
Accounts Receivable [3]	12 936	87 561	Loan – DolFin [7]	10 200	26 806
Non-Current Assets			**Non-Current Liabilities**		
Premises *		200 000	Loan – DolFin [7]		9 800
Office equipment [4]	2 400				
Less Accumulated Depreciation	(20)	2 380	**Owner's equity**		
			Capital *	249 050	
			Add Net Profit[8]	5 325	
				254 375	
			Less Drawings [9]	1 040	253 335
Total Assets		**289 941**	**Total Equities**		**289 941**

Notes to the Budgeted Balance Sheet

1 Bank from Budgeted Cash Flow Statement (Figure 17.2)

2 Inventory

Balance at start (30 September 2030)	52 000
+ Credit purchases	14 000
	66 000
– Cost of Sales (Fig. 17.4 – includes cost of Sales returns)	14 880
– Inventory loss (Fig. 17.4)	300
– Drawings of Inventory	140
Balance at end (31 October 2030)	50 680

3 Accounts Receivable

Balance at start (30 September 2030)	10 000
+ Credit sales (Fig. 17.4) plus GST	13 200
– Sales returns (Fig. 17.4) plus GST	264
	22 936
– Receipts from Accounts Receivable (Fig. 17.2)	9 000
– Discount expense (Fig. 17.4)	1 000
Balance at end (31 October 2030)	**12 936**

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4 Office equipment from Budgeted Cash Flow Statement (Figure 17.2) less Accumulated depreciation (one month's Depreciation expense) from Budgeted Income Statement (Figure 17.4)

5 Accounts Payable

Balance at start (30 September 2030)	14300
+ Credit purchases plus GST	15400
	29700
– Payments to Accounts Payable (Fig. 17.2)	13585
– Discount revenue (Fig. 17.4)	715
Balance at end (31 October 2030)	15400

6 GST payable

Balance at start (30 September 2030)	450
– GST settlement (Fig. 17.2)	450
	nil
+ GST on Sales ($30000 × 10%)	3000
– GST on Sales returns ($240 × 10%)	24
	2976
– GST paid (Fig. 17.2)	370
– GST on Credit purchases	1400
Balance at end (31 October 2030)	1206

7 Loan – DolFin — Repayable $850 per month (12 × $850 = CL; remainder NCL)

8 Net Profit — From Budgeted Income Statement (Figure 17.4)

9 Drawings — Cash drawings ($900) plus Drawings of inventory ($140)

* Other items — From previous Balance Sheet – no change

Using the Budgeted Balance Sheet

As an **aid to decision-making**, the Budgeted Balance Sheet provides a standard against which actual trading performance can be measured, allowing problems to be identified and corrective action taken. Benchmarks for balances of inventory, Accounts Receivable and Accounts Payable, loans and even capital can also be used to assess actual balances at the end of the period so that corrective action can be made.

By reporting the value of assets at some point in the future, the Budgeted Balance Sheet also **assists planning** for their replacement and planning for the repayment of loans. In this case, the office equipment is quite new, but nearer the end of its useful life the Budgeted Balance Sheet will show its Carrying value approaching its Residual value, prompting the owner to plan for its replacement.

(In this example, the premises have not been depreciated, which might raise some questions about the *Relevance* of the report and whether it provides all information that is capable of influencing decision-making.)

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Review questions 17.6

1 **Explain** the role of a Budgeted Balance Sheet.
2 **Explain** the role of the Budgeted Cash Flow Statement and Budgeted Income Statement in the preparation of the Budgeted Balance Sheet.
3 **Show** the formula to calculate the budgeted balance of:
   - inventory
   - Accounts Receivable
   - Accounts Payable
   - GST payable/receivable.
4 **Explain** how a Budgeted Balance Sheet can be used to assist decision-making.
5 **Explain** how a Budgeted Balance Sheet can be used to assist planning.

17.7 Variance reports

One of the key reasons for preparing a Budgeted Cash Flow Statement is that it provides a standard or benchmark for the assessment of actual performance. By comparing actual and budgeted figures, differences – and problems in particular – can be identified, allowing the owner to make decisions to improve the firm's performance. This comparison is facilitated by the preparation of a **variance report**.

variance report
an Accounting report that compares actual and budgeted figures, highlighting variances so that problems can be identified and corrective action taken

Cash Flow Statement Variance Report
an Accounting report that compares actual and budgeted cash flows, highlighting variances so that problems can be identified and corrective action taken

variance
the difference between an actual figure and a budgeted figure, expressed as 'favourable' or 'unfavourable'

Cash Flow Statement Variance Report

A **Cash Flow Statement Variance Report** compares actual and budgeted cash figures, highlighting any differences (which are known as 'variances') so that problems can be identified and corrected. In appearance, it is very similar to a Budgeted Cash Flow Statement, but is has additional columns for actual figures and the calculation of the variance. It is prepared once the actual figures are available, but before the next budget.

A **variance** is simply the difference between the budgeted figure and actual figure. Whether it is favourable or unfavourable depends – in the Cash Flow Statement Variance Report – on its effect on cash:

- A variance is favourable (F) if it means *cash will be higher than expected* in the budget.
- A variance is unfavourable (U) if it means *cash will be lower than expected* in the budget.

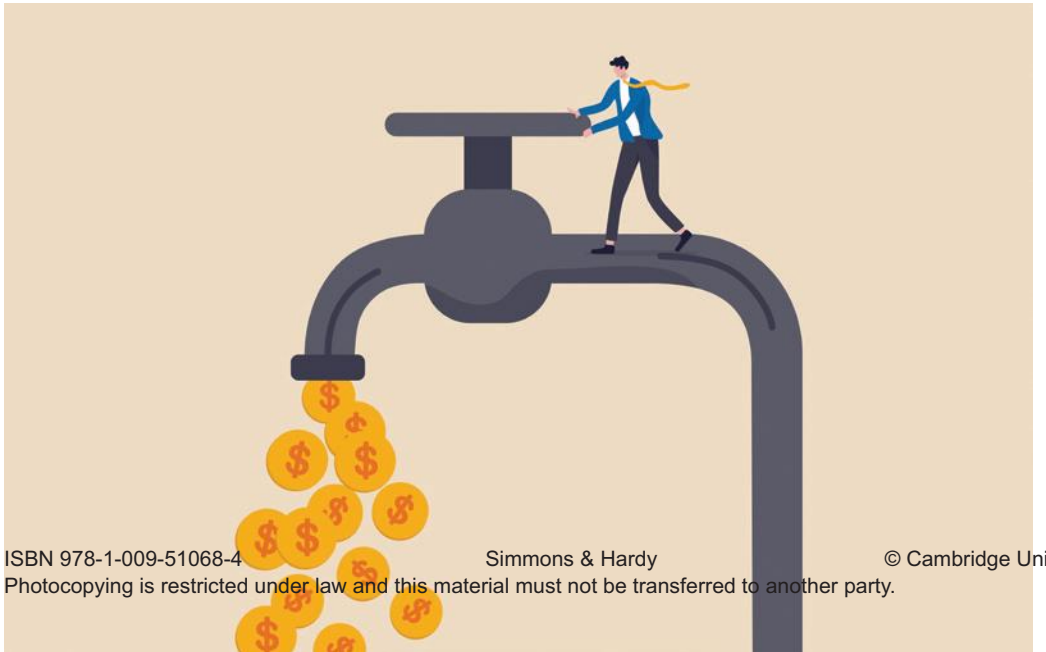

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Figure 17.6 shows the Cash Flow Statement Variance Report for Perfect Portraits for October 2030:

Figure 17.6 Cash Flow Statement Variance Report

PERFECT PORTRAITS
Cash Flow Statement Variance Report for October 2030

	Budget	Actual	Variance	F/U
CASH FLOWS FROM OPERATING ACTIVITIES				
Cash sales	18 000	15 000	3 000	U
GST received	1 800	1 500	300	U
Receipts from Accounts Receivable	9 000	8 000	1 000	U
Total Operating Cash Inflows	**28 800**	**24 500**	**4 300**	**U**
Payments to Accounts Payable	(13 585)	(12 500)	1 085	F
Supplies	(700)	(750)	50	U
Wages	(7 500)	(7 500)	–	–
Advertising	(600)	(200)	400	F
Interest	(150)	(150)	–	–
GST settlement	(450)	(450)	–	–
GST paid	(370)	(395)	25	U
Total Operating Cash Outflows	**(23 355)**	**(21 945)**	**1 410**	**F**
Net Cash Flows from Operating Activities	**5 445**	**2 555**	**2 890**	**U**
CASH FLOWS FROM INVESTING ACTIVITIES				
Office equipment	(2 400)	(3 000)	600	U
Net Cash Flows from Investing activities	**(2 400)**	**(3 000)**	**600**	**U**
CASH FLOWS FROM FINANCING ACTIVITIES				
Loan – DolFin	20 000	25 000	5 000	F
Drawings	(900)	(1 200)	300	U
Net Cash Flows from Financing activities	**19 100**	**23 800**	**4 700**	**F**
Net Increase (Decrease) in cash position	**22 145**	**23 355**	**1 210**	**F**
Add Bank Balance at start	**1 800**	**1 800**	**–**	**–**
Bank Balance at end	**23 945**	**25 155**	**1 210**	**F**

Study tip

It doesn't really matter whether you subtract budgeted figures from actual, or the other way around. The important thing is to identify the variance correctly as favourable or unfavourable.

Study tip

If there is no variance at all, then it is neither favourable nor unfavourable; don't get too excited just because the budget was accurate!

Note that in this example, the variance in cash paid to Accounts Payable is reported as favourable because cash will not decrease as much as was expected. The fact that the amount owed to Accounts Payable will not decrease by as much does not affect its classification in the Cash Flow Statement Variance Report. The same principle applies to payment for the office equipment: the fact that assets will be higher than expected does not affect its classification as unfavourable because cash will decrease more than expected.

Interpreting the Cash Flow Statement Variance Report

In this example, the increase in cash was $1 210 higher than was expected: why did this occur?

- Cash sales was $3 000 lower than budgeted, perhaps as a result of a lower than expected payment for advertising. Taking into account lower GST received, this decreased cash inflows by $3 300.
- Given that receipts from Account Receivable were based on sales made in the previous period, the unfavourable variance might indicate poor collection procedures.

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- The favourable variance in payments to Accounts Payable should be investigated to ensure payments were made on time to receive the discount revenue.
- Despite lower sales, there was no favourable variance in Wages, which might suggest poor management of staffing levels but might also reflect that the shop needs to be staffed even when sales are not occurring.
- The business paid $600 more than budgeted for the office equipment, perhaps because of higher prices, a late decision to buy more/better quality or an inaccurate estimate.
- The Loan – DolFin was $5000 higher than expected, with this favourable variance more than compensating for the unfavourable variances in Operating and Investing cash flows.

Study tip

Variance reports are also known as performance reports, as they assess the firm's performance in meeting its budget.

Income Statement Variance Report

In the same way that a Cash Flow Statement Variance Report compares actual and budgeted cash flows, an **Income Statement Variance Report** can be prepared to compare actual and budgeted revenue and expenses.

Variances in this report are classified as favourable or unfavourable depending on their effect on profit:

- A variance is favourable (F) if it means *profit will be higher than expected* in the budget.
- A variance is unfavourable (U) if it means *profit will be lower than expected* in the budget.

Figure 17.7 shows the Income Statement Variance Report for Perfect Portraits for October 2030:

Income Statement Variance Report
an Accounting report that compares actual and budgeted revenue and expenses, and highlights variances so that problems can be identified and corrective action taken

Figure 17.7 Income Statement Variance Report

PERFECT PORTRAITS
Income Statement Variance Report for October 2030

	Budget	Actual	Variance	F/U
Sales	30000	24000	6000	U
Less Sales returns	240	150	90	F
Net Sales	**29760**	**23850**	**5910**	**U**
Less Cost of Goods Sold				
Cost of Sales	14880	14500	380	F
Gross Profit	**14800**	**9350**	**5530**	**U**
Less Inventory loss	300	350	50	U
Adjusted Gross Profit	**14580**	**9000**	**5580**	**U**
Add Other revenue				
Discount revenue	715	660	55	U
	15295	**9660**	**5635**	**U**
Less Other expenses				
Discount expense	1000	800	200	F
Supplies	700	750	50	U
Wages	7500	7500	–	–
Advertising	600	200	400	F
Interest	150	150	–	–
Depreciation of Office equipment	20	25	5	U
Total Other expenses	**9970**	**9425**	**545**	**F**
Net Profit	**5325**	**235**	**5090**	**U**

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Interpreting the Income Statement Variance Report

In this example, Net Profit was $5090 lower than was expected: why did this occur?

- Sales was $6000 lower than expected. While some of this decrease may be attributable to the lower expenditure on Advertising ($400 favourable variance), such a large unfavourable variance may indicate other issues such as prices that are too high or inventory that is not in demand. Alternatively, it could indicate no change in sales volume but instead a decrease in selling prices.
- The favourable variance in Sales returns can be explained by lower (credit) sales.
- Given the large unfavourable variance in Sales, the small favourable variance in Cost of Sales is concerning and may indicate a change in mark-up: perhaps cost prices charged by suppliers increased or selling prices were reduced (in response to lower sales volume?).
- Discount revenue and expense both vary with the changes in amounts paid to Accounts Payable and received from Accounts Receivable (as shown in the Budgeted Cash Flow Statement Variance Report in Figure 17.6).
- Overall there is a large unfavourable variance in Sales revenue but only a small favourable variance in expenses, meaning Net Profit is $5090 lower than expected.

Using the variance reports

Assuming the variances are not caused by poor estimates, then both the Cash Flow Statement Variance Report and the Income Statement Variance Report are valuable **aids to decision-making**. The unfavourable variances should be investigated, and their cause(s) identified. This will allow the owner to take corrective action.

Even if the variances are simply the result of poor budgeting, this does not mean the variance reports are useless. Both variance reports can be used to **assist planning** for the next reporting period by providing a basis for the preparation of the next budget so that it is more accurate and thus more useful as a benchmark and decision-making tool.

Review questions 17.7

1. **Explain** what is shown in a variance report.
2. **Define** the term ‘variance’.
3. **Explain** when a variance in the Cash Flow Statement Variance Report would be considered to be:
   - favourable
   - unfavourable.
4. **Explain** when a variance in the Income Statement Variance Report would be considered to be:
   - favourable
   - unfavourable.
5. **Explain** how a variance report can be used to assist decision-making.
6. **Explain** how a variance report can be used to assist planning.

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Where have we been?

- Budgeting is the process of preparing reports to estimate or predict the financial consequences of likely future transactions.
- Budgets use estimates of future events rather than actual, verifiable data.
- Budgets assist planning by predicting what is likely to occur in the future and aid decision-making by providing a benchmark or yardstick against which actual performance can be measured.
- Cash and profit are different measures of performance, and the change in cash and profit or loss might be different because:
  - some cash flows are not revenue or expenses
  - some revenue and expenses are not cash flows
  - some items affect both cash and profit but by differing amounts.
- A variance is the difference between the budgeted figure and actual figure and is classified as favourable or unfavourable depending on its effect on Bank (for a Cash Flow Statement Variance Report) or profit (for an Income Statement Variance Report).
- Variance reports compare actual and budgeted figures, highlighting variances so that problems can be identified and corrected.

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Exercises

Please note: asterisks indicate that an answer for that question is available in the Selected Answers section at the end of this book.

Exercises 17.1

Budgeted Cash Flow Statement

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On 31 December 2029, Finishing Touch Paints had $1 600 in its bank account. It has provided the following list of expected transactions for January 2030:

Cash sales	$24 000	plus GST
Credit sales (to begin in January 2030)	12 000	plus GST
Cash purchases of paint	18 000	plus GST
Wages paid	3 600	
Electricity paid	1 500	plus GST
Loan repayment	800	
Drawings: cash	3 200	
Drawings: paint	300	
Interest on loan	450	
Purchase of shelving	5 000	plus GST

Required

a. **Explain** why budgets do **not** satisfy the Qualitative characteristic of *Verifiability*.

b. **Calculate** budgeted GST paid for January 2030.

* **c.** **Prepare** a Budgeted Cash Flow Statement for Finishing Touch Paints for January 2030.

d. Referring to your answer to part **c**, **suggest** two actions the owner may take to prepare for the predicted outcome.

e. **Identify** one reason why the budgeted Net Profit of Finishing Touch Paints for January 2030 might be different from its budgeted net increase (decrease) in cash. **Explain** your answer.

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Exercises 17.2

Budgeted Cash Flow Statement

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Langwarrin Laundry Equipment (LLE) sells washing machines and dryers to hotels and hospitals. The firm's expected transactions for July 2030 are listed below:

- Sales are expected to be $143 000 including $13 000 GST. All sales are made on credit, but 90% of Accounts Receivable pay in the month of sale. Actual sales for June 2030 was $120 000 plus GST.
- Inventory is purchased on credit but paid for in the month of sale to earn a 5% discount. In July 2030, the business expects to purchase inventory worth $65 000 plus GST.
- A new delivery van will be bought for $32 000 (plus GST). The purchase will be financed by a loan for $35 000 from AJNL Finance.
- The following expenses will be paid:

Advertising	$682	including GST
Interest on loan	$150	
Rent expense	$6 000	plus GST
Wages	$1 250	

- A GST settlement of $1 800 is due in July 2030.
- The owner plans to withdraw $1 000 cash and contribute her own computer worth $1 200 for business use.
- As at 30 June 2030, the business had a bank overdraft of $1 300.

Required

a. Referring to one Qualitative characteristic, **explain** one benefit of preparing a Budgeted Cash Flow Statement.

b. **Calculate** the following budgeted amounts for July 2030:
- receipts from Accounts Receivable
- payments to Accounts Payable
- GST paid to suppliers.

* **c.** **Prepare** a Budgeted Cash Flow Statement for Langwarrin Laundry Equipment for July 2030.

d. Referring to your answer to part **c**, **explain** how Langwarrin Laundry Equipment can use this Budgeted Cash Flow Statement to aid its planning.

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Exercise 17.3

Budgeted Cash Flow Statements – consecutive periods

page 315

Plato Says sells books on philosophy and the history of Ancient Greece and has provided the following information regarding its expected transactions for October to December 2030:

- As at 1 October 2030, the business had $2 190 in its bank account.
- Sales and purchases of inventory are expected to be as follows:

	Sales	Purchases
September (actual)	$1 000 plus GST	$600 plus GST
October	$1 300 plus GST	$800 plus GST
November	$2 400 plus GST	$1 500 plus GST
December	$800 plus GST	$500 plus GST

- Sales are usually 20% cash and 80% credit, with Accounts Receivable paying the month following the sale.
- Inventory is purchased using cash.
- Wages are set at 60% of total sales (excluding GST).
- Administration expenses are usually $275 (including GST) per month.
- Stationery supplies are purchased as required with the next payment of $350 plus GST due in December 2030.
- Advertising of $220 including GST will be paid in October 2030.
- The owner expects to receive a gift of $1 500 from a relative in November 2030 and is planning to contribute this cash to the business.
- A GST refund of $400 is due in October 2030.
- The owner plans to take $450 drawings per month.
- New shelving will be purchased for $12 000 plus GST in October 2030.

Required

a. **Explain** why the way Plato Says manages its sales and purchases of inventory might have negative consequences for its liquidity.

b. **Calculate** cash and credit sales for October, November and December 2030.

c. **Calculate** budgeted GST paid for October, November and December 2030.

* **d.** **Prepare** a Budgeted Cash Flow Statement for Plato Says for October, November and December 2030.

e. The business needs new shelving, which is currently on sale for a special price of $12 000 (plus GST). From 1 November 2030, the shelving will increase in price to $15 000 (plus GST). **Discuss** when the business should purchase the shelving.

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Exercise 17.4

Budgeted Income Statement

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Melinda Fricke runs Sebastapol Electrics, which sells electrical parts in Western Victoria. She has provided the following information regarding its expected transactions for April 2030:

- Sales are estimated to be $54 000 (plus GST). One customer has permission to pay his account of $3 700 (plus GST) in May 2030.
- All inventory will be sold at a 100% mark-up, but Melinda is wondering if this is high enough.
- An inventory loss of 1% of sales is expected.
- Inventory worth $34 000 (plus GST) will be purchased on credit from Global Tools. Most of this will be paid by the end of the month, earning discount revenue of $520.
- The following expenses will be paid during April 2030:

Advertising	$1 320	including GST
Rent	$1 000	plus GST
Wages	$2 000	

- A GST settlement of $800 is due in April 2030.
- On 30 April 2030, a new van will be purchased for $30 000 (plus GST).
- Depreciation of shop fittings is $3 000 per year.
- Cash drawings will be $2 500.

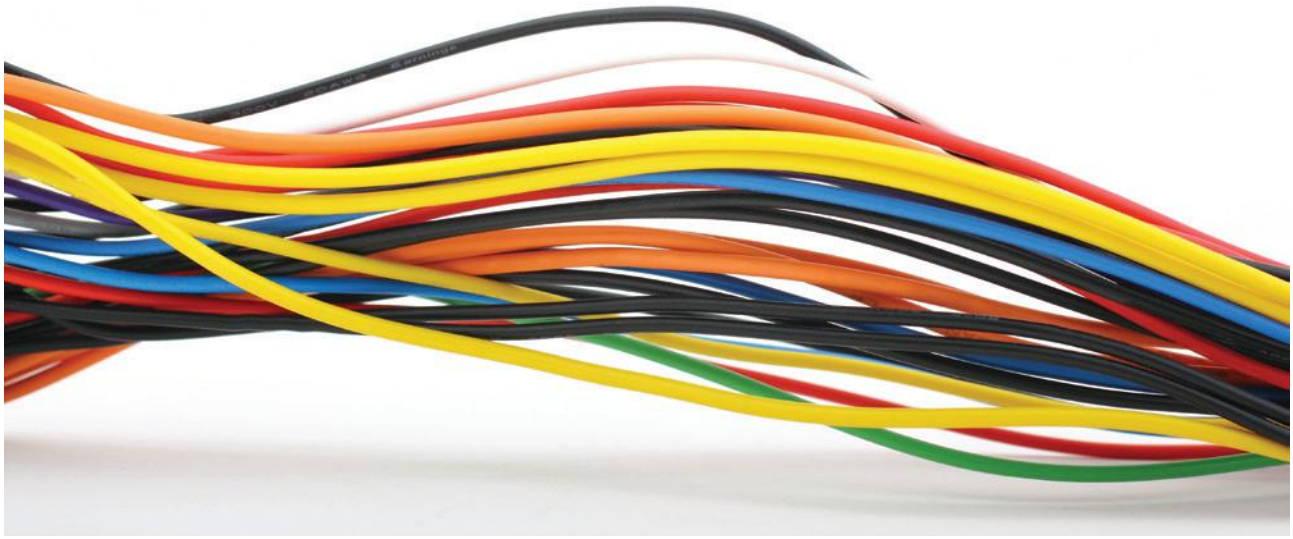
Required

* **a.** **Prepare** a Budgeted Income Statement for Sebastapol Electrics for April 2030.

b. Referring to your answer to part **a**, **explain** how Sebastapol Electrics can use this Budgeted Income Statement to assist planning.

c. Referring to your answer to part **a**, **discuss** whether the business should increase its mark-up on sales.

d. **Identify** one reason why the budgeted net increase (decrease) in cash of Sebastapol Electrics for April 2030 might be different from its budgeted Net Profit. **Explain** your answer.



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Exercise 17.5
Budgeted Income Statement

page 320

Magnificent Mowers sells mowing and gardening equipment, and has provided the following information regarding expected transactions for September 2030:

- Sales for July and August 2030 were $50 000 plus GST but sales are expected to grow by 20% in September 2030 due to the coming of spring.
- 70% of sales are made on credit and sales returns are usually 5% of credit sales. Bad debts are usually 1% of credit sales.
- Inventory is sold at a 50% mark-up, and inventory losses are usually 2% of Net sales.
- Wages for the office assistant will be $3 700 and Rent expense will be $4 500 plus GST.
- Advertising in the local paper is paid every three months with the next $5 720 payment (including GST) due in September 2030.
- Office equipment with a carrying value of $30 000 is depreciated at 20% p.a.
- Monthly instalments of $500 are made on a loan, with interest of $320 due in September 2030.
- Drawings is usually $850, but the owner is planning to withdraw an extra $600 in September 2030 to make a deposit on a summer holiday.

Required

a. **Calculate** Budgeted Sales for September 2030.

* **b.** **Prepare** a Budgeted Income Statement for Magnificent Mowers for September 2030.

c. Referring to your answer to part **b**, **explain** how Magnificent Mowers can use this Budgeted Income Statement to assist decision-making.

d. **Explain** two actions the owner could take to increase budgeted Adjusted Gross Profit for September 2030.

Exercise 17.6
Budgeted reports

page 322

On 1 December 2030, Tyfanni Connally started BTrue2, which sells active wear online. Tyfanni has provided the following estimates for the first month of operations:

- Tyfanni will contribute $15 000 of her own cash as well as her personal laptop worth $2 500. The laptop will be depreciated at $40 per month.
- Rent of factory space will cost $3 000 (plus GST), to be paid in cash on 1 December 2030.
- Shelving costing $11 000 including GST will be purchased on 1 December 2030 using a loan from EK Finance. The shelving will have a useful life of 5 years and a residual value of $2 500. Monthly interest on the loan will be 3.6% p.a., with the first monthly principal repayment of $400 due on 31 December 2030.
- All sales will be made for cash and in December 2030 are expected to be $5 000 plus GST. Sales will be marked up 100%.
- Inventory worth $3 500 plus GST will be purchased on credit but Tyfanni expects purchase returns of $300 plus GST.
- Tyfanni plans to pay Accounts Payable at the end of every week, leaving $495 owing at the end of December 2030 but earning discount revenue of $60.
- The following expenses are expected:

Advertising	$3 400 plus GST
Inventory loss	2% of sales
Administration expenses	5% of sales plus GST

- Tyfanni plans to withdraw $700 in cash and $120 worth of inventory during December 2030.

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Required

a. **Calculate** the following budgeted amounts for December 2030:
   - Administration expenses
   - GST paid
   - Interest expense
   - Payments to Accounts Payable.

* b. **Prepare** a Budgeted Cash Flow Statement for BTrue2 for December 2030.

c. **Calculate** budgeted Depreciation of Shelving for December 2030.

* d. **Prepare** a Budgeted Income Statement for BTrue2 for December 2030.

e. **Identify** two reasons why BTrue2 is expecting to generate a net increase in cash despite incurring a Net Loss for December 2030. **Explain** your answer.

f. **Calculate** the following budgeted balances as at 31 December 2030:
   - inventory
   - GST.

* g. **Prepare** a Budgeted Balance Sheet for BTrue2 as at 31 December 2030.

Exercise 17.7
Budgeted reports

page 327

BHM Trading is owned and operated by Bob Bevan and sells hardware. As at 31 July 2030, the business had the following assets and equities:

Assets	$	Equities	$
Inventory	120 000	Bank	5 000
GST receivable	1 300	Accounts Payable	34 100
Accounts Receivable	40 000	Loan – EastBank	30 000
Office furniture	35 000	Capital	110 200
Less Accumulated depreciation	(17 000)		
Total Assets	**179 300**	**Total Equities**	**179 300**

Bob has predicted the following transactions for August 2030:

- Sales are estimated to be $60 000 plus GST. All sales are made on credit and sales returns are usually 5% of credit sales. Bad debts are expected to be $1 000 plus GST.
- Inventory is sold at a 50% mark-up and inventory losses are usually 1% of sales.
- 40% of Accounts Receivable pay in the month of sale to earn a 5% discount. The rest pay in the following month. The balance of Accounts Receivable is budgeted to be $36 960 as at 31 August 2030.
- Credit purchases of inventory will be $38 500 including GST but purchase returns of $550 including GST are expected. All Accounts Payable are paid in the month following purchase.
- The following expenses can usually be calculated reliably as a percentage of sales:

Wages	30%
Administration expenses	5% plus GST

- Depreciation of Office furniture is calculated using the reducing balance method at 12% p.a.
- The loan from EastBank was taken out in July 2030 and will be put towards the purchase of a van worth $33 000 including GST in September 2030. The loan is repayable in instalments of $500 plus $120 interest per month.
- Advertising expense of $480 plus GST is paid every month.
- Bob takes cash drawings of $2100 per month but also expects to withdraw inventory worth $400.
- A GST refund is expected on 3 August 2030.

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Required

a. **Calculate** the following budgeted amounts for August 2030:
- Discount expense
- Receipts from Accounts Receivable
- GST paid.

* **b.** **Prepare** a Budgeted Cash Flow Statement for BHM Trading for August 2030.

* **c.** **Prepare** a Budgeted Income Statement for BHM Trading for August 2030.

d. **Explain** two reasons why the budgeted Net Operating Cash Flows of BHM Trading is expected to be higher than its budgeted Net Profit for August 2030.

e. **Suggest** two strategies Bob could employ to improve budgeted Net Profit for August 2030.

f. **Calculate** the following budgeted balances as at 31 August 2030:
- Inventory
- GST.

* **g.** **Prepare** a Budgeted Balance Sheet for BHM Trading as at 31 August 2030.

Exercise 17.8
Cash Flow Statement Variance Report

page 332

Hair Apparent has provided the following partially complete report:

HAIR APPARENT
Cash Flow Statement Variance Report for June 2030

	Budget	Actual	Variance	F/U
CASH FLOWS FROM OPERATING ACTIVITIES				
Cash sales	8970	9500		
GST received	897	950		
Total Operating Cash Inflows	**9867**	**10450**		
Cash purchase of inventory	(3500)	(4900)		
Advertising	(800)	(950)		
Wages	(1700)	(2300)		
Interest on loan	(100)	(120)		
GST paid	(430)	(825)		
Total Operating Cash Outflows	**(6530)**	**(9095)**		
Net Cash Flows from Operating Activities	**3337**	**1355**		
CASH FLOWS FROM INVESTING ACTIVITIES				
Cash register	–	(2400)		
Net Cash Flows from Investing activities	–	**(2400)**		
CASH FLOWS FROM FINANCING ACTIVITIES				
Capital contribution	–	2000		
Loan principal	(700)	(500)		
Drawings	(1420)	(1200)		
Net Cash Flows from Financing activities	**(2120)**	**300**		
Net increase (decrease) in cash	**1217**	**(745)**		
Add Bank Balance at start (1 June 2030)	**360**	**360**		
Bank Balance at end (30 June 2030)	**1577**	**(385)**		

The proprietor, Sophie, had organised an overdraft limit with the bank of $1000.

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Required

a. **Complete** the Cash Flow Statement Variance Report for Hair Apparent for June 2030.
b. **State** one reason why there is no variance for Bank Balance at start.
c. **Suggest** one possible reason for the capital contribution.
d. **Suggest** one reason for the variance in:
- Wages
- Interest on loan.

e. **Explain** how a Cash Flow Statement Variance Report can be used to assist decision-making.

Exercise 17.9
Cash Flow Statement Variance Report

page 334

Huntingdale Plumbing Supplies has provided the following partially complete report:

HUNTINGDALE PLUMBING SUPPLIES
Cash Flow Statement Variance Report for March 2030

	Budget	Actual	Variance	F/U
CASH FLOWS FROM OPERATING ACTIVITIES				
Cash sales		13 000		
GST received	1 200	1 300		F
Total Operating Cash Inflows				
Cash purchase of inventory	(6 300)	(6 300)		
Advertising	(350)	(270)		
Wages		(2 100)	100	U
GST paid	(860)		43	F
Total Operating Cash Outflows				
Net Cash Flows from Operating Activities				
CASH FLOWS FROM INVESTING ACTIVITIES				
Office equipment		(1 600)	350	F
Net Cash Flows from Investing activities				
CASH FLOWS FROM FINANCING ACTIVITIES				
Loan – Credit Co-op.	4 000	6 000	2 000	
Drawings	(850)			
Net Cash Flows from Financing activities			1 500	F
Net increase (decrease) in cash				
Add Bank Balance at start (1 March 2030)	(5 600)	(5 600)		
Bank Balance at end (31 March 2030)				

Required

a. **Complete** the Cash Flow Statement Variance Report for Huntingdale Plumbing Supplies for March 2030.
b. **Explain** whether the Loan variance is favourable or unfavourable.
c. Apart from Bank, **identify** two items in the Balance Sheet of Huntingdale Plumbing Supplies as at 31 March 2030 that will differ as a consequence of the variances in the Cash Flow Statement Variance Report. **Justify** your answer.
d. **Explain** how a Cash Flow Statement Variance Report can be used to assist planning.

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Exercise 17.10
Income Statement Variance Report

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Easy Motors has provided the following partially complete report:

EASY MOTORS
Income Statement Variance Report for December 2030

	Budget	Actual	Variance	F/U
Sales	42 000	48 000		
Less Sales returns	2 000	2 500		
Net Sales	**40 000**	**45 500**		
Less Cost of Goods Sold				
Cost of Sales	28 000	32 000		
Gross Profit	**12 000**	**13 500**		
Less Inventory loss	600	1 200		
Adjusted Gross Profit	**11 400**	**12 300**		
Add Other revenue				
Discount revenue	350	400		
	11 750	**12 700**		
Less Other expenses				
Advertising	1 200	2 700		
Depreciation of Shelving	300	300		
Discount expense	250	370		
Interest	–	100		
Rent expense	970	970		
Wages	3 400	3 900		
Total Other expenses	**6 120**	**8 340**		
Net Profit	**5 630**	**4 360**		

Required

a. **Complete** the Income Statement Variance Report for Easy Motors for December 2030.

b. Referring to the information provided, **suggest** one reason for the variance in Sales. **Justify** your answer.

c. **Explain** one reason why the owner should not be overly concerned about the variance in Cost of Sales.

d. **Explain** why there is no variance in:
- Rent expense
- Depreciation of Shelving.

e. **Discuss** whether the decisions the owner made in December 2030 were helpful in earning profit.

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Exercise 17.11
Income Statement Variance Report

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Hutchesson Sports has provided the following partially complete report:

HUTCHESSON SPORTS
Income Statement Variance Report for April 2030

	Budget	Actual	Variance	F/U
Sales	59 000		4 000	U
Less Sales returns		1 250		
Net Sales	**58 000**			
Less Cost of Goods Sold				
Cost of Sales	39 000	32 000		
Gross Profit				
Less Inventory loss		800	200	U
Adjusted Gross Profit				
Less Other expenses				
Advertising	2 300		300	U
Depreciation of Fittings	2 500	2 100		
Interest		450		
Office expenses		3 750	70	U
Rent expense	16 000		2 000	F
Wages	14 000			
Total Other expenses	**39 080**	**35 900**		
Net Profit				

At the start of April 2030, the business started purchasing inventory from a cheaper supplier.

Required

a. **Complete** the Income Statement Variance Report for Hutchesson Sports for April 2030.
b. **Identify** one item that has varied favourably and one item that has varied unfavourably as a result of the change in supplier.
c. **Suggest** one action the business may have taken to cause the variance in Interest expense.
d. **Suggest** one reason for the variance in Depreciation of Fittings. **Justify** your answer.
e. **Discuss** whether the decision to change suppliers was worthwhile in terms of earning profit.
f. **Suggest** two strategies Hutchesson Sports could implement in order to increase its Net Profit.

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Chapter 18
Evaluating performance

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Learning intentions

After completing this chapter, you should be able to:

- **define** profitability, liquidity, efficiency and stability
- **distinguish** between profit and profitability
- **calculate** and **interpret** various financial indicators
- **identify** and **explain** the relationships between financial indicators
- **analyse** and **evaluate** business performance using trends, variances, benchmarks, financial indicators and non-financial information
- **suggest** and **discuss** strategies to improve business performance.

Key terms

After completing this chapter, you should be familiar with the following terms:

- benchmark
- financial indicator
- gearing
- expense control
- vertical analysis
- Quick Asset Ratio (QAR)
- trend.

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18.1 Analysis and interpretation

The whole point of gathering, recording and reporting Accounting information is so that we can assist the owner of the business in making financial decisions. Those responsible for the Accounting records must ensure that the information reported provides a Faithful representation of the events that it represents. This ensures that the information is *Relevant* and is therefore capable of influencing decision-making. Another important factor is *Timeliness* to make sure that the information is available to decision-makers in time so that decisions can influence the business performance. The last is *Understandability* so that it is comprehendible by users.

So, once we have the reports – the Cash Flow Statement, Income Statement and Balance Sheet – we need to analyse and interpret what they show so that we can provide advice to the owner on the strengths and weaknesses of the business, and strategies and techniques the owner can use to improve its performance.

analysing
examining the financial reports in detail to identify changes or differences in performance

interpreting
examining the relationships between the items in the financial reports in order to explain the cause and effect of changes or differences in performance

efficiency
the ability of the business to manage its assets and liabilities

In Accounting terms, **analysing** involves examining the reports in great detail to identify *changes or differences in performance*; **interpreting** involves examining the relationships between the items in the reports in order to explain the cause and effect of those changes or differences. Once *the causes and effects* of changes or differences in performance are understood, a course of action can be recommended to the owner to assist decision-making.

Any analysis of business performance must include an assessment of:

- *profitability* – the ability of the business to earn profit, measured by comparing its profit against a base like sales, assets or owner's equity
- *liquidity* – the ability of the business to meet its short-term debts as they fall due
- ***efficiency*** – the ability of the business to manage its assets and liabilities
- *stability* – the ability of the business to meet its debts and continue its operations in the long term.

Business survival depends on having both satisfactory profitability *and* satisfactory liquidity: obviously earning a profit is the point of being in business in the first place, but a profitable business will still fail if it cannot pay its debts.

(In addition to evaluating profitability and liquidity, it is smart business practice to assess the firm's efficiency – its ability to manage its assets and liabilities. This would include an assessment of Inventory Turnover, Accounts Receivable Turnover and Accounts Payable Turnover, covered in Chapters 12 and 15.)

Tools for assessing performance

There are various tools available to assess performance, including:

- trends
- variances
- benchmarks
- financial indicators.

Trends

trend
the pattern formed by changes in an item over a number of periods

Where changes over a number of periods form a pattern, this is known as a **trend**. Trends can be very useful for identifying areas of business performance that are improving or declining. The trend in sales and Net Profit can be used as a starting point to analyse profitability, with an upward trend indicating improving performance. The same technique could be applied to liquidity via the trend in the bank balance. Obviously, the reasons behind the trend would then need to be investigated, but it is by identifying the trend that the need for an investigation is revealed.

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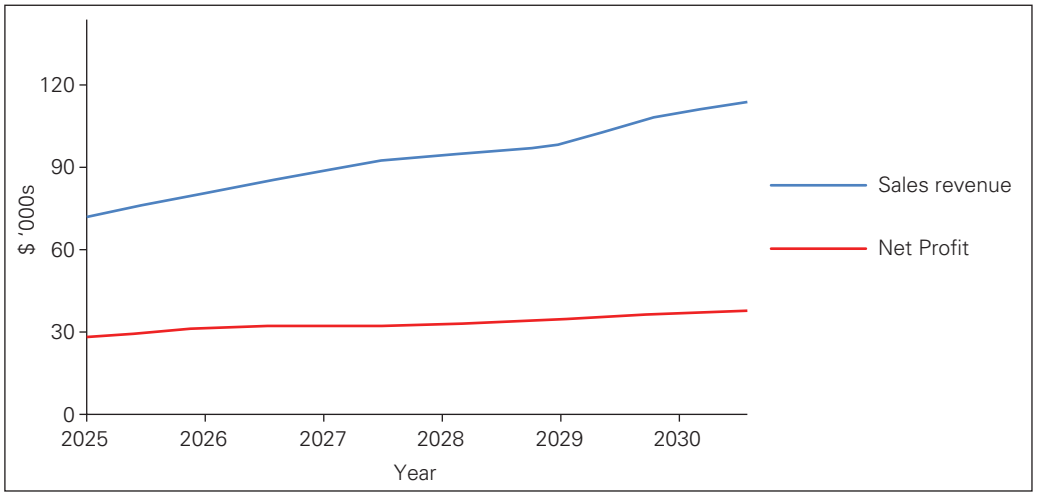
In order to improve the *Understandability* of the information, trends may be presented as line or bar graphs. This makes them easier to understand for users who have little or no Accounting knowledge. Figure 18.1 shows a line graph showing Sales revenue and Net Profit for 2025 to 2030:

Figure 18.1 Line graph: Sales revenue and Net Profit



The trend in both Sales revenue and Net Profit is upwards, and this may indicate improved profitability. However, the divergence in the trends – with Sales revenue increasing much faster than Net Profit – might indicate that expense control has deteriorated. This would need to be investigated in more detail using other analysis tools, but this is the trend that has sparked the need for that investigation.

Variances

Trends highlight changes from one period to the next, but they do not allow the owner to assess whether the business has met its targets or goals for that period. A variance is identified by comparing the actual figures against the **budgeted** or expected figures to identify areas in which performance has been below – or hopefully above – expectations. Particularly by identifying unfavourable variances, the owner can identify where corrective or remedial action is needed.

Benchmarks

What trends and variances have in common is that they compare actual performance with a **benchmark** of some sort, which is an acceptable standard of performance (sometimes known as a yardstick). By comparing current performance against performance in a **previous period**, trends can be identified, and the owner can assess whether performance has *improved* or *worsened*. Alternatively, comparing current performance against the **budgeted figures** allows the owner to identify variances and assess whether the firm's performance was *satisfactory* or *unsatisfactory* in terms of meeting its goals/expectations.

benchmark
an acceptable standard against which the firm's actual performance can be assessed

Benchmarks such as these use *internal* information and compare the performance of one business with its own previous or expected results. However, it is also desirable to use *external* benchmarks to compare the firm's performance against that of other, **similar firms**. This type of inter-firm comparison is sometimes measured by an *industry average*, and it allows the firm's performance to be compared against its competitors in the same industry. This supports the Qualitative characteristic of *Comparability*.

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Financial indicators

financial indicator
a measure that expresses business performance in terms of the relationship between two different elements of that performance

In addition to the tools outlined previously, the owner may ask the accountant to calculate any number of financial indicators. Sometimes known as ratios (even though most are actually presented as percentages), **financial indicators** express business performance in terms of the relationship between two elements of that performance. As a result, differences between years and also between businesses can be assessed, as the indicator expresses performance according to a common base.

Profitability indicators express an element of profit in relation to some other aspect of business performance, and include:

- Return on Owner's Investment (ROI)
- Return on Assets (ROA)
- Asset Turnover (ATO)
- Net Profit Margin (NPM)
- Gross Profit Margin (GPM).

Also important to an assessment of profitability is the Debt Ratio. Although it assesses long-term stability, it has a direct and significant effect on profitability as measured by the Return on Owner's Investment.

A similar approach can be used to assess liquidity, by measuring the funds available to meet short-term debts and comparing this against the level of debts that must be met. Liquidity indicators include:

- Working Capital Ratio (WCR)
- Quick Asset Ratio (QAR)
- Cash Flow Cover.

The efficiency indicators discussed in earlier chapters – Inventory Turnover, Accounts Receivable Turnover and Accounts Payable Turnover – also affect liquidity (and in the case of Inventory Turnover, profitability) by determining the speed at which cash is generated.

Review questions 18.1

1 **State** four Qualitative characteristics that provide guidelines for information to assist decision-making.
2 **Explain** the difference between analysing and interpreting financial information.
3 **Define** the following terms:
   - profitability
   - liquidity
   - efficiency
   - stability.
4 **Explain** how the following measures can be used in an assessment of performance:
   - trends
   - variances.
5 **List** three benchmarks that can be used to assess business performance. **State** the Qualitative characteristic that this supports.
6 **Explain** how financial indicators can be used to assess business performance.
7 **List** the indicators that can be used to assess profitability.
8 **List** the indicators that can be used to assess liquidity.
9 **Explain** how turnover indicators affect liquidity.

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18.2 Assessing profitability

Profitability: the ability of the business to earn profit, measured by comparing its profit against a base like sales, assets or owner's equity.

In simple terms, a firm's ability to earn profit is dependent on its ability to:

- earn revenue
- control its expenses.

Consequently, any assessment of profitability must examine the firm's performance in these two areas, with an analysis of the Income Statement a logical starting point.

However, an assessment of profitability must not concentrate on profit (in dollar terms) alone. The size of the business (in terms of the assets it controls), the size of the investment by the owner and the level of sales are all significant in determining how much profit a business is able to earn. For example, a larger firm is likely to generate a much larger profit (in dollar terms) than a smaller rival. Comparing these firms on the basis of profit alone will not tell us which one is more *able* to use its assets to earn profit, it will simply tell us that one firm had *more assets to use*. However, if the profit was expressed *per dollar of assets*, a comparison of the ability of each firm to earn profit if they had the same asset base would be possible, showing which was more profitable.

Thus, profitability is more than assessing the firm's profit; it is about assessing the firm's *capacity or ability* to earn profit, assuming all these other factors were equal. Expressing profit *relative to another measure* therefore allows for comparisons between different firms and different periods.

Review questions 18.2

1 **State** the two basic factors on which the ability to earn a profit is dependent.
2 **Explain** why an evaluation of business performance assesses profitability rather than just profit.

18.3 Return on Owner's Investment

One of the idiosyncrasies of a sole-trader business is that the owner is also the manager. As a result, the owner will be interested in the firm's profitability as its *owner* and as its *manager*, and this may require different information.

From an investor's point of view, the main measure of profitability is the Return on Owner's Investment (ROI), which assesses how effectively the business has used the owner's funds to earn profit, which is useful in helping the owner to assess how profitable the firm is as an investment and to decide between alternative investments. The formula for Return on Owner's Investment is shown in Figure 18.2:

Figure 18.2 Formula: Return on Owner's Investment

$$\text{Return on Owner's Investment (ROI)} = \frac{\text{Net Profit}}{\text{Average Capital}} \times 100$$

Specifically, Return on Owner's Investment measures Net Profit earned (return) per dollar of capital invested by the owner. Given that the Net Profit figure is earned *over*

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a period, but Capital is measured at a *point in time*, 'Average Capital' is used in the calculation of Return on Owner's Investment to account for any increases or decreases in capital over the year. This Average Capital is calculated as:

Figure 18.3 Formula: Average Capital

$$\textbf{Average Capital} = \frac{\textbf{Capital at start + Capital at end}}{\textbf{2}}$$

Example

The owner of Basia's Paints has provided the following information:

Net Profit	$33 600
Capital – 1 July 2029	$234 000
Capital – 30 June 2030	$246 000

The owner is disappointed with the firm's profit as she was expecting to earn $47 000 for the year.

The Return on Owner's Investment would be calculated as is shown in Figure 18.4:

Figure 18.4 Calculation: Return on Owner's Investment

$$\textbf{ROI} = \frac{\$33\,600}{(\$234\,000 + \$246\,000)/2} \times 100$$
$$= \frac{\$33\,600}{\$240\,000} \times 100$$
$$= 14\%$$

A Return on Owner's Investment of 14% means that for every dollar of capital she has invested, the owner has earned 14c profit. This might not seem like much – and this seems to be the owner's view – but before we decide on its adequacy, we must compare it against some sort of benchmark.

Assessing Return on Owner's Investment

As with most profitability indicators, there is no set level at which the Return on Owner's Investment would be considered to be satisfactory. Rather, it should be compared against one or more of the following benchmarks:

- the Return on Owner's Investment from **previous periods**
- the **budgeted** Return on Owner's Investment
- the Return on Owner's Investment of **similar businesses**/alternative investments.

This last benchmark is particularly important, because Return on Owner's Investment assesses profitability from an *investor's* point of view, and we must not lose sight of the fact that owners take risks by investing their own money in the business.

In addition, by investing in the business, the owner has given up the opportunity to invest elsewhere, and therefore forgone the return that might be earned by investing in property, shares, financial products or other valuables (such as art, wine, antiques or even sporting memorabilia – see Chapter 3). For this reason, the Return on Owner's Investment might be compared against:

- the interest rate on a term deposit
- the rent earned from property

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- the dividends earned on shares
- the Return on Owner's Investment earned by similar businesses.

Some owners may demand a Return on Owner's Investment that is *above* these alternative investments to account for the risk they took by investing and the long hours they work. Conversely, the satisfaction that comes from running your own business may mean the owner is willing to accept a slightly *lower* return as a trade-off.

Return on Owner's Investment and the Debt Ratio

Obviously, the Net Profit the business earns is a significant determinant of the Return on Owner's Investment, but so is the level of investment made by the owner, and this will depend on how the business is financed. Thus, the firm's Debt Ratio – which measures its **gearing** – will affect its Return on Owner's Investment. The formula for Debt Ratio is shown in Figure 18.5:

gearing
the extent to which the business relies on borrowed funds to finance the purchase of its assets

Figure 18.5 Formula: Debt Ratio

$$\text{Debt Ratio} = \frac{\text{Total Liabilities}}{\text{Total Assets}} \times 100$$

This indicator measures the percentage of the firm's total assets that have been financed using borrowed funds (liabilities). We saw in Chapter 4 that a business that relies heavily on borrowed funds will have a high Debt Ratio (high gearing), which is generally considered to be a danger sign for long-term stability. However, a high Debt Ratio can actually have a positive effect on profitability, because the owner still receives all the profit, but the business is using someone else's funds to buy the assets to earn that profit.

Example

	Hilda's Hardware	Steve's Supplies
Net Profit	$25 000	$25 000
Total Liabilities	$75 000	$1 20 000
Owner's equity	$1 25 000	$80 000
Total Assets	$2 00 000	$2 00 000
Debt Ratio	37.5%	60%
Return on Owner's Investment	20%	31.25%

In this example, both firms are the same size (with total assets of $200 000) and have earned the same Net Profit of $25 000. However, the way they have financed their assets is different: with a Debt Ratio of 60%, Steve's Supplies has used more borrowed funds to purchase its assets. As a consequence, the owner has had to contribute $45 000 *less* capital than the owner of Hilda's Hardware, resulting in a higher Return on Owner's Investment (31.25%, compared with 20%).

(Even though a higher Debt Ratio means a higher Return on Owner's Investment, it also means a higher risk that the business will be unable to repay its debts and meet the interest payments. Therefore, the owner must judge carefully so that the Debt Ratio is high enough to maximise the Return on Owner's Investment without sending the business into difficulties in relation to its debt burden.)

Study tip

The Debt Ratio does not *measure* profitability, but it has a significant *effect* on profitability.

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Review questions 18.3

1 **State** what is measured by Return on Owner's Investment.
2 **Show** the formula to calculate Return on Owner's Investment.
3 **List** three benchmarks that could be used to assess the adequacy of the Return on Owner's Investment.
4 **Explain** the significance of the return on similar investments as a benchmark for assessing the Return on Owner's Investment.
5 **State** what is measured by the Debt Ratio.
6 **Explain** how the Debt Ratio can affect the Return on Owner's Investment.

18.4 Return on Assets

Whereas Return on Owner's Investment assesses profitability from an investor's point of view, Return on Assets (ROA) assesses profitability from a manager's point of view: it assesses how effectively the firm has used its assets to earn profit. The formula for Return on Assets is shown in Figure 18.6:

Figure 18.6 Formula: Return on Assets

$$\textbf{Return on Assets (ROA)} = \frac{\textbf{Net Profit}}{\textbf{Average Total Assets}} \times \textbf{100}$$

Return on Assets measures Net Profit earned per dollar of assets controlled by the business. Just as the formula for Return on Owner's Investment used Average Capital, Return on Assets uses Average Total Assets to acknowledge that the level of assets used to earn profit may change over time.

Example

Jan's Jewellery has provided the following information for 2030:

Net Profit	$21 600
Total Assets – 1 January 2030	$175 000
Total Assets – 31 December 2030	$185 000

The Return on Assets would be calculated as is shown in Figure 18.7:

Figure 18.7 Calculation: Return on Assets

$$\textbf{ROA} = \frac{\$21\,600}{(\$175\,000 + \$185\,000)/2} \times 100$$
$$= \frac{\$21\,600}{\$180\,000} \times 100$$
$$= 12\%$$

A Return on Assets of 12% means that for every dollar of assets under the control of Jan's Jewellery, it has earned 12c profit.

Study tip

If Total Assets has not changed significantly, or an average cannot be calculated, Total Assets at the end of the period may be used.

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Assessing Return on Assets

Because it expresses profit relative to assets, the Return on Assets can be used to compare the profitability of:

- businesses of different sizes
- one business over time.

Compare the profitability of businesses of different sizes

If we were to compare two businesses of different sizes – one with more assets under its control than the other – we would not be surprised if the larger business had a larger profit. However, this does not mean that larger businesses are always more profitable; they could in fact be less profitable than a smaller, more effectively run business. By calculating the Return on Assets, businesses of different sizes can be compared to ascertain which has used its assets more effectively to earn profit.

Compare the profitability of one business over time

If a business increased its asset base, it would expect both its revenue and profit to increase, making an assessment of the reasons for the change in its profitability difficult to identify. That is, was the business more profitable, or just bigger? By calculating the Return on Assets, the effect of changes in assets can be isolated from changes in its profitability.

Return on Owner's Investment and Return on Assets

When comparing these two profitability indicators, the owner will probably realise that the Return on Owner's Investment will always be higher than the Return on Assets, because owner's equity will always be lower than total assets. This of course is due to the firm's liabilities. The greater the liabilities (and therefore the greater the Debt Ratio), the greater will be the gap between the Return on Owner's Investment and Return on Assets.

As many small business owners are both investors and managers, they will need to look at both the Return on Owner's Investment and the Return on Assets when assessing profitability. The Return on Owner's Investment will tell the owner whether it is worth continuing the investment in the business, and the Return on Assets will tell the owner how effectively the business has been managed. Sometimes these indicators will provide conflicting advice – such as a well-managed business that is nonetheless an unprofitable investment – and in these cases the owner must decide between their demands as an investor and as a manager/operator.

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Net Profit and Return on Assets

Assuming assets do not change, a change in the Return on Assets will be solely the result of a change in profit, which may itself be the result of a change in the firm's ability to earn revenue or control its expenses (or both). As a result, the Return on Assets will depend heavily on the firm's ability to earn revenue and control its expenses. Thus, the Return on Assets is dependent on two other profitability indicators:

- Asset Turnover (which measures revenue-earning ability)
- Net Profit Margin (which measures expense control).

Review questions 18.4

1. **State** what is measured by Return on Assets.
2. **Show** the formula to calculate Return on Assets.
3. **List** three benchmarks that could be used to assess the adequacy of the Return on Assets.
4. **Explain** why a firm's Return on Owner's Investment will always be higher than its Return on Assets.
5. **Explain** how Return on Assets is affected by the Asset Turnover and Net Profit Margin.

18.5 Earning revenue: Asset Turnover

Asset Turnover (ATO) is actually an efficiency indicator: it assesses how efficiently the firm has used it assets to generate revenue. However, earning revenue is crucial to earning profit: no revenue means no profit! Therefore, assessing a firm's Asset Turnover is integral to assessing its profitability. The formula for Asset Turnover is shown in Figure 18.8:

Figure 18.8 Formula: Asset Turnover

$$\textbf{Asset Turnover (ATO)} = \frac{\textbf{Net Sales}}{\textbf{Average Total Assets}}$$

Note: Net Sales = Sales – Sales returns

This is expressed as 'times per period'.

Specifically, this indicator measures the number of times in a period the value of the firm's assets is earned as Sales revenue: the higher the Asset Turnover, the more capable the firm is of using its assets to earn revenue.

Example

Drake and Cain clothing shop has provided the following information for 2030:

Net Sales	$243 000
Average Total Assets	$90 000

The Asset Turnover would be calculated as is shown in Figure 18.9:

Figure 18.9 Calculation: Asset Turnover

$$\textbf{ATO} = \frac{\$243\,000}{\$90\,000}$$

$$= 2.7 \text{ times}$$

An Asset Turnover of 2.7 times means that during the period (in this case a year), Sales revenue was 2.7 times the size of assets. Therefore the ATO was 2.7 times per year.

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Assessing Asset Turnover

Just like Return on Assets, Asset Turnover expresses an element of profitability (in this case, Net Sales) relative to assets over a period of time, so it can be used to assess revenue-earning ability *independent of the level of assets* involved. This means it can be used not only to assess different businesses, but also the same business over time. An increase in revenue should flow from an increase in the assets that are used to earn that revenue. But, by measuring Asset Turnover, the owner can identify if there were any improvements or deteriorations in how productively those assets were used.

(In cases where an expansion is planned – and average assets are expected to increase – *budgeted* Asset Turnover may be the best benchmark to use for assessment, as it reflects the firm's goal for increased Sales revenue on a greater asset base.)

Asset Turnover and Return on Assets

Both the Return on Assets and Asset Turnover assess the firm's ability to use its assets, the only difference being that the Return on Assets relates to profit, whereas Asset Turnover relates only to revenue. Theoretically, a higher Asset Turnover (meaning more Sales revenue per dollar of assets) should mean an increase in the Return on Assets (and more Net Profit per dollar of assets). However, revenue does not always translate into profit: expense control is also required.

Study tip

Make sure when you are doing comparisons that each measure was calculated over the same period of time.

Review questions 18.5

1 **State** what is measured by Asset Turnover.
2 **Show** the formula to calculate Asset Turnover.
3 **List** three benchmarks that could be used to assess the adequacy of a firm's Asset Turnover.
4 **Explain** the relationship between Asset Turnover and Return on Assets.

18.6 Controlling expenses: Net Profit Margin

As we noted earlier in this chapter, earning profit is – at its most basic – fairly simple: all the business has to do is earn enough revenue and control its expenses. Unfortunately, earning revenue and controlling expenses are far from simple tasks, and they require careful and constant attention. We have already noted how Asset Turnover measures how productively a business has used its assets to earn revenue, so let's now turn our attention to an assessment of expense control.

Expense control refers to the firm's ability to manage its expenses so that they either decrease or increase no more than Sales revenue. Although a reduction in expenses is desirable, we must also recognise that some expenses (like Cost of Sales and Wages) must increase as Sales revenue increases. For these items, *control* rather than *reduction* is the goal. Further, some expenses (like Advertising) may in fact have to increase in order to generate greater sales. As long as expenses like these do not increase more than sales, we can consider this to be evidence of satisfactory expense control. Should they actually fall or increase by less than sales, we would consider this to be evidence of improved expense control.

expense control
the firm's ability to manage its expenses so that they either decrease, or in the case of variable expenses, increase no faster than Sales revenue

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Net Profit Margin

Although expenses are a necessary part of doing business, every dollar of Sales revenue that is consumed by expenses means one dollar less as profit for the owner. This means that effective expense control is a fundamental characteristic of a profitable small business, and it should be part of any assessment of profitability.

If we measure the percentage of Sales revenue that is retained as Net Profit, we will be able to assess the effectiveness of the firm's expense control, and this is done using the Net Profit Margin (NPM). The formula for Net Profit Margin is shown in Figure 18.10:

Figure 18.10 Formula: Net Profit Margin

$$\textbf{Net Profit Margin (NPM)} = \frac{\textbf{Net Profit}}{\textbf{Net Sales}} \times 100$$

This indicator measures how much of every dollar of Net Sales revenue is retained as Net Profit (and thus – by extension – how much was consumed by expenses).

Example

Kris Toyland has provided the following information for 2030:

Sales revenue	$155 000
Sales returns	$5 000
Net Profit	$24 000

The Net Profit Margin would be calculated as is shown in Figure 18.11:

Figure 18.11 Calculation: Net Profit Margin

$$\textbf{NPM} = \frac{\$24\,000}{\$150\,000} \times 100$$

$$= 16\%$$

A Net Profit Margin of 16% means that for every dollar of Net Sales revenue the business earned, it retained 16c as Net Profit. Another way of looking at the Net Profit Margin is from an expense perspective – expenses consumed 84c ($1 less 16c profit) of every dollar of Sales revenue.

Assessing Net Profit Margin

Because this indicator expresses Net Profit *per dollar of sales*, it can be used to identify changes in profit independent of changes in the total value of Net Sales revenue. This means it can be compared against the figures from **previous periods, similar businesses** or in the **budgets**. Any changes will indicate a change in expense control, rather than just a change in expenses or revenue in dollar terms.

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Net Profit Margin, Asset Turnover and Return on Assets

We now have two specific indicators that measure the two factors that determine whether a firm will generate a satisfactory Return on Assets:

- Asset Turnover to assess revenue-earning capability
- Net Profit Margin to assess expense control.

Therefore, the Return on Assets will be a function of the Asset Turnover and the Net Profit Margin: if these indicators change, then so too will the Return on Assets.

Review questions 18.6

1 **Define** the term 'expense control'.
2 **State** two reasons why some expenses must increase in the pursuit of profit.
3 **State** what is measured by the Net Profit Margin.
4 **Show** the formula to calculate the Net Profit Margin.
5 **Explain** the relationship between Asset Turnover, Net Profit Margin and Return on Assets.

18.7 Gross Profit Margin

The Net Profit Margin can be used to assess control of expenses *overall*, but for a trading business there is one expense where control is particularly important: Cost of Goods Sold. The Gross Profit Margin (GPM) assesses how effectively the business has managed its Cost of Goods Sold by measuring the percentage of each dollar of Sales revenue that is retained as Gross Profit. And given that Gross Profit is used to assess the adequacy of the firm's mark-up (the difference between the selling price and cost price of its inventory), the Gross Profit Margin can be used to assess the average mark-up on all goods sold during a particular period. The formula for Gross Profit Margin is shown in Figure 18.12:

Figure 18.12 Formula: Gross Profit Margin

$$\text{Gross Profit Margin (GPM)} = \frac{\text{Gross Profit}}{\text{Net Sales}} \times 100$$

Example

Geelong Car Sound has provided the following information for 2030:

Sales revenue	$220 000
Sales returns	$10 000
Cost of Goods Sold	$126 000
Gross Profit	$84 000
Other expenses	$52 500
Net Profit	$31 500
Net Profit Margin	15%

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The Gross Profit Margin would be calculated as is shown in Figure 18.13:

Figure 18.13 Calculation: Gross Profit Margin

$$\text{GPM} = \frac{\$84\,000}{\$210\,000} \times 100$$

$$= 40\%$$

A Gross Profit Margin of 40% means that for every dollar of Net Sales revenue earned, 40c was retained as Gross Profit (and 60c was consumed by Cost of Goods Sold).

Assessing Gross Profit Margin

The size of the Gross Profit Margin indicates the size of the average mark-up – the gap between selling and cost prices. Should this gap increase, the business will make more Gross Profit *per sale*, but this is not always easy and does not always translate into greater profit overall.

For instance, a *higher selling price* will increase the average mark-up, but it carries the risk of lowering demand and thus reducing the volume of sales. In a competitive market, customers can be sensitive to price increases and could simply go elsewhere if prices increase (or increase too much). This could mean that while the business may make a higher Gross Profit *per item* (and a higher Gross Profit Margin), it may make fewer actual sales, and if sales volume drops too far, Gross Profit *in dollar terms* will actually fall.

On the other hand, finding a supplier with a *lower cost price* might mean no discernible change for customers – unless the quality of the new products is inferior! Poor quality inventory could mean a loss of customers and a decrease in sales volume, as well higher returns and inventory losses (through damage).

This does not mean the business should not look for a cheaper supplier: all businesses should be alert to cheaper and better ways of doing business. But it does mean the business must be vigilant about the quality of its inventory and mindful of the demands of its customers. The challenge is to find a price that customers are willing to pay for inventory that will still generate revenue to meet the firm's expenses.

In the face of competition from large businesses (which have the financial strength to absorb a lower average mark-up), small businesses are frequently better off competing on quality and service rather than price.

Review questions 18.7

1 **State** what is measured by the Gross Profit Margin.
2 **Show** the formula to calculate the Gross Profit Margin.
3 **Explain** two ways a business could increase its average mark-up.
4 **Explain** how an increase in mark-up could actually lead to a decrease in Gross Profit.

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18.8 Vertical analysis of the Income Statement

The Net Profit Margin and Gross Profit Margin allow us to evaluate expense control because they reveal what percentage of each dollar of revenue is retained as Net Profit and Gross Profit, respectively. A similar approach can be applied to every item in the Income Statement in order to determine the percentage of Sales revenue consumed by each expense. This technique of calculating every figure in a report in terms of a base figure (in this case Sales) is known as a **vertical analysis**.

vertical analysis
a report that expresses every item as a percentage of a base figure (in this case, Sales revenue)

The vertical analysis for Geelong Car Sound for 2030 is shown in Figure 18.14:

Figure 18.14 Income Statement: Vertical analysis

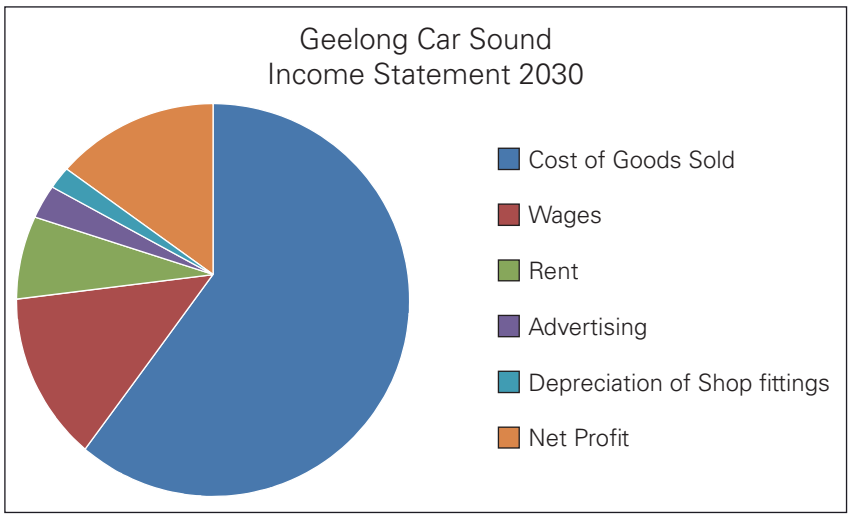
GEELONG CAR SOUND Income Statement for 2030		
2030	**$**	**%**
Sales	210000	100
Less: Cost of Goods Sold	126000	60
Gross Profit	**84000**	40
Less Other expenses		
Wages	27300	13
Rent	14700	7
Advertising	6300	3
Depreciation of Shop fittings	4200	2
Net Profit	**31500**	15

The figures show that *for every dollar of Sales revenue* that is earned:

- Cost of Goods Sold consumes 60c, leaving 40c as Gross Profit (meaning a Gross Profit Margin of 40%).
- Of the 40c retained as Gross Profit, 13c is consumed by Wages, 7c by Rent, 3c by Advertising and 2c by Depreciation of Shop fittings, leaving 15c as Net Profit (meaning a Net Profit Margin of 15%).

Given that not all business owners are accountants, presenting a vertical analysis in a pie chart is one way of ensuring *Understandability* in the Accounting reports. Figure 18.15 shows the pie chart for 2030:

Figure 18.15 Vertical analysis: pie chart



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In order to improve *profit*, the owner should aim to increase the size of the pie – the amount of revenue that is earned. But in order to improve *profitability*, owners should aim to increase the size of the slice that is retained as Net Profit. If they can do both, then both profit and profitability will increase.

Assessing the vertical analysis

The great benefit of preparing a vertical analysis is that we can see changes not just in expense amounts, but also in expenses as a percentage of sales. That is, it shows what each revenue and expense would be *if sales had been constant*, thus allowing us to assess the effectiveness of expense control.

Review questions 18.8

1 **Explain** what is shown in a vertical analysis of the Income Statement.
2 **Explain** one benefit of preparing a vertical analysis as a pie chart.

18.9 Assessing liquidity

As we have seen many times, it is possible that a profitable business may still fail because it cannot pay its debts on time. Therefore, an assessment of business performance must consider the firm's liquidity – its ability to meet its short-term debts as they fall due.

The importance of the Budgeted Cash Flow Statement

In terms of assessing whether a business will be able to meet its debts in the coming year, there is no substitute for the Budgeted Cash Flow Statement. This report predicts cash inflows and cash outflows for the coming year, allowing the owner to assess exactly whether the business will have enough liquid funds to meet its debts. (See Chapter 17 for a reminder.)

If the Budgeted Cash Flow Statement predicts a cash deficit – or perhaps worse, an overdraft – the business is likely to have difficulties meeting its short-term debts as they fall due. However, at least the owner will be prepared well in advance, and may then take corrective action. Such actions might be to:

- defer the purchase of non-current assets or use a loan for their purchase
- defer loan repayments
- reduce cash drawings
- make a cash capital contribution
- organise (or extend) an overdraft facility.

A predicted cash surplus should mean few liquidity problems; however, too much cash on hand can be a problem of an entirely different nature. Should the Budgeted Cash Flow Statement predict a cash surplus, which creates a large bank balance, the owner may choose to:

- purchase more/newer non-current assets
- increase loan repayments
- increase cash drawings
- expand trading activities by increasing advertising, employing more staff etc.

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Other tools for assessing liquidity

Aside from the Budgeted Cash Flow Statement, the same types of tools that were used to assess profitability can be applied to an assessment of liquidity:

- trends (particularly in relation to the level of liquid funds on hand)
- variances
- benchmarks
- liquidity indicators.

Review questions 18.9

1 **Define** the term 'liquidity'.
2 **Explain** the role of the Budgeted Cash Flow Statement in evaluating liquidity.
3 **Suggest** four strategies the owner may implement to address a predicted cash deficit.
4 **Suggest** two strategies the owner may implement to use a predicted cash surplus.

18.10 Working Capital Ratio

In addition to the Budgeted Cash Flow Statement, there are three key indicators that can be used to assess liquidity, the first of these being the Working Capital Ratio (WCR). This indicator assesses the firm's ability to meet its short-term debts as they fall due by measuring how many dollars of current assets are available to meet each dollar of current liabilities. The formula for Working Capital Ratio is shown in Figure 18.16:

Figure 18.16 Formula: Working Capital Ratio

$$\text{Working Capital Ratio (WCR)} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

Example

HOLDEN PLASTICS
Balance Sheet (extract) as at 30 June 2030

Current Assets	$	Current Liabilities	$
Bank	4 000	Accounts Payable	31 000
Accounts Receivable	11 000	Loan – GV Bank	18 000
Inventory	45 000	GST payable	1 000
Total Current Assets	**60 000**	**Total Current Liabilities**	**50 000**

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The Working Capital Ratio would be calculated as is shown in Figure 18.17:

Figure 18.17 Calculation: Working Capital Ratio

$$\text{WCR} = \frac{\$60\,000}{\$50\,000}$$

$$= 1.2{:}1$$

A Working Capital Ratio of **1.2:1** means that the business has $1.20 of current assets for every dollar of current liabilities.

Assessing the Working Capital Ratio

The assumption underlying the Working Capital Ratio is that if all current liabilities were due for repayment at once, the current assets could be liquidated, and the funds used to meet the debts. Therefore, if current assets are greater than current liabilities – resulting in a Working Capital Ratio of *1:1 or better* – the general rule of thumb is that the business should have few difficulties in meeting its short-term debts as they fall due, meaning it has a *satisfactory* level of liquidity.

At the same time, a Working Capital Ratio that is *too high* may indicate that the business has current assets that are idle:

- excess cash in the *bank account* is likely to earn relatively little interest
- excess *inventory* can create problems in terms of storage costs, inventory loss and obsolescence
- an excessive *Accounts Receivable* balance may mean that Accounts Receivable are not paying (on time or at all), and that debts are less likely to be collected.

Depending on which particular current asset is deemed to be *too high*, the owner may choose to:

- employ cash to repay debt
- expand the business (via non-current asset purchases, advertising or hiring staff)
- increase drawings
- allow inventory levels to run down before reordering
- contact Accounts Receivable to collect amounts outstanding.

By contrast, a Working Capital Ratio of *less than 1:1* usually indicates unsatisfactory liquidity: the business has insufficient current assets to cover its current liabilities and may not be able to meet its short-term debts as they fall due. In such difficulties, the owner may be required to:

- make a (cash) capital contribution
- seek additional finance by entering into (or extending) an overdraft facility
- take out a loan for the purchase of non-current assets.

Review questions 18.10

1 **State** what is measured by the Working Capital Ratio.
2 **Show** the formula to calculate the Working Capital Ratio.
3 **Explain** why the Working Capital Ratio should be at least 1:1.
4 **Explain** one problem associated with an excessively high Working Capital Ratio.
5 **State** two actions the owner may be required to take if Working Capital Ratio is:
   - too low
   - too high.

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18.11 Quick Asset Ratio

The Working Capital Ratio assumes that, if necessary, all current assets can be liquidated immediately to generate cash. However, this may not be the most realistic assessment of the amount of cash available to meet short-term debts.

For a start, a business cannot just assume that it will be able to liquidate all its *inventory* just because the firm is facing liquidity problems! And there is virtually no chance of this happening immediately. Further, current assets such as *prepaid expenses* (an amount paid in advance) may not be able to be liquidated at all, especially if the business has entered into a written contract with the supplier.

As a consequence, it may be appropriate to assess liquidity using the **Quick Asset Ratio (QAR)** as it excludes these items, thus indicating the firm's ability to meet its immediate debts using its immediate assets. The formula for Quick Asset Ratio is shown in Figure 18.18:

Quick Asset Ratio (QAR)
a liquidity indicator that assesses the firm's ability to meet its immediate debts by measuring the ratio of quick assets to quick liabilities

Figure 18.18 Formula: Quick Asset Ratio

$$\text{Quick Asset Ratio (QAR)} = \frac{\text{Current Assets (excluding inventory and prepaid expenses)}}{\text{Current Liabilities}}$$

Example

PRIORITY PARTS
Balance Sheet (extract) as at 30 September 2030

Current Assets	$	Current Liabilities	$
Accounts Receivable	10 000	Bank overdraft	5 000
Inventory	29 000	Accounts Payable	25 000
Prepaid Rent expense	4 000		
GST receivable	2 000		
Total Current Assets	**45 000**	**Total Current Liabilities**	**30 000**

Figure 18.19 shows a comparison of the Working Capital Ratio and Quick Asset Ratio:

Figure 18.19 Working Capital Ratio versus Quick Asset Ratio

Working Capital Ratio	Quick Asset Ratio
$\text{WCR} = \frac{\$45\,000}{\$30\,000}$	$\text{QAR} = \frac{\$12\,000}{\$30\,000}$
$= 1.5 : 1$	$= 0.40 : 1$

A Quick Asset Ratio of 0.40:1 means the business has only 40c of quick assets for every $1 of quick liabilities.

Assessing the Quick Asset Ratio

Although the Quick Asset Ratio is a slightly different measure of liquidity, the benchmarks for assessing its adequacy remain the same as those used to assess the Working Capital Ratio. That is, the Quick Asset Ratio should be *at least 1:1*.

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In this example, the Quick Asset Ratio states that the business has only 40c of quick assets available to pay each $1 of quick liabilities, indicating that the business does not have sufficient immediate liquidity: it may have difficulty meeting its immediate debts and may suffer liquidity problems.

Working Capital Ratio and Quick Asset Ratio

Both the Working Capital Ratio and the Quick Asset Ratio assess the level of liquidity, and the benchmark for both is 1:1. So what does it mean if the two indicators provide conflicting information?

In Figure 18.19, the Working Capital Ratio indicates that liquidity is satisfactory as the business has $1.50 of current assets for every $1 of current liabilities. However, the Quick Asset Ratio indicates that liquidity is *not* satisfactory as the business has only 40c of quick assets for every $1 of quick liabilities. How can the two indicators provide a seemingly contradictory assessment?

The answer lies in the different ways the ratios are calculated, and in particular, the fact that the Quick Asset Ratio does not include *inventory*. In the previous example, it is only due to the heavy investment in inventory that the Working Capital Ratio is satisfactory: the Quick Asset Ratio indicates that without the cash from its sales, the business will have liquidity problems. Together, the indicators suggest that if the business can sell its inventory, it will be able to meet its debts as they fall due; if not, liquidity problems may result.

Review questions 18.11

1 **State** what is measured by the Quick Asset Ratio.
2 **Show** the formula to calculate the Quick Asset Ratio.
3 **Explain** why the following items are excluded from the calculation of the QuickAsset Ratio:
   - inventory
   - prepaid expenses.
4 **Explain** what is indicated if the Working Capital Ratio is satisfactory, but the Quick Asset Ratio is unsatisfactory.

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18.12 Cash Flow Cover

We have already looked at two indicators of liquidity, Working Capital and Quick Asset Ratio; however, these are static ratios based on balances and do not consider cash flows. Another useful indicator of liquidity that uses cash flows is the Cash Flow Cover. The formula for Cash Flow Cover is shown in Figure 18.20:

Figure 18.20 Formula: Cash Flow Cover

$$\text{Cash Flow Cover} = \frac{\text{Net Cash Flow from Operating Activities}}{\text{Average Current Liabilities}}$$

Example

HOLDEN PLASTICS
Balance Sheet (extract) as at 30 June 2030

Current Assets	$	Current Liabilities	$
Bank	4 000	Accounts Payable	31 000
Accounts Receivable	11 000	Loan – GV Bank	18 000
Inventory	45 000	GST payable	1 000
Total Current Assets	**60 000**	**Total Current Liabilities**	**50 000**

Additional Information: Current Liabilities as at 1 July 2029 were $40 000 and the Net Cash Flow from Operating Activities for the year ended 30 June 2030 was $67 500. The Cash Flow Cover would be calculated as is shown in Figure 18.21:

Figure 18.21 Calculation: Cash Flow Cover

$$\text{Cash Flow Cover} = \frac{\text{Net Cash Flow from Operating Activities}}{\text{Average Current Liabilities}}$$

$$= \frac{\$67\,500}{(\$40\,000 + \$50\,000)/2)}$$

$$= \frac{\$67\,500}{\$45\,000}$$

$$= 1.5 \text{ times}$$

A Cash Flow Cover of **1.5 times** means that the business can pay (cover) every dollar of current liabilities one and a half times over the period covered, which in this case is a year. Therefore the Cash Flow Cover is 1.5 times per year. This indicates that the business is financially healthy and can meet its short-term financial obligations through the cash generated by its normal operating activities.

Assessing the Cash Flow Cover

The more times a business's Net Operating Cash Flow can cover its current liabilities, the better off a business will be in terms of its liquidity and meeting its short-term financial obligations. With a high Cash Flow Cover due to a high Net Operating Cash Flow, the business can use excess cash to:

- expand its current operations
- reduce its debt by paying down loans

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- invest to increase cash revenue streams and have a backup to provide support in case of economic downturns.

However, a Cash Flow Cover of less than 1 time per period would indicate unsatisfactory liquidity: the business has insufficient cash flow from its everyday activities to cover its current liabilities, and therefore may not be able to meet its short-term debts as they fall due. If this is the case, the owner may be required to seek to increase forms of cash receipts and seek to decrease cash payments to attempt to improve the Net Cash Flow from Operating activities or look to reduce current debt by perhaps refinancing short-term debt with long-term finance.

Review questions 18.12

1 **State** what is measured by the Cash Flow Cover.
2 **Show** the formula to calculate the Cash Flow Cover.
3 **Explain** why the Cash Flow Cover should be greater than 1 time per period.
4 **Explain** two courses of action if the Cash Flow Cover is high.
5 **State** two actions the owner may be required to take if the Cash Flow Cover is too low.

18.13 The speed of liquidity

As previously outlined, the central weakness of using static ratios is that they identify *how much* current assets and current liabilities are but not *when* they will involve a cash flow. That is, they give no indication about the *timing* of cash inflows and cash outflows that is crucial to an assessment of whether debts will be paid on time.

Study tip

The static nature of the Working Capital Ratio and Quick Asset Ratio is one of the reasons why the Budgeted Cash Flow Statement is crucial to an assessment of liquidity.

In fact, businesses can survive in spite of an unsatisfactory level of liquidity if the speed of their trading cycle is fast enough. That is, if a business can sell its inventory and collect the cash from its customers before that cash is needed, it will be able to survive even with a very low Working Capital Ratio.

Businesses such as this may never have a high level of cash on hand, but they can survive because their turnover is so fast. Therefore, our assessment of liquidity must also consider the speed of the firm's:

- Inventory Turnover
- Accounts Receivable Turnover
- Accounts Payable Turnover.

(These indicators were considered in detail in earlier chapters, but it is important to note here their significance for liquidity.)

Inventory Turnover

Inventory Turnover calculates the average number of days taken to convert inventory into sales. The formula for Inventory Turnover is shown in Figure 18.22:

Figure 18.22 Formula: Inventory Turnover

$$\text{Inventory Turnover} = \frac{\text{Average inventory}}{\text{Cost of Goods Sold}} \times 365$$

Fast Inventory Turnover – as measured by low days – means, on average, inventory is sold quickly. This will enhance the firm's ability to generate cash from the sale of inventory and assist its liquidity. Slow Inventory Turnover (i.e. a high number of days) means the

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firm is less able to generate sales, and therefore less able to generate cash inflows (from Cash Sales and Receipts from Accounts Receivable) in time to meet debts as they fall due.

Accounts Receivable Turnover

Accounts Receivable Turnover is an important factor influencing a firm's liquidity because it measures the average number of days it takes to collect cash from Accounts Receivable. The formula for Accounts Receivable Turnover is shown in Figure 18.23:

Figure 18.23 Formula: Accounts Receivable Turnover

$$\text{Accounts Receivable Turnover} = \frac{\text{Average Accounts Receivable}}{\text{Net Credit Sales (plus GST)}} \times 365$$

Fast Accounts Receivable Turnover means it takes (on average) few days to collect cash from Accounts Receivable. This will mean cash is collected quickly and can then be used to meet debts as they fall due. However, slow Accounts Receivable Turnover will mean cash is unavailable to meet debts, creating problems for liquidity.

Accounts Payable Turnover

In contrast to Inventory Turnover and Accounts Receivable Turnover – which measure the speed of cash inflows – Accounts Payable Turnover measures the speed of cash outflows. Specifically, it measures the average number of days taken to pay Accounts Payable. The formula for Accounts Payable Turnover is shown in Figure 18.24:

Figure 18.24 Formula: Accounts Payable Turnover

$$\text{Accounts Payable Turnover} = \frac{\text{Average Accounts Payable}}{\text{Net Credit Purchases (plus GST)}} \times 365$$

If Accounts Payable Turnover is too slow, then the business will miss out on potential discounts, and if it is well above the credit terms offered by the supplier, it could lose its credit facilities. Conversely, an Accounts Payable Turnover that is too *fast* may mean the business does not have sufficient time to generate cash, and therefore does not have cash available to meet other obligations.

Inventory, Accounts Receivable and Accounts Payable Turnover

A firm's ability to pay its Accounts Payable will rely heavily on its ability to generate cash from its inventory. This means Accounts Payable Turnover is reliant on Inventory Turnover and (if the business deals mainly on credit) Accounts Receivable Turnover. If Inventory Turnover and/or Accounts Receivable Turnover are fast, cash will be available to pay Accounts Payable on time, and liquidity problems may be avoided.

Ideally, a firm will want its cash inflow – from Inventory Turnover and Accounts Receivable Turnover – to be as fast as possible (i.e. the lowest number of days possible), whereas it will want to pay its Accounts Payable as slowly as possible (i.e. the highest number of days possible without exceeding credit terms).

The best circumstance for a trading business is to sell inventory for cash and to buy inventory on credit. This approach provides time for the business to sell its inventory before paying their Accounts Payable, and it should minimise liquidity problems.

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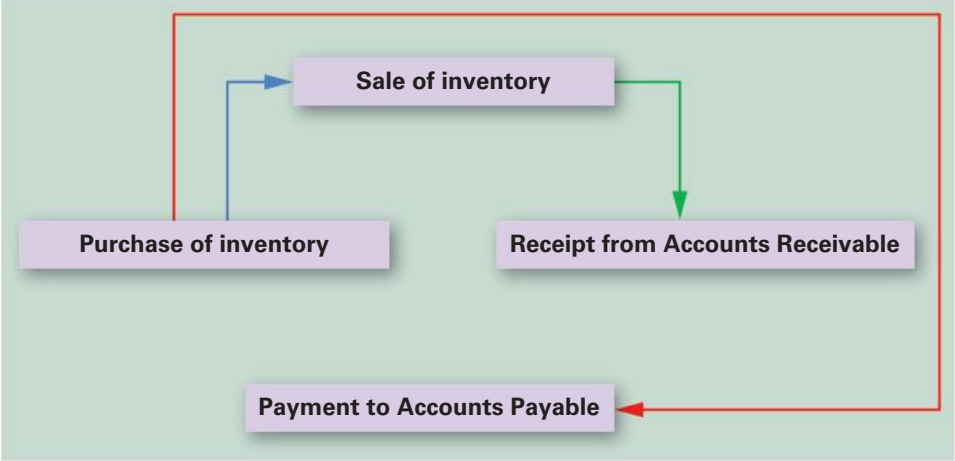
Figure 18.25 represents the relationship between these elements of the cash cycle:

Figure 18.25 Cash cycle



Ideally, the days taken for Inventory Turnover and Accounts Receivable Turnover together should be less than the days taken for Accounts Payable Turnover. This ensures the business has enough time to generate sales and collect cash before it must pay its Accounts Payable.

Review questions 18.13

1. **Explain** how a firm with a high turnover may avoid liquidity problems despite an unsatisfactory Working Capital Ratio.
2. **State** what is measured by Inventory Turnover.
3. **Show** the formula to calculate Inventory Turnover.
4. **State** what is measured by Accounts Receivable Turnover.
5. **Show** the formula to calculate Accounts Receivable Turnover.
6. **State** what is measured by Accounts Payable Turnover.
7. **Show** the formula to calculate Accounts Payable Turnover.
8. **Explain** the importance of Inventory Turnover, Accounts Receivable Turnover and Accounts Payable Turnover for liquidity.
9. **Explain** why it is advantageous for a trading firm to buy on credit but sell on cash.

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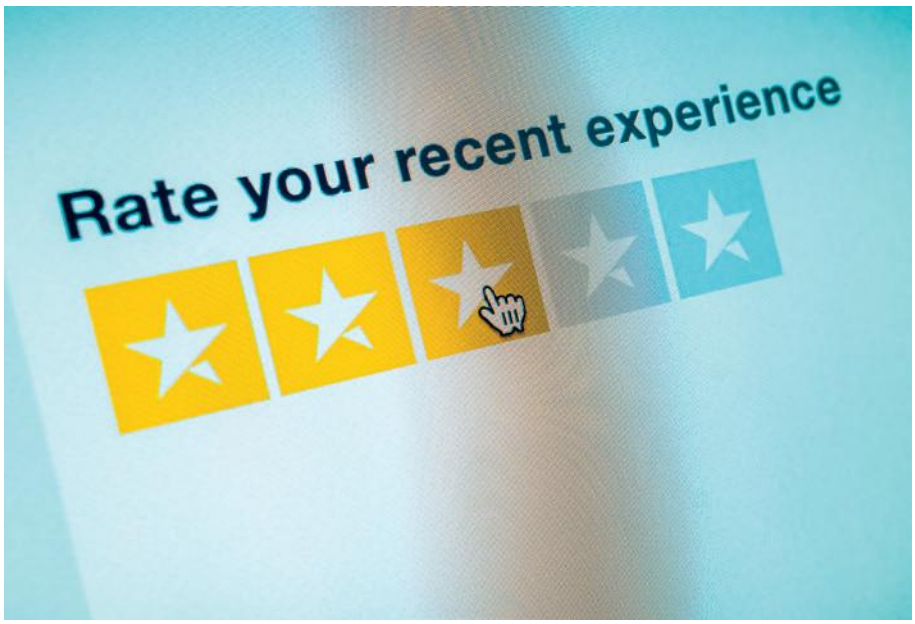
18.14 Non-financial information

Obviously, the indicators detailed in this chapter are useful for assessing profitability and liquidity, but we need to be mindful that there are limits on the ability of this information to assist the owner in making financial decisions:

- the reports use *historical data* – they do not guarantee what will happen in the future
- many indicators rely on *averages*, and this may conceal details about individual items
- reports contain *incomplete information* as many items are not reported in the financial statements
- firms use *different Accounting methods* that can undermine the *Comparability* of the reports (and indicators).

As a consequence, the owner should not rely just on the reports and indicators: non-financial information can be just as important in aiding decision-making.



Non-financial information is a fairly broad term covering basically any information that is not expressed in dollars and cents, or reliant on dollars and cents for its calculation. It refers to information that cannot be found in the financial statements. The types of non-financial information that could be useful to the owner of a small business are impossible to quantify, but in assessing the firm's performance, the owner may want information about:

- **the firm's relationship with its customers**
  This could be assessed by customer satisfaction surveys, the number of repeat sales, the number of sales returns or the number of customer complaints.
- **the suitability of inventory**
  This could be assessed by the number of sales returns, the number of purchase returns or the number of customer complaints.
- **the firm's relationship with its employees**
  This could be assessed by performance appraisals, the number of days lost due to sick leave/industrial action, or the staff turnover/average length of employment.
- **the state of the economy**
  This could be assessed by examining interest rates, the unemployment rate, the level of inflation or the number of competitors in the market.

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Review questions 18.14

1 **State** three limitations of relying solely on the financial statements and financial indicators to evaluate performance.
2 **Define** the term 'non-financial information'.
3 **State** two measures that could be used to assess:
- the firm's relationship with its customers
- the suitability of inventory
- the firm's relationship with its employees
- the state of the economy.

Where have we been?

- Profitability is the ability of the business to earn profit, measured by comparing its profit against a base like sales, assets or owner's equity.
- Liquidity is the ability of the business to meet its short-term debts as they fall due.
- Tools available to assess performance include trends, variances, benchmarks and financial indicators.
- Profitability indicators include Return on Owner's Investment, Return on Assets, Asset Turnover, Net Profit Margin and Gross Profit Margin.
- Liquidity indicators include Working Capital Ratio, Quick Asset Ratio and Cash Flow Cover.
- The Budgeted Cash Flow Statement predicts cash inflows and cash outflows for the coming year, allowing the owner to assess exactly whether the business will have enough liquid funds to meet its debts.
- The speed of liquidity is determined by Inventory Turnover, the Accounts Payable Turnover and the Accounts Receivable Turnover.
- If a business can sell its inventory – and collect the cash from its customers – before that cash is needed, it may still be able to survive even with a very low Working Capital Ratio.
- Assessing performance using reports and indicators is limited by the use of historical data, averages, incomplete information and different Accounting methods.
- Non-financial information refers to information that cannot be found in the financial statements.

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Exercises

Exercise 18.1
Profitability

page 341

Dean Simkin is the owner of two different lighting stores, and last year the Vermont store earned $14 000 more profit than the Burwood store. Dean is thinking of selling the Burwood store because it is much less profitable.

Required

a. **Explain** the difference between profit and profitability.
b. **State** two bases that profit could be compared against in an assessment of profitability.
c. **Suggest** two reasons why Dean should not sell the Burwood store.

Exercise 18.2
Return on Owner's Investment

page 342

Ceyda Sanli is the owner of Sandals and Saris, a beachwear shop in Apollo Bay. Ceyda has provided the following information relating to the firm's performance:

	2029	2030
Owner's equity (31 December)	$90 000	$110 000
Net Profit		$8 100

Before investing in this business, Ceyda had earned 6% p.a. on an investment in shares.

Required

a. **Calculate** the Return on Owner's Investment for Sandals and Saris for 2030.
b. Referring to your answer to part **a**, **explain** whether Ceyda should be satisfied with the firm's Return on Owner's Investment in 2030.
c. **State** one reason why a small business owner may be willing to accept a Return on Owner's Investment that is lower than the return on an alternative investment.
d. **State** two other benchmarks Ceyda could use to assess the adequacy of the Return on Owner's Investment.

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Exercise 18.3
Return on Owner's Investment

page 343

Michael Gowland is the owner of Country House Furniture and has provided the following information relating to its performance over the past two years:

	2029	2030
Average Owner's equity	$390 000	$310 000
Net Profit	$48 750	$46 500

Required

a. **Calculate** the Return on Owner's Investment for Country House Furniture for 2029 and 2030.
b. **Explain** the cause(s) of the change in the Return on Owner's Investment from 2029 to 2030.
c. **Explain** one reason why Michael should be concerned about the firm's profitability in 2030.

Exercise 18.4
Return on Owner's Investment and Return on Assets

page 344

Ferdinand Photography and Cara's Cameras both sell cameras and photographic equipment. The following information relates to their trading performance for 2030:

	Ferdinand Photography	Cara's Cameras
Net Profit	$28 000	$33 600
Average Owner's equity	$120 000	$280 000
Average Total Assets	$400 000	$350 000
Return on Owner's Investment	23.3%	12%

Required

a. **Calculate** the Return on Assets for each firm for 2030.
b. **Explain** one reason why the owner of Ferdinand Photography would be pleased with her firm's profitability in 2030.
c. **Explain** one reason why the owner of Ferdinand Photography would be disappointed with her firm's profitability in 2030.
d. **Explain** why a firm's Return on Owner's Investment will always be greater than its Return on Assets.

Exercise 18.5
Return on Owner's Investment and Return on Assets

page 345

Posh and Punk are clothing boutiques in Armadale. The following information relates to their trading performance for 2030:

	Posh	Punk
Net Profit	$32 400	$32 400
Average Owner's equity	$180 000	$80 000
Average Total Assets	$240 000	$240 000

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Required

a. **Calculate** the Return on Owner's Investment and Return on Assets for each business for 2030.
b. **Identify** which business is the better investment. **Justify** your answer.
c. **Calculate** the Debt Ratio for each business for 2030.
d. **Discuss** the effects of a higher Debt Ratio.

Exercise 18.6
Return on Assets and Asset Turnover

page 347

Zaheer Hussein owns The Game Golfer, which sells golf gear and clothing and has presented the following information relating to its performance for 2029 and 2030:

	2029	2030
Sales revenue	$570 000	$700 000
Sales returns	$10 000	$7 000
Net Profit	$33 600	$34 650
Average Total Assets	$280 000	$330 000
Return on Assets	12%	10.5%

Zaheer argues that higher Net Profit in 2030 is evidence of improved profitability.

Required

a. **Calculate** Asset Turnover for The Game Golfer for 2029 and 2030.
b. **Explain** what is revealed by the change in Asset Turnover from 2029 to 2030.
c. Using the information provided, **explain** whether expense control has improved or worsened in 2030.
d. **Suggest** two strategies the owner could adopt to improve the Return on Assets without changing Asset Turnover.

Exercise 18.7
Asset Turnover and Net Profit Margin

page 348

Lowland Trailbikes has provided the following information relating to its performance for 2030:

	Lowland Trailbikes	Industry average
Return on Owner's Investment	20%	12.5%
Return on Assets	6%	8%
Asset Turnover	0.60 times	0.64 times
Net Profit Margin	10%	12.5%

Required

a. **State** two reasons why the Return on Assets of Lowland Trailbikes is lower than the industry average.
b. **State** two benchmarks other than the industry average that could be used to assess the Return on Assets of Lowland Trailbikes.
c. **Suggest** two strategies Lowland Trailbikes could adopt to improve its Asset Turnover.
d. **Explain** why an improvement in expense control could still see total expenses increase.

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Exercise 18.8
Net Profit Margin

page 349

Christou Clocks has provided the following information about its trading performance for 2029 and 2030:

	2029	2030
Sales	$150 000	$160 000
Sales returns	$10 000	$6 000
Net Profit	$7 000	$9 900
Asset Turnover	1.6 times	1.4 times
Return on Assets	8%	9%

Required

a. Referring to the information above, **identify** one indicator that supports the claim that the firm's ability to earn revenue has worsened.

b. **Explain** one reason for the decrease in the firm's Asset Turnover.

c. **Calculate** the Net Profit Margin for 2029 and 2030.

d. **Identify** two factors that support the claim that expense control improved in 2030. **Justify** your answer.

Exercise 18.9
Gross Profit Margin

page 350

Up There Trophies sells trophies and medals to sporting clubs and has provided the following information for 2030:

Sales revenue	$163 500
Sales returns	$3 500
Gross Profit	$72 000
Net Profit	$88 000
Budgeted Gross Profit Margin	60%

Required

a. **Calculate** the Gross Profit Margin for 2030.

b. **State** two strategies the owner could adopt to improve the Gross Profit Margin without increasing the Asset Turnover.

c. **Explain** how increasing selling prices could lead to an increase in the Gross Profit Margin but a decrease in Gross Profit in dollar terms.

d. **State** two pieces of non-financial information the owner may want to see to assess the quality of his inventory.

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Exercise 18.10
Vertical Analysis of the Income Statement

page 351

Wheelie Hot Wheels sells mag wheels and performance tyres and has provided the following information for the years ended 30 June 2029 and 2030:

WHEELIE HOT WHEELS
Income Statement for 2029 and 2030

	2029	%	2030	%
Sales revenue	$180 000		$150 000	
Less Cost of Goods Sold	77 940		63 150	
Gross Profit	**102 060**		**86 850**	
Less Inventory loss	1 800		1 800	
Adjusted Gross Profit	**100 260**		**85 050**	
Less Other expenses				
Wages	48 420		39 300	
Administration expenses	31 320		26 100	
Advertising	5 580		3 450	
Depreciation of Fittings	4 500		4 500	
Net Profit	**$10 440**		**$11 700**	

Required

a. **Enter** the information into a spreadsheet and **conduct** a vertical analysis.
b. Referring to your spreadsheet, **suggest** two reasons for the decrease in Sales revenue in 2030.
c. **State** whether overall expense control has improved or worsened in 2030. **Justify** your answer.
d. **Suggest** two possible reasons for the increase in the Gross Profit Margin in 2030.
e. **State** one reason why the owner should be concerned that Inventory loss is $1 800 in 2029 and 2030.
f. **Explain** why there has been no change in 'Depreciation of Fittings' in dollar terms but an increase in percentage terms.
g. **State** two pieces of non-financial information the owner could use to assess the firm's relationship with its staff.

Exercise 18.11
Liquidity

page 352

As at 1 July 2029, Harrington Hardware had $6 800 cash in the bank. By 30 June 2030, this had fallen to $1 200, leading the owner to comment that liquidity must have fallen.

Required

a. **Explain** why the owner's comment about the firm's liquidity may be incorrect.
b. **State** two indicators that can be used to assess the level of liquidity.

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Exercise 18.12
Working Capital Ratio

page 353

Belle Formal Wear has provided the following information from its Balance Sheet as at 30 June 2030:

Current assets	$67 500
Current liabilities	$90 000

Required

a. **Calculate** the Working Capital Ratio for Belle Formal Wear as at 30 June 2030.
b. Referring to your answer to part **a**, **state** whether the Working Capital Ratio is satisfactory or unsatisfactory. **Justify** your answer.
c. **Suggest** two actions the owner may need to take to ensure the business is able to meet its short-term debts as they fall due.

Exercise 18.13
Working Capital Ratio

page 354

Yackandandah Antiquities has provided the following information:

	2029	**2030**
Working Capital Ratio	2.3 : 1	4.5 : 1

Required

a. **State** what is measured by the Working Capital Ratio.
b. **Explain** what this trend indicates about the liquidity of Yackandandah Antiquities.
c. **Explain** one reason why the owner might be concerned about the Working Capital Ratio for 2030.
d. **Explain** how the Budgeted Cash Flow Statement could be used to assess liquidity.

Exercise 18.14
Working Capital Ratio, Quick Asset Ratio and Cash Flow Cover

page 355

Stoneham Sunglasses has provided the following extract from its Balance Sheet:

STONEHAM SUNGLASSES
Balance Sheet (extract) as at 31 March 2030

Current Assets	$	Current Liabilities	$
Bank	3 000	Loan	7 200
Inventory	27 000	Accounts Payable	20 400
Accounts Receivable	18 000	GST payable	2 400
Prepaid rent expense	6 000		
Total Current Assets	**54 000**	**Total Current Liabilities**	**30 000**

The Working Capital Ratio of Stoneham Sunglasses as at 28 February 2030 was 2.5:1. Total Current Liabilities as at 1 March 2030 were $50 000. The Net Cash Flow from Operating activities for the month ended 31 March 2030 was $20 000.

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Required

a. **Calculate** the Working Capital Ratio for Stoneham Sunglasses as at 31 March 2030.
b. **Calculate** the Quick Asset Ratio of Stoneham Sunglasses as at 31 March 2030.
c. Referring to your answer to part **b**, **state** whether the Quick Asset Ratio is satisfactory or unsatisfactory. **Justify** your answer.
d. **Explain** why Inventory is excluded from the calculation of the Quick Asset Ratio.
e. **Calculate** the Cash Flow Cover of Stoneham Sunglasses as at 31 March 2030.
f. Referring to your answer to part **e**, **state** whether the Cash Flow Cover is satisfactory or unsatisfactory. **Justify** your answer.
g. **Explain** how the efficiency of this business in managing its current assets will affect its liquidity.
h. **State** two courses of action necessary for Stoneham Sunglasses to improve its liquidity.

Exercise 18.15
Working Capital Ratio, Quick Asset Ratio and Cash Flow Cover

W B page 357

Velocity Skates has provided the following extract from its Balance Sheet:

VELOCITY SKATES
Balance Sheet (extract) as at 30 June 2030

Current Assets	$	Current Liabilities	$
Inventory	13 700	Bank overdraft	5 000
Accounts Receivable	43 000	Accounts Payable	35 000
Prepaid registration	300	Accrued Wages	3 400
GST receivable	1500	Mortgage – nab	21 600
Total Current Assets	**58 500**	**Total Current Liabilities**	**65 000**

The Bank overdraft has a limit of $15 000. Total Current Liabilities as at 1 July 2029 were $55 000. The Net Cash Flow from Operating activities for the year ended 30 June 2030 was $120 000.

Required

a. **Explain** how GST receivable will assist liquidity.
b. **Calculate** the Quick Asset Ratio of Velocity Skates as at 30 June 2030.
c. Referring to your answer to part **b**, **state** whether the Quick Asset Ratio is satisfactory or unsatisfactory. **Justify** your answer.
d. **Calculate** the Cash Flow Cover of Velocity Skates as at 30 June 2030.
e. **State** two reasons why this firm may not have liquidity problems despite what is shown by its Quick Asset Ratio.

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Exercise 18.16
Working Capital Ratio and Quick Asset Ratio

page 358

Atlas Weights has provided the following information:

	2029	2030
Working Capital Ratio	1.8 : 1	5.2 : 1
Quick Asset Ratio	1.3 : 1	0.6 : 1

Required

a. **Explain** how it is possible for the Quick Asset Ratio to be less than 1:1 when the Working Capital Ratio is greater than 1:1.
b. **Explain** one negative consequence if the Working Capital Ratio is too high.
c. **Discuss** whether Atlas Weights will be able to meet its debts.

Exercise 18.17
Inventory Turnover

page 359

Bairnsdale Bricks sells bricks and pavers and has provided the following information for 2030:

Cost of Goods Sold	$1 095 000
Average inventory	$120 000
Budgeted Inventory Turnover	35 days

Required

a. **State** what is measured by Inventory Turnover.
b. **Calculate** Inventory Turnover for Bairnsdale Bricks for 2030.
c. Referring to your answer to part **b**, **explain** why the owner would consider this Inventory Turnover to be unsatisfactory.
d. **Explain** how slow Inventory Turnover can have negative consequences for:
- profitability
- liquidity.

Exercise 18.18
Accounts Receivable Turnover

page 360

Bubble On sells soaps, bath bombs and other toiletries and has provided the following information relating to its activities for 2030:

Cash sales	$10 000
Credit sales	$113 150
Average Accounts Receivable	$12 400
Credit terms offered to customers	30 days
Inventory Turnover	21 days

Required

a. **State** what is measured by Accounts Receivable Turnover.
b. **Calculate** the Accounts Receivable Turnover for Bubble On for 2030.
c. Referring to your answer to part **b**, **state** whether the Accounts Receivable Turnover is satisfactory or unsatisfactory. **Justify** your answer.
d. **Explain** why Bubble On may have liquidity problems in the near future.
e. **State** two other pieces of information that may be useful in an assessment of the liquidity of Bubble On.

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Exercise 18.19
Accounts Payable Turnover

page 361

Dewey Copiers sells photocopiers and fax machines and has provided the following information for the year ended 30 June 2030:

Credit purchases	$228 125
Average Accounts Payable	$30 000
Credit terms offered by suppliers	60 days
Cash sales	$160 000
Budgeted Sales revenue	$90 000

Accounts Payable Turnover was 56 days in the previous reporting period.

Required

a. **State** what is measured by Accounts Payable Turnover.
b. **Calculate** the Accounts Payable Turnover for Dewey Copiers for the year ended 30 June 2030.
c. Referring to your answer to part **b**, **explain** why this Accounts Payable Turnover may present problems for liquidity.
d. **State** two negative consequences of exceeding the credit terms offered by suppliers.

Exercise 18.20
Assessing performance

page 362

Bags of Bags sells luggage and other bags and has provided the following information relating to its activities for 2029 and 2030:

	2029	2030
Return on Owner's Investment	24%	28%
Return on Assets	16%	15%
Asset Turnover	1.33 times	1.5 times
Net Profit Margin	12%	10%
Inventory Turnover	41 days	44 days
Accounts Receivable Turnover	35 days	27 days
Accounts Payable Turnover	63 days	56 days
Credit terms offered to customers		30 days
Credit terms offered by suppliers		60 days
Inventory Turnover – industry average		25 days

Required

a. **Explain** how it is possible that the firm's Return on Owner's Investment increased while its Return on Assets decreased.
b. **Identify** one indicator that suggests the firm's ability to earn revenue improved in 2030.
c. **Identify** two factors that suggest the firm's expense control worsened in 2030.
d. **Explain** why a trading firm should buy its inventory on credit.
e. **Suggest** one reason why the Accounts Payable Turnover has improved in 2030. **Justify** your answer.
f. Referring to one other liquidity indicator, **explain** how this business could avoid liquidity problems without raising further external finance in 2030.

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Unit 3

Financial Accounting for a trading business

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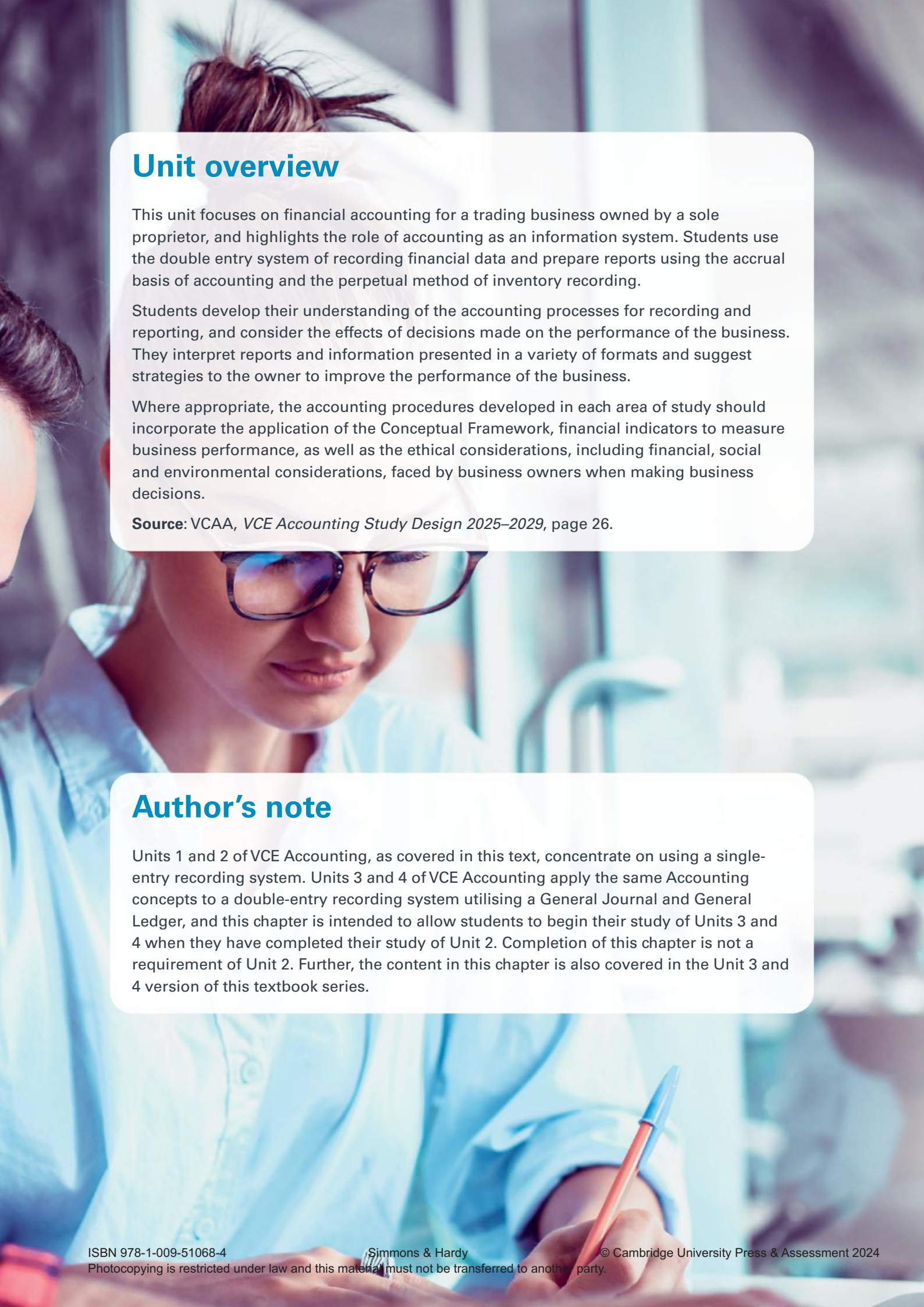

Unit overview

This unit focuses on financial accounting for a trading business owned by a sole proprietor, and highlights the role of accounting as an information system. Students use the double entry system of recording financial data and prepare reports using the accrual basis of accounting and the perpetual method of inventory recording.

Students develop their understanding of the accounting processes for recording and reporting, and consider the effects of decisions made on the performance of the business. They interpret reports and information presented in a variety of formats and suggest strategies to the owner to improve the performance of the business.

Where appropriate, the accounting procedures developed in each area of study should incorporate the application of the Conceptual Framework, financial indicators to measure business performance, as well as the ethical considerations, including financial, social and environmental considerations, faced by business owners when making business decisions.

Source: VCAA, *VCE Accounting Study Design 2025–2029*, page 26.

Author's note

Units 1 and 2 of VCE Accounting, as covered in this text, concentrate on using a single-entry recording system. Units 3 and 4 of VCE Accounting apply the same Accounting concepts to a double-entry recording system utilising a General Journal and General Ledger, and this chapter is intended to allow students to begin their study of Units 3 and 4 when they have completed their study of Unit 2. Completion of this chapter is not a requirement of Unit 2. Further, the content in this chapter is also covered in the Unit 3 and 4 version of this textbook series.

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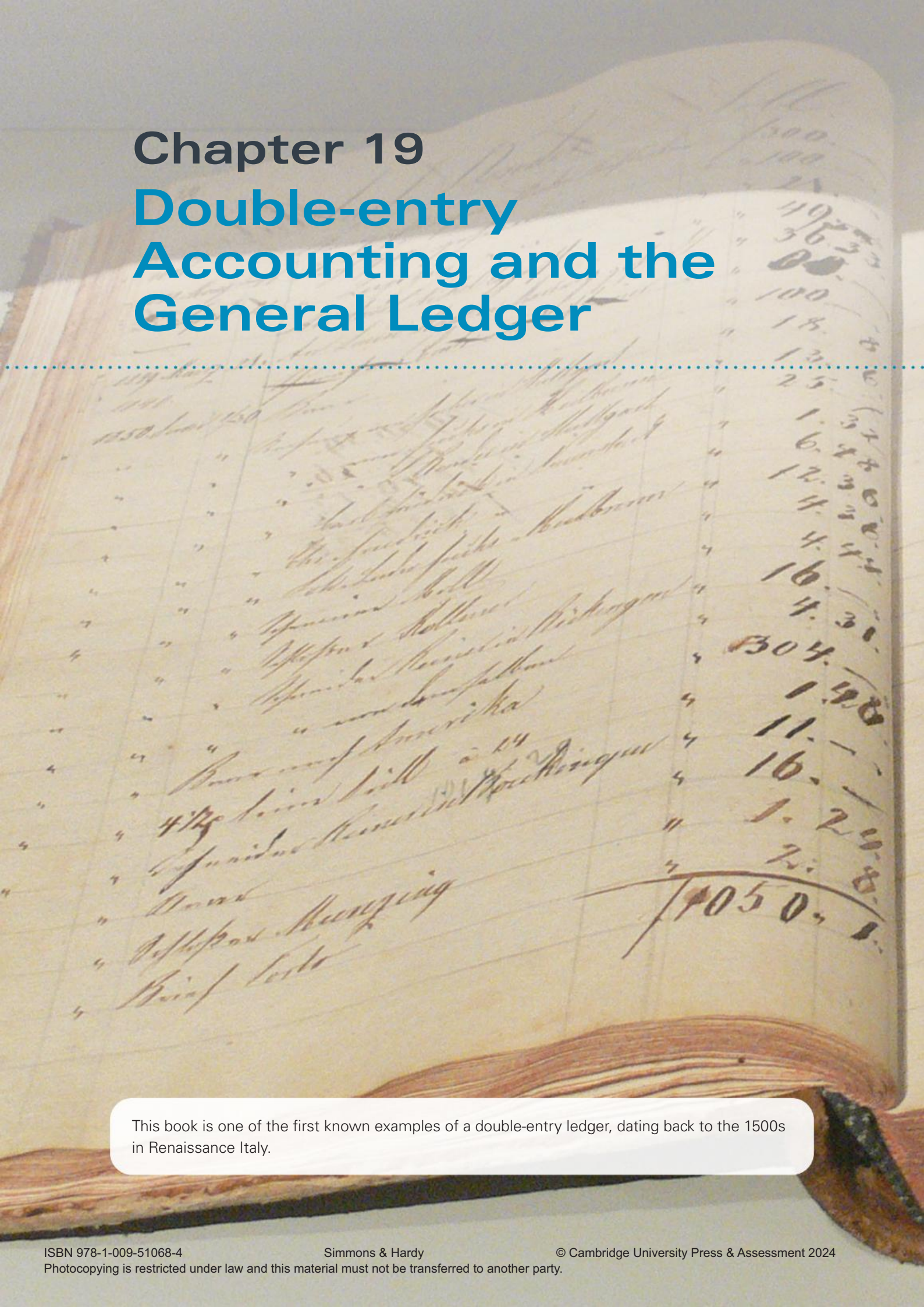
Chapter 19
Double-entry Accounting and the General Ledger



This book is one of the first known examples of a double-entry ledger, dating back to the 1500s in Renaissance Italy.

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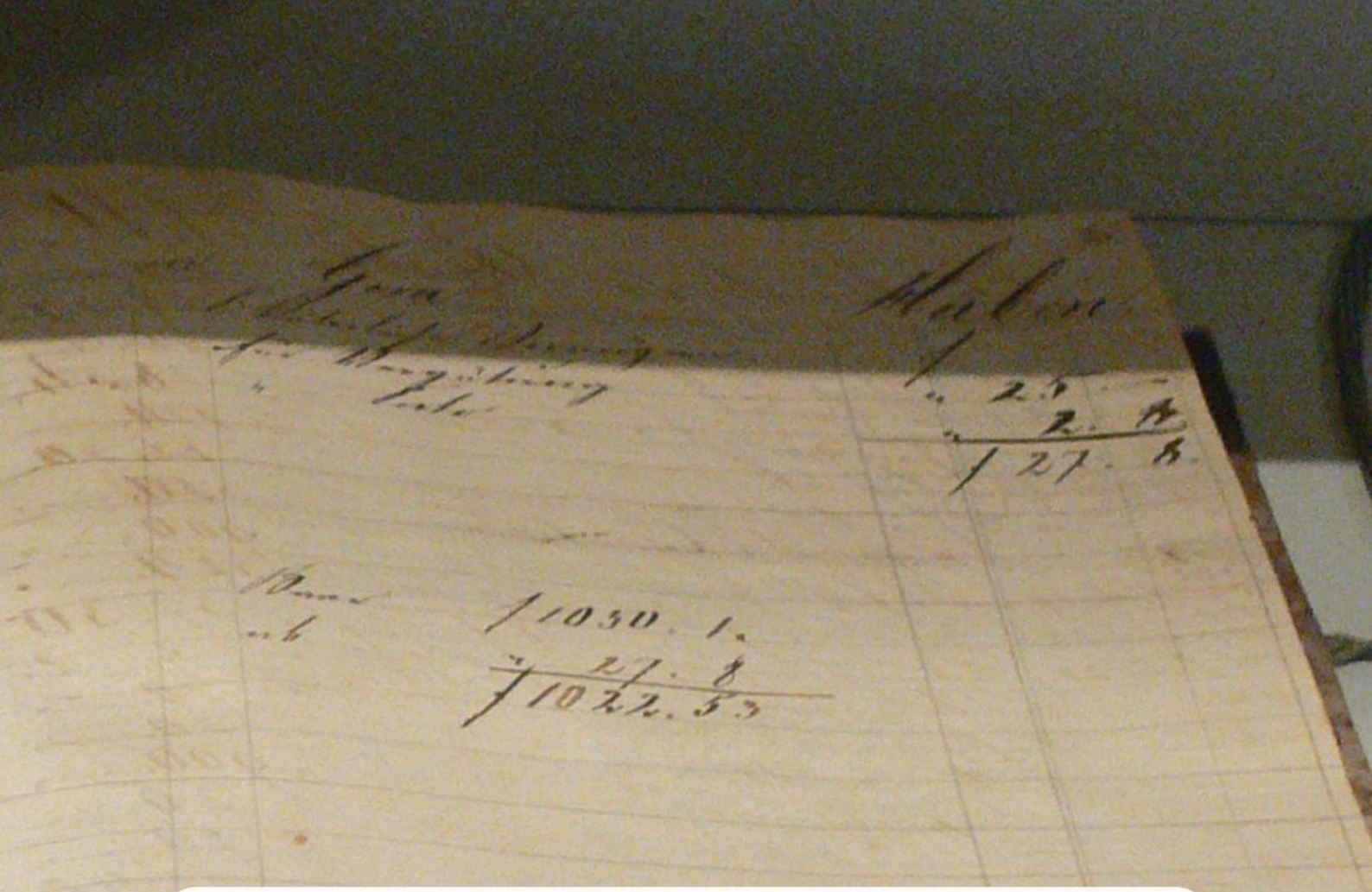

Learning intentions

After completing this chapter, you should be able to:

- **apply** the rules of double-entry Accounting
- **analyse** how transactions affect the Accounting equation and the Balance Sheet
- **explain** the role of the General Ledger
- **apply** the rules of double-entry Accounting to the General Ledger
- **identify** the effect of transactions on the Accounting equation using an Analysing Chart
- **explain** the role of a cross-reference
- **record** transactions in the General Ledger, including:
  - opening balances
  - cash and credit purchases of inventory
  - cash and credit sales of inventory
  - receipts from Accounts Receivable
  - payments to Accounts Payable
  - drawings by the owner
- **foot** ledger accounts
- **prepare** a Trial Balance
- **balance** ledger accounts.

Key terms

After completing this chapter, you should be familiar with the following terms:

- double-entry Accounting
- ledger account
- General Ledger
- debit side
- credit side
- cross-reference
- GST Clearing
- Analysing Chart
- Trial Balance
- footing
- balancing.

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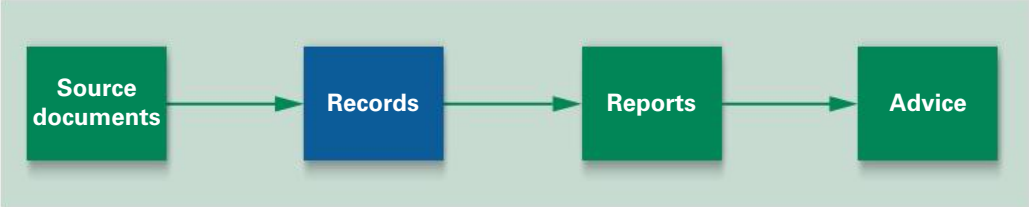
19.1 Double-entry Accounting and the General Ledger



Study tip

Units 1 and 2 use a single-entry Accounting system; Units 3 and 4 use a double-entry Accounting system.

Until now, this text has concentrated on single-entry Accounting – the process of recording transactions in special journals and then using the summarised information to prepare reports. Each transaction led to at least two changes in the Accounting equation – and the net effect of these changes resulted in the Accounting equation (and Balance Sheet) remaining in balance – but these changes were not recorded at the time.

For example, a cash contribution by the owner was recorded in the Cash Receipts Journal, but the balances of Bank and Capital were not updated: they were determined only at the end of the Period.

Double-entry Accounting

double-entry Accounting
a system that records at least two effects on the Accounting equation as a result of each transaction

By contrast, **double-entry Accounting** records at least two effects on the Accounting equation as a result of each transaction, at the time it occurs. This ensures that the Accounting equation is updated constantly.

Rules of double-entry Accounting

Under double-entry Accounting, whenever a business exchanges goods and/or services with another entity, and at least two items change in its Accounting equation (and therefore its Balance Sheet), they are recorded. The system records *both* – or (in the case of more than two effects) *all* – the effects of a transaction. This is true of every transaction that a firm could have. Having said that, after all of the effects of a transaction have been recorded, the Accounting equation – and therefore the Balance Sheet – must still balance.

These two rules form the basis of **double-entry Accounting**:

1 Each transaction is recorded as a change to at least two items in the Accounting equation.
2 After recording a transaction, the Accounting equation must always balance.

Ledger accounts and the General Ledger

Double-entry Accounting rests on the premise that because each transaction affects at least two items in the Accounting equation, the Accounting equation and the Balance Sheet effectively need to be rewritten after every transaction. However, it may by now have occurred to you that rewriting the Accounting equation after every transaction would not be practical for a real, functioning small business. (In addition, the accountant or bookkeeper would probably find it very repetitive and boring!)

This is particularly the case when we consider that although every transaction will change at least two items in the Accounting equation, there may well be a large number of items that do *not* change. For instance, a credit purchase of inventory will increase Inventory (asset), decrease GST payable (liability) and increase Accounts Payable (liability), but will have no effect whatsoever on Bank, Accounts Receivable, Loans or even Capital. There may be many items that do not need to be changed, but they would still need to be rewritten in an updated version of the Accounting equation.

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The challenge then is to develop an Accounting system that is capable of recording changes in the Accounting equation without requiring it to be rewritten every time. The response to this challenge is to record transactions in ledger accounts.

Ledger accounts and the General Ledger

As part of the Accounting process, a **ledger account** is an Accounting record (like a scrollable page) where the effects of transactions are written down, with each ledger account recording all of the transactions that affect a particular item in the financial reports. For instance, the Bank ledger account will record all movements of cash in and out of the firm's bank account; the Inventory ledger account will record all movements of Inventory in and out of the business; each Accounts Payable ledger account will record all increases and decreases in what the firm owes to that supplier.

ledger account
an Accounting record showing all the transactions that affect a particular item

There must be a separate ledger account for each item in the reports; that is, a separate ledger account for Bank, and a separate ledger account for each of Inventory, Accounts Receivable, Accounts Payable, GST, Loans, Capital, etc. If the business has 400 items in its reports, it will need 400 ledger accounts. Collectively, this group of ledger accounts is known as the General Ledger, and when taken together the accounts in the **General Ledger** sort, classify and summarise financial data to transform it into information that can then be used in Accounting reports.

General Ledger
the collective name for the main group of ledger accounts

At the same time, each individual ledger account only records the increases or decreases *in that particular item*. That is, the Bank ledger account will only record changes to Bank, and the Accounts Payable ledger account will only record changes to amounts owed to suppliers.

Each transaction changes at least two items in the Accounting equation, so at least two ledger accounts will need to be changed, but by recording each transaction *only in the ledger accounts of the items that are affected*, changes to the Accounting equation can be recorded without having to rewrite every item in that Accounting equation.

The 'T-form' ledger account

The most basic form of a ledger account is a '*T*-form' account, created by dividing the page into two columns. The left-hand column is labelled the debit column (or **debit side**) and the right-hand column is labelled the credit column (or **credit side**). Figure 19.1 shows the format of a T-form account:

debit side
the left-hand side of a ledger account

credit side
the right-hand side of a ledger account

Figure 19.1 T-form account

Name of item/account	
Debit column/side (**Dr**)	Credit column/side (**Cr**)

The word 'debit' in this context simply means the left side of a ledger account, and 'credit' means the right side of a ledger account; neither one should be thought of as good or bad. One of these columns will be used to record increases in the value of the item; the other will be used to record decreases.

Review questions 19.1

1 **Explain** the term 'double-entry Accounting'.
2 **Explain** the role of a ledger account.
3 In reference to ledger accounts, **define** the following terms:
- General Ledger
- debit side
- credit side.

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19.2 Double-entry recording in ledger accounts

There are set rules for recording transactions in ledger accounts, rules that apply the concepts of double-entry recording and preserve the Accounting equation.

Just as every transaction will affect at least two items in the Accounting equation, every transaction will affect at least two ledger accounts. In order to ensure that the Accounting equation remains in balance, the transaction must be recorded in one of those ledger accounts on the debit side and in the other account on the credit side. The **double-entry rules for recording in ledger accounts** are:

1. Each transaction must be recorded in at least two ledger accounts.
2. Each transaction must be recorded on the debit side of at least one ledger account and on the credit side of at least one other account.

Given that every transaction must be recorded on the debit side of one ledger account and the credit side of another, the most obvious question is: when are transactions recorded on the debit side, and when are they recorded on the credit side? Unfortunately, there is no one answer as it depends on what type of item is in question. Fortunately, just as a T-form account looks like a Balance Sheet, the rules for recording in a ledger account follow a similar pattern.

Assets

Asset items appear on the *left* of the Balance Sheet, so *increases* to assets are recorded on the *left* – the *debit* side – of the asset account. By the law of opposites, *decreases* in assets must be recorded on the *credit* side of the asset account.

Bank (Asset)

Increases are recorded on the **debit side**	Decreases are recorded on the **credit side**

Liabilities and owner's equity

Liabilities and owner's equity items appear on the *right* of the Balance Sheet, so *increases* in liabilities or owner's equity are recorded on the right – the *credit* side – of those ledger accounts. By the law of opposites, *decreases* in liabilities and owner's equity must be recorded on the *debit* side of these accounts.

Accounts Payable (Liability)

Decreases are recorded on the **debit side**	Increases are recorded on the **credit side**

Capital (Owner's equity)

Decreases are recorded on the **debit side**	Increases are recorded on the **credit side**

Recording ledger entries

Let's examine a transaction to see how it would be recorded in the General Ledger accounts.

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Example

On 1 January 2030, Bill Brighton deposited $40 000 of his own funds in a business bank account to commence operations as Bright Books.

What ledger entries are required to record this transaction?

First, the deposit by the owner means that the firm's Bank is increasing. Because Bank is an asset, which will appear on the *left* side of the Balance Sheet, the $40 000 increase must be recorded on the *left* side – the debit side – of the Bank ledger account. This would be described as 'debiting the Bank account'.

Bank (A)

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
Jan. 1		40 000			

At the same time, the fact that the cash has come from the owner means that Capital is increasing. As an owner's equity item, Capital would appear on the *right* side of the Balance Sheet, so the increase must be recorded on the *right* side – the credit side – of the Capital ledger account. This would be described as 'crediting the Capital account'.

Capital (Oe)

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
			Jan. 1		40 000

One transaction has produced an effect on two different accounts, with one entry on the debit side (in the Bank account) and one entry on the credit side (in the Capital account).

The cross-reference

Note how each entry in this example shows both the date of the transaction and its amount. It has probably not escaped your attention that there is a gaping hole in each of the ledger accounts shown – a hole that seems to require an additional piece of information. (If it had initially escaped your attention, it should be obvious now that it has been pointed out!)

This space between the date and the amount of each transaction is used to record what is known as the **cross-reference**. Because each transaction affects two ledger accounts at the same time, these accounts are linked. The cross-reference specifies the link between these accounts by identifying the *other* account affected. In the Bank account, for example, the cross-reference would be 'Capital', while in the Capital account the cross-reference would be 'Bank'.

cross-reference the name of the other account/s affected by a transaction, so that all accounts affected by a particular transaction can be identified

The two accounts – with their cross-references now entered – would show:

Bank (A)

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
Jan. 1	Capital	40 000			

Capital (Oe)

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
			Jan. 1	Bank	40 000

In reading these ledger accounts, it is the side on which the *amount* is placed that determines whether the account has been debited or credited. A common misconception is to confuse the cross-reference with the account. In this example, the $40 000 appears on the left side of the Bank account, so it is this account that has been debited. The cross-reference 'Capital' appears only to show the name of the *other* account affected by that particular transaction.

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Example (continued)

Bright Books had the following transactions in its first week of operations:

Jan. 2 Borrowed $20 000 from Sunbank

Jan. 3 Purchased inventory on credit from KH Books for $12 000 plus GST

Jan. 4 Paid $45 000 plus GST for a van to use for business deliveries

Video 19.1
Recording in ledger accounts

Continuing with the ledger accounts used on the previous page, the transactions would be recorded as follows:

Jan. 2 Borrowed $20 000 from Sunbank

Like a capital contribution, this transaction will increase Bank, which as an asset is found on the left-hand side of the Balance Sheet, so this increase must be recorded on the debit side of the Bank account. And although the source of the cash is a loan (liability) rather than the owner, liabilities are also found on the right-hand side of the Balance Sheet, so this increase must also be recorded on the credit side, but this time to the Loan – Sunbank account.

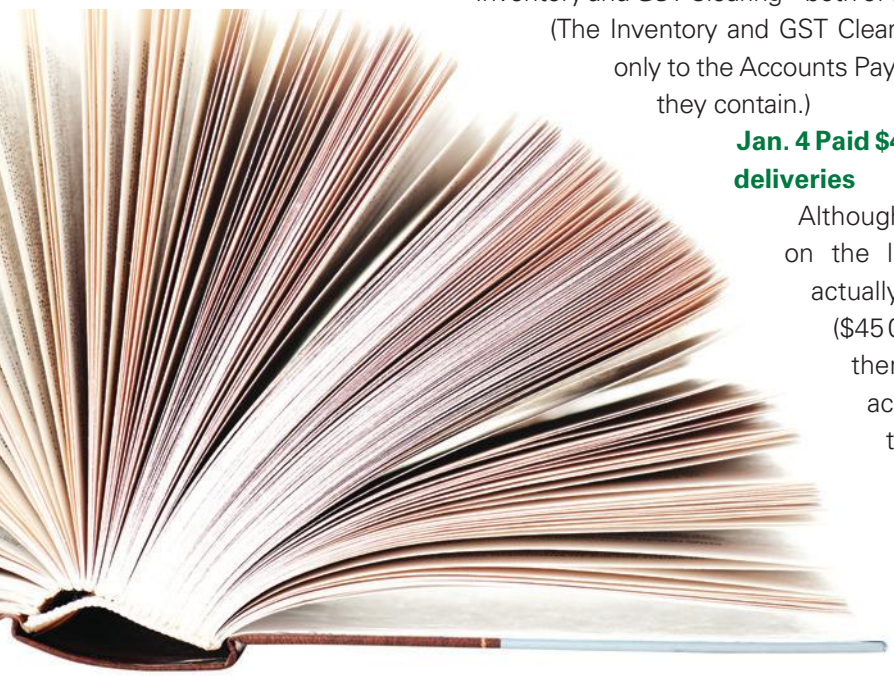
Jan. 3 Purchased inventory on credit from KH Books for $12 000 plus GST

This transaction will increase Inventory (asset – left-hand side of the Balance Sheet) by $12 000, so this increase must be recorded on the debit side of the Inventory account. Because GST is involved, it also results in an increase in GST receivable of $1 200, that is, 10% of $12 000. (Transactions will usually not specify that the rate of GST in Australia is 10%.) This increase in an asset (left-hand side of the Balance Sheet) must also be recorded on the debit side, but because the GST balance can be either an asset or a liability, the General Ledger uses an account called **GST Clearing** to summarise GST transactions.

GST Clearing
a ledger account that records all GST transactions

At the same time, because this is a credit purchase, it will increase the amount owed to Accounts Payable (liability – right-hand side of the Balance Sheet), so the increase must be recorded on the credit side of the Accounts Payable account. Note that the $13 200 credit to Accounts Payable is equal to the two debit entries added together – the $12 000 for the Inventory *plus* the $1 200 for the GST – as both amounts are owed to the Account Payable.

Note also that because the Accounts Payable account is linked to two other accounts – Inventory *and* GST Clearing – both of these accounts are noted in the cross-reference. (The Inventory and GST Clearing accounts are not linked to each other, but only to the Accounts Payable account, so this is the only cross-reference they contain.)



Jan. 4 Paid $45 000 plus GST for a van to use for business deliveries

Although Bank is an asset and would normally appear on the left of the Balance Sheet, this transaction actually involves a *decrease* to Bank of $49 500 ($45 000 for the Van plus GST of $4 500), which is therefore recorded on the credit side of the Bank account. The increase to assets (in the form of the new van, and the extra GST receivable) is recorded as $45 000 on the debit side of the Van account, and $4 500 on the debit side of the GST Clearing account. The cross-reference in the Bank account reflects that the payment is linked to both of these accounts.

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As a result of these transactions, the accounts in the General Ledger would then appear as shown in Figure 19.2:

Figure 19.2 General Ledger accounts

General Ledger – Bright Books
Bank (A)

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
Jan. 1	Capital	40 000	Jan. 4	Van/GST Clearing	49 500
2	Loan – Sunbank	20 000			

Capital (Oe)

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
			Jan. 1	Bank	40 000

Loan – Sunbank (L)

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
			Jan. 2	Bank	20 000

Inventory (A)

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
Jan. 3	Accounts Payable	12 000			

GST Clearing (A or L)

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
Jan. 3	Accounts Payable	1 200			
4	Bank	4 500			

Accounts Payable (L)

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
			Jan. 3	Inventory/GST Clearing	13 200

Van (A)

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
Jan. 4	Bank	45 000			

Note that every transaction has been recorded in at least two accounts, with at least one debit entry in one account and at least one credit entry in another account and, because the debits and credit for each transaction match are equal, the General Ledger has been left in balance after every transaction.

Study tip

Although it is likely that there will be more than one line of inventory, all transactions affecting Inventory will be recorded in the same General Ledger account.

Study tip

It is normal for a new business, which has purchased expensive non-current assets and may not have made many sales, to have an asset balance in its GST Clearing account.

Review questions 19.2

1 **State** the two rules of recording in ledger accounts.
2 **Identify** on which side of a ledger account a transaction would be recorded in order to:
- increase an asset account
- decrease an asset account
- increase a liability or owner's equity account
- decrease a liability or owner's equity account.

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19.3 Recording revenues and expenses

The ledger rules for recording revenues and expenses can be determined by referring to their relationship to owner's equity.

Revenues

Revenues represent an *increase* in owner's equity (it is, in fact, part of the definition), so the rules for recording revenue are the same as those for recording an increase in owner's equity: *increases* are recorded on the *credit side* of the ledger account and, by the law of opposites, decreases are recorded on the *debit* side.

Sales (Revenue)	
Decreases are recorded on the **debit side**	Increases are recorded on the **credit side**

Study tip

Revenues and expenses are recorded on opposite sides of the ledger: revenues on the credit side, expenses on the debit side.

Expenses

Expenses represent a *decrease* in owner's equity (again, as dictated by the definition), so the rules for recording expenses are the same as those for recording a decrease in owner's equity: an *increase* in expenses (which means a decrease to owner's equity) is recorded on the *debit* side of the expense account, with *decreases* in expenses recorded on the *credit* side.

Wages (Expense)	
Increases are recorded on the **debit side**	Decreases are recorded on the **credit side**

Example (continued)

Bright Books had two further transactions in its first week of operations:
Jan. 5 Received $600 interest revenue
Jan. 6 Paid wages $1 200

These revenue and expense transactions would be recorded in the General Ledger as is shown in Figure 19.3:

Figure 19.3 General Ledger: Revenues and Expenses

General Ledger – Bright Books
Bank (A)

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
Jan. 1	Capital	40 000	Jan. 4	Van/GST Clearing	49 500
2	Loan – Sunbank	20 000	6	Wages	1 200
5	Interest revenue	600			

Interest revenue (R)

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
			Jan. 5	Bank	600

Wages (E)

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
Jan. 6	Bank	1 200			

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Figure 19.4 summarises how to record an increase or decrease in each type of ledger account:

Figure 19.4 Summary of ledger entries

Type of account	Debit side	Credit side
Asset	Increase	Decrease
Liability	Decrease	Increase
Owner's equity	Decrease	Increase
Revenue	Decrease	Increase
Expense	Increase	Decrease

Analysing Charts

Until these recording rules become second nature (which they will and, in fact, must), it may be worthwhile to follow the four simple steps outlined below to record transactions in the General Ledger:

1. Identify the items (accounts) affected. (There will be at least two.)
2. Identify what type of accounts they are (A / L / Oe / R / E).
3. Identify whether they are increasing or decreasing.
4. Use the Balance Sheet (or the table in Figure 19.4) to identify whether the account should be debited or credited.

This procedure can be followed by completing what is known as an **Analysing Chart**. The Analysing Chart for the six transactions of Bright Books is shown in Figure 19.5:

Analysing Chart
a tool used to identify the steps for recording transactions in the General Ledger

Figure 19.5 Analysing Chart

Date	Accounts affected	Type of account	Increase/ Decrease	Debit $	Credit $
Jan. 1	Bank	Asset	Increase	40 000	
	Capital	Owner's equity	Increase		40 000
Jan. 2	Bank	Asset	Increase	20 000	
	Loan – Sunbank	Liability	Increase		20 000
Jan. 3	Inventory	Asset	Increase	12 000	
	GST Clearing	Asset	Increase	1 200	
	Accounts Payable	Liability	Increase		13 200
Jan. 4	Van	Asset	Increase	45 000	
	GST Clearing	Asset	Increase	4 500	
	Bank	Asset	Decrease		49 500
Jan. 5	Bank	Asset	Increase	600	
	Interest revenue	Revenue	Increase		600
Jan. 6	Wages	Expense	Increase	1 200	
	Bank	Asset	Decrease		1 200

Study tip

If the GST Clearing account had a credit balance instead, the transactions on January 3 and 4 would still require debit entries, but they would decrease a liability rather than increase an asset.

By convention, the debit entry is shown first, and the second entry is indented slightly to emphasise that it is the credit entry.

The Analysing Chart is *not* an Accounting record; it is simply a tool to use until the ledger entries become automatic (like training wheels when you learn to ride a bike). When you feel that you know the ledger rules (and can balance on your own two wheels), you can stop using the Analysing Chart and record the transactions straight into the ledger accounts.

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Review questions 19.3

1 Referring to their relationship to owner's equity, **explain** why:
- revenue accounts increase on the credit side
- expense accounts increase on the debit side.

2 **Draw** a table to summarise the rules for recording in ledger accounts.

3 **Explain** the role of an Analysing Chart.

19.4 Specific transactions

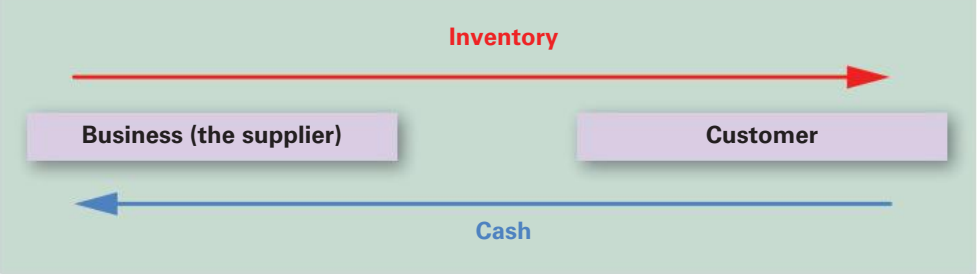
The principles of recording in ledger accounts can be applied to any transaction using the approach just described, but let's consider some specific transactions.

Cash sales (of inventory)

Most of the entries that have been dealt with to date have had only one double-entry effect on the ledger accounts, even if that effect required two debits to match one credit (or vice versa). The sale of inventory – whether for cash or on credit – is more complicated because it requires *two* separate, yet related, double-entries, involving two different prices.

Figure 19.6 represents the flows of cash and goods from a sale of inventory:

Figure 19.6 Sale of inventory



The simple mechanics of a cash sale involves the business (the supplier) receiving cash in exchange for providing goods (inventory) to the customer.

However, the cash received and the inventory sold will be valued differently: the cash will be for the selling price (and will include GST), whereas the inventory sold will be valued at its cost price. (In fact, it is the difference between the selling price and the cost price that creates a Gross Profit from the sale.)

And because there are two prices to record, there are two double-entries to record in the General Ledger.

Example

On 7 July 2030, McCallister Holdings made a cash sale of inventory for $590 plus GST. The inventory had a cost price of $320.

Selling price

A cash sale results in a receipt of cash for both the selling price ($590) and the GST on the sale ($59), so the total cash received (**$649**) is recorded as a debit to the Bank account to recognise the increase in this asset. Sales revenue is then credited by $590 to recognise the revenue earned from the sale, and GST Clearing is credited by $59 to recognise the increase in the liability owed to the ATO.

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Cost price

At the same time, the sale results in a decrease in the Inventory held by the business, and this is recorded by way of a credit entry to this account. However, goods are valued in the Inventory account at their original purchase price, so this reduction in assets will be recorded at the cost price of $320.

The value of the decrease in Inventory as a result of the sale is also recorded as an expense, as it arises as a result of ordinary business activities, and it leads to a decrease in owner's equity. This expense that has been incurred is called **Cost of Sales** and is recorded via a debit of $320 to this (expense) account.

Cost of Sales
the value of inventory that has been sold in a particular period, valued at its cost price

In essence then, a cash sale leads to a decrease in one asset (Inventory) valued at cost price, in return for an increase in another asset (Bank) valued at selling price, with the difference between the Sales revenue and Cost of Sales expense representing the Gross Profit earned from the sale. (The GST received increases the asset – Bank – and increases the liability – GST Clearing – without affecting Gross Profit at all.)

Figure 19.7 shows how this sale would affect the ledger accounts in the Analysing Chart:

Figure 19.7 Analysing Chart: Cash sale

Date	Accounts affected	Type of account	Increase/ Decrease	Debit $	Credit $
July 7	Bank	Asset	Increase	649	
	Sales	Revenue	Increase		590
	GST Clearing	Liability	Increase		59
	Cost of Sales	Expense	Increase	320	
	Inventory	Asset	Decrease		320

The cash sale would be recorded in the General Ledger as shown in Figure 19.8:

Figure 19.8 General Ledger: Cash sale

General Ledger
Bank (A)

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
July 1	Balance	1 000			
7	Sales/GST Clearing	649			

GST Clearing (A or L)

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
			July 1	Balance	1 600
			7	Bank	59

Sales (R)

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
			July 7	Bank	590

Inventory (A)

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
July 1	Balance	4000	July 7	Cost of Sales	320

Cost of Sales (E)

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
July 7	Inventory	320			

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Effect on the Accounting equation

A cash sale thus has the following effect on the Accounting equation:

	Increase/Decrease/No effect	Amount $
Assets	Increase (increase Bank $649, decrease Inventory $320)	329
Liabilities	Increase (GST Clearing $59)	59
Owner's equity	Increase (Sales $590 less Cost of Sales $320 = profit $270)	270

Credit sales

A credit sale involves the same provision of inventory as a cash sale, but it differs in that the cash is received from the customer *at a later date*.

As with a cash sale, a credit sale generates revenue because it creates an increase in assets that leads to an increase in owner's equity. The only difference is that for a cash sale, the increase in assets is in the form of cash (Bank), whereas for a credit sale, the asset is in the form of an amount owed by Accounts Receivable.

Example (continued)

On 12 July 2030, McCallister Holdings made a credit sale of inventory for $720 plus GST. The inventory had a cost price of $480.

Figure 19.9 shows how this credit sale would affect the ledger accounts in the Analysing Chart:

Figure 19.9 Analysing Chart: Credit sale

Date	Accounts affected	Type of account	Increase/ Decrease	Debit $	Credit $
July 12	Accounts Receivable	Asset	Increase	792	
	Sales	Revenue	Increase		720
	GST Clearing	Liability	Increase		72
	Cost of Sales	Expense	Increase	480	
	Inventory	Asset	Decrease		480

Despite no cash being received, credit sales should still be recognised as revenue in the *Period* when the sale is made, because it is at this point that the increase in assets (the amount owed by the Accounts Receivable) occurs and, as a consequence, the revenue is earned. Failing to include credit sales as revenue would breach the *Accrual basis assumption*, and it would omit from the Income Statement an important and *Relevant* piece of information, capable of making a difference to decision-making.

Effect on the Accounting equation

A credit sale thus has the following effect on the Accounting equation:

	Increase/Decrease/No effect	Amount $
Assets	Increase (increase Accounts Receivable $792, decrease Inventory $480)	312
Liabilities	Increase (GST Clearing $72)	72
Owner's equity	Increase (Sales $720 less Cost of Sales $480 = profit $240)	240

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In terms of profit, a credit sale and a cash sale are identical: the only difference is in the nature of the asset (Accounts Receivable instead of Bank) that increases as a result of the sale.

Cash received from Accounts Receivable

Following a credit sale, the business will at some point in the future receive the cash from the Accounts Receivable customer. The most common error in recording this kind of transaction is to treat it as additional revenue, rather than as simply the swapping of one asset (**Accounts Receivable**) for another (**Bank**).

Indeed, the fact that *assets do not increase overall* means that cash received from Accounts Receivable *cannot* be recorded as revenue: it does not fit the definition. In addition, recording this cash as revenue would be double-counting the revenue that was already recorded – as a credit sale – when it was earned; that is, at the point of sale, when the goods were provided to the customer.

Example (continued)

On 24 July 2030 McCallister Holdings received **$500** from an Account Receivable.

Figure 19.10 shows how this receipt from an Accounts Receivable customer would be entered in the ledger accounts:

Figure 19.10 Analysing Chart: Receipt from Accounts Receivable

Date	Accounts affected	Type of account	Increase/ Decrease	Debit $	Credit $
July 24	Bank	Asset	Increase	**500**	
	Accounts Receivable	Asset	Decrease		**500**

Effect on the Accounting equation

A receipt of cash from an Accounts Receivable customer thus has the following effect on the Accounting equation:

	Increase/Decrease/No effect	Amount $
Assets	No effect (increase **Bank**, decrease **Accounts Receivable**)	nil
Liabilities	No effect	nil
Owner's equity	No effect	nil

Overall, there is no change to total assets or, for that matter, liabilities or owner's equity (and therefore there is no revenue earned, so there can be no profit from this transaction). All that changes are the individual assets, with **Bank** increasing and **Accounts Receivable** decreasing by the same amount.

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The credit sale and the receipt of cash from the Accounts Receivable customer would be posted to the General Ledger as shown in Figure 19.11:

Figure 19.11 General Ledger: Credit sale and receipt from Accounts Receivable

General Ledger
Bank (A)

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
July 1	Balance	1 000			
7	Sales/GST Clearing	649			
24	Accounts Receivable	500			

Accounts Receivable (A)

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
July 1	Balance	900	July 24	Accounts Receivable	500
12	Sales/GST Clearing	792			

GST Clearing (A or L)

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
			July 1	Balance	1 600
			7	Bank	59
			12	Accounts Receivable	72

Sales (R)

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
			July 7	Bank	590
			12	Accounts Receivable	720

Inventory (A)

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
July 1	Balance	4 000	July 7	Cost of Sales	320
			12	Cost of Sales	480

Cost of Sales (E)

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
July 7	Inventory	320			
12	Inventory	480			

Drawings

Drawings represents the value of the assets the owner has withdrawn from the business. Although it is classified as an owner's equity account, because it only records *decreases* in owner's equity, it is in fact a *negative* owner's equity account. This account must therefore be *debited* when drawings occur. The account to be credited depends on the asset the owner has withdrawn: if cash has been withdrawn, the Bank account would be credited to record the decrease; if inventory has been withdrawn, then the Inventory account would be credited.

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Example (continued)

McCallister Holdings had the following transactions at the end of the month:
July 28 Owner withdrew $650 in cash
July 31 Owner took home inventory worth $1 200

Figure 19.12 shows how these drawings would be entered in the ledger accounts:

Figure 19.12 Analysing Chart: Drawings

Date	Accounts affected	Type of account	Increase/ Decrease	Debit $	Credit $
July 28	Drawings	– Owner's equity	Increase	650	
	Bank	Asset	Decrease		650
31	Drawings	– Owner's equity	Increase	1 200	
	Inventory	Asset	Decrease		1 200

These entries would be posted to the General Ledger as shown in Figure 19.13:

Figure 19.13 General Ledger: Drawings

General Ledger
Bank (A)

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
July 1	Balance	1 000	28	Drawings	650
7	Sales/GST Clearing	649			
24	Accounts Receivable	500			

Inventory (A)

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
July 1	Balance	4 000	July 7	Cost of Sales	320
			12	Cost of Sales	480
			31	Drawings	1 200

Drawings (-Oe)

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
July 28	Bank	650			
31	Inventory	1 200			

Effect on the Accounting equation

Drawings – of cash or some other asset – thus has the following effect on the Accounting equation:

	Increase/Decrease/No effect	Amount $
Assets	Decrease (decrease Bank $650, Inventory $1 200)	1 850
Liabilities	No effect	
Owner's equity	Decrease (increase Drawings $1 850)	1 850

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Total Drawings – in this case $1 850 ($650 cash and $1 200 inventory) – is then reported in the Balance Sheet under the heading 'Owner's equity', but as a deduction from Capital, as is shown in Figure 19.14:

Figure 19.14 Balance Sheet: Owner's equity

MCCALLISTER HOLDINGS
Balance Sheet (extract) as at 31 July 2030

	$	$
Owner's equity		
Capital	23 000	
Plus Net Profit	510	
	23 510	
Less Drawings	1 850	21 660

Opening balances

When ledger accounts are started for a business that has already been trading for some time, there will be pre-existing balances for items in its reports, and these balances must be entered in the ledger accounts before any new transactions can be recorded. The normal rules for recording in ledger accounts still apply, such as increases in assets on the debit side, and increases in liabilities and owner's equity on the credit side. However, the balances in each account will be the product of a number of different transactions and thus will not be traceable to one single account. This means that the cross-reference can be stated as simply 'Balance'.

Example

The assets and equities of McCallister Holdings as at 1 July 2030 were as follows:

Bank	$ 1 000	Accounts Payable	$ 2 000	
Inventory	4 000	GST Clearing	1 800	CR
Accounts Receivable	3 000	Capital – Malloy	21 200	
Shelving	17 000			

Even when entering opening balances, a proper double-entry must still be recorded, with total debits equalling total credits. Figure 19.15 shows the Analysing Chart to enter these opening balances:

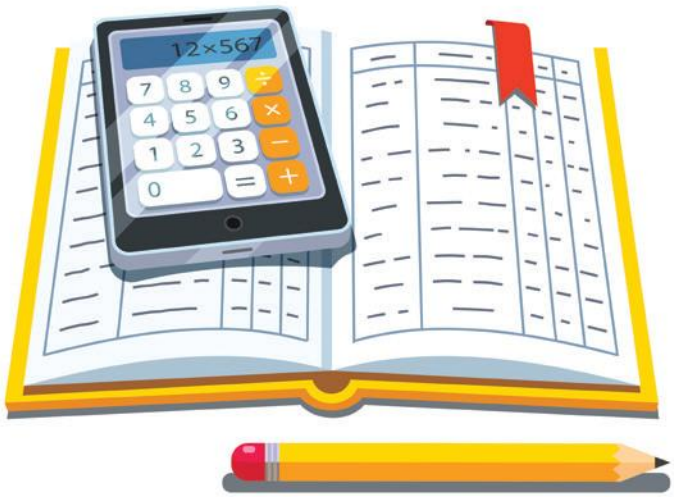

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Figure 19.15 Analysing Chart: Opening balances

Date	Accounts affected	Type of account	Increase/ Decrease	Debit $	Credit $
July 1	Bank	Asset	Increase	1 000	
	Inventory	Asset	Increase	4 000	
	Accounts Receivable	Asset	Increase	3 000	
	Shelving	Asset	Increase	17 000	
	Accounts Payable	Liability	Increase		2 000
	GST Clearing	Liability	Increase		1 800
	Capital	Owner's equity	Increase		21 200

Figure 19.16 shows how these opening balances would be entered in the ledger accounts:

Figure 19.16 General Ledger: Opening balances

General Ledger
Bank (A)

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
July 1	Balance	1 000			

Inventory (A)

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
July 1	Balance	4 000			

Accounts Receivable (A)

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
July 1	Balance	3 000			

Shelving (A)

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
July 1	Balance	17 000			

Accounts Payable (L)

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
			July 1	Balance	2 000

GST Clearing (L)

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
			July 1	Balance	1 800

Capital (Oe)

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
			July 1	Balance	21 200

Study tip

If the capital figure is not given, it must be calculated using the Accounting equation: Oe = A – L.

Review questions 19.4

1 **Show** the debit and credit entries necessary to record:
- a cash sale (of inventory)
- a credit sale (of inventory)
- a receipt from Accounts Receivable
- cash drawings.

2 **Explain** why cash received from Accounts Receivable does not increase profit.

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19.5 The Trial Balance

Trial Balance
a list of all the accounts in the General Ledger, and their balances, to determine if total debits equal total credits

Once all transactions have been recorded in the General Ledger, it must be checked to see that the Accounting equation still balances; that is, that the total debits equal the total credits. This check is carried out by preparing a **Trial Balance**, which is a list of all the ledger accounts and their balances, with the balance being the 'net amount' left in an account.

Footing ledger accounts

footing
an informal process used to determine the balance of a ledger account

Before the Trial Balance can be prepared, each ledger account must be 'footed'. **Footing** is the process of informally calculating the balance of an account, and it involves the following steps:

1. Adding up all the amounts on the debit side, and then pencilling the total below the last debit amount.
2. Adding up all the amounts on the credit side, and then pencilling the total below the last credit amount.
3. Deducting the smaller total from the larger total.
4. Pencilling this figure – the balance – on the side of the larger total, and then drawing a circle around it.

This balance should *not* be written in the same column as the other amounts, because this risks inadvertently (and incorrectly) counting it as an additional entry. The balance should be written in the cross-reference section to make it clear that it is not an *entry*, but the *footed balance* of the account. Figure 19.17 shows how a Bank account would be footed:

Figure 19.17 Footing an account

General Ledger
Bank (A)

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
March 1	Balance	12 500	March 3	Wages	4 000
15	Sales/GST Clearing	6 000	12	Rent/GST Clearing	9 000
22	Accounts Receivable	3 400	25	Drawings	6 250
	(2650)				
		21 900			19 250

The balance of the Bank account is thus $2 650 (on the debit side, meaning it is an asset).

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The Trial Balance

Once all the accounts have been footed, the balances are listed in two columns: one for debit balances and one for credit balances. The columns are then totalled and – if the ledger recording is correct – the totals should be the same. Figure 19.18 shows the Trial Balance for Clack's Shoe Shop as at 31 March 2030:

Figure 19.18 Trial Balance

CLACK'S SHOE SHOP
Trial Balance as at 31 March 2030

Account	Debit $	Credit $
Accounts Payable		6500
Accounts Receivable	8900	
Advertising	400	
Bank	2650	
Buying expenses	200	
Capital – Clack		18850
Cost of Sales	5600	
Drawings	2500	
GST Clearing		500
Inventory	22000	
Interest revenue		100
Loan – KH Bank		40000
Rent	1500	
Sales		13000
Shop fittings	33100	
Wages	2100	
Totals	**78950**	**78950**

Study tip

If the Trial Balance does not balance, look for a transaction involving the amount identified as the difference, half the difference or twice the difference, and check this entry first.

Errors revealed

If the Trial Balance does **not** balance, the ledger entries have not been recorded correctly, perhaps because:

- two entries have been recorded on the *same side* of the General Ledger (for example, two debits or two credits, instead of one debit and one credit)
- only *one entry* has been recorded (for example, one debit entry without a corresponding credit entry, or vice versa)
- *different amounts* have been recorded on each side (for example, $450 on the debit side, but $4500 on the credit side).

In this case, the entry that has caused the difference between the two totals must be found and corrected.

Errors **not** revealed

In spite of its benefits, the usefulness of a Trial Balance as a diagnostic tool in detecting errors is limited: it will only detect errors if total debits do not equal total credits. One or more of the following errors may be present in the ledger accounts even when the Trial Balance balances:

- A transaction has been *omitted* altogether.
- The debit and credit entries have been *reversed*. (For example, instead of recording a payment to an Account Payable by debiting Accounts Payable and crediting

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Bank, the entry is erroneously recorded as a debit to Bank and a credit to Accounts Payable.)

- The transaction has been recorded in the *wrong ledger accounts*. (For example, instead of recording the payment of wages as a debit to the Wages account, the transaction is incorrectly debited to Rent.)
- An *incorrect amount* is recorded on both sides of the ledger.

None of these (incorrect) entries would be detected or revealed by a Trial Balance, because each of them still has matching debit and credit entries. That is, even though the entry would be wrong, there would still be an amount recorded on the debit side and an equal amount recorded on the credit side. The Trial Balance is a useful tool, but it will not detect all the errors that may exist in the ledger.

Review questions 19.5

1 **State** the purpose of a Trial Balance.
2 Referring to ledger accounts, **state** what is meant by the term 'footing'.
3 **List** the steps involved in footing a ledger account.
4 **State** three errors that will be detected by the preparation of a Trial Balance.
5 **State** four errors that will **not** be detected by the preparation of a Trial Balance.

19.6 Balancing

balancing
ruling off an asset, liability or owner's equity account to determine its balance at the end of the current period and transferring that balance to the next period

Footing is an informal process that can be done to any account at any time to determine its balance. But **balancing** asset, liability and owner's equity accounts must occur at the end of the period, with these accounts formally 'ruled off' so that their balances can be reported in the Balance Sheet and also carried forward to the next period. This helps to ensure *Relevance* in the Balance Sheet, as only the accurate and up-to-date figures (from the end of the period) that might make a difference to decision-making are reported.

Balancing ledger accounts

Balancing an account involves the following steps:

1 Totalling the amounts on each side, and then writing the larger of these two totals on both sides.
In the example shown in Figure 19.19, the transactions on the debit side add up to $21 900, and the transactions on the credit side add up to only $19 250, so $21 900 is written *on both sides*. This figure should be 'ruled off' with a double line to indicate that in the current period there are no more transactions that affect the account.
This is **not** the *balance* of the account: it is the *total*. At this point, the amounts on only one side – in this case the debit side – will add up to this total of $21 900.
2 Calculating the balance by deducting the total of the smaller side from the total of the account.
In the example, this is $21 900 (total) – $19 250 (smaller side) = $2 650 (balance).
3 Entering this balance as a proper ledger entry, with a matching debit and credit:
– above the total on the smaller side
– below the total on the larger side.

This entry 'carries forward' the balance from the end of one period to the start of the next. This is why in the example the date is given as March 31 *above* the total but as April 1 *below*.

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Figure 19.19 shows the 'Bank' account after it has been balanced:

Figure 19.19 Balancing an account

General Ledger
Bank (A)

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
March 1	Balance	12 500	March 3	Wages	4 000
15	Sales/GST Clearing	6 000	12	Rent/GST Clearing	9 000
22	Accounts Receivable	3 400	25	Drawings	6 250
			31	Balance	2 650
		21 900			21 900
April 1	Balance	2 650			

Study tip

Compare this 'balanced' account with the 'footed' account in Figure 19.17. The balance of the account is the same, but this account has been more formally completed.

In this example, the balance of $2 650 must be recorded *on the credit side above the total* so that the credit side adds up to $21 900. It must then be transferred to the *debit side, but below the total*, as the opening balance for the next period (beginning 1 April 2030).

Balancing versus footing

Both footing and balancing involve calculating the balance of an account, but there are three main differences:

1. Balancing is done only at the end of the period.
2. Only asset, liability and owner's equity accounts are balanced. (Revenue and expense accounts are *closed*. This is covered in the Unit 3 and 4 version of this textbook series.)
3. Balancing is a more formal process, involving a proper double-entry; that is, a debit and matching credit entry.

Video 19.2
Balancing and footing

Review questions 19.6

1. **List** the steps involved in balancing a ledger account.
2. **Explain** why the entries required to balance a ledger account are shown with different dates.
3. **List** three differences between footing and balancing a ledger account.

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Where have we been?

- Double-entry Accounting involves recording at least two effects on the Accounting equation as a result of each transaction.
- A ledger account is an Accounting record showing all the transactions that affect a particular item.
- The General Ledger is the collective name for the main group of ledger accounts.
- The left-hand side of a ledger account is the debit side; the right-hand side is the credit side.
- Every transaction must be recorded in at least two ledger accounts. Every transaction must have at least one debit entry and at least one credit entry, and these entries must balance.
- To record an increase in assets or expenses, record the transaction on the debit side.
- To record an increase in liabilities, owner's equity or revenues, record the transaction on the credit side.
- The cross-reference specifies the link between accounts by identifying the other account/s affected.
- Footing is an informal process to calculate the balance of an account.
- Errors a Trial Balance *will* reveal: two entries recorded on the same side, only one entry recorded or a different amount recorded on each side.
- Errors a Trial Balance *will not* reveal: a transaction omitted altogether, debit and credit entries reversed, a transaction recorded in the wrong ledger accounts or an incorrect amount recorded on both sides of the ledger.
- Balancing involves ruling off an asset, liability or owner's equity account to determine its balance at the end of the current period and transferring that balance to the next period.

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Exercises

Exercise 19.1
Transactions and the Accounting equation

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State the effect on the Accounting equation of each of the following transactions:

a. A loan for $5 000 was received from ANZ Bank.
b. Office furniture worth $19 000 plus GST was purchased with cash.
c. $450 was paid to Accounts Payable.
d. The owner contributed to the business a vehicle worth $25 000.
e. $1 000 was paid off the loan principal.
f. Inventory worth $3 000 plus GST was purchased on credit from HP Enterprises.
g. $800 was received from an Account Receivable.

Exercise 19.2
Recording in the General Ledger

page 366

Jane Green is a former groundskeeper who has just gone into business for herself selling lawn seed, operating under the name Reap and Sow. Her transactions for the first week of May 2030 are shown below:

May 1 Contributed $40 000 cash to commence business
2 Rented a small office, paying $500 plus GST for May 2030
3 Purchased inventory worth $8 000 plus GST on credit from Lush Lawnseed
4 Paid $3 000 plus GST for office furniture
5 Paid $150 plus GST for advertising in the local paper
6 Jane contributed to the business her personal computer (fair value $1 200)

Required

a. **Prepare** an Analysing Chart to show the double entry required to record each entry in the General Ledger of Reap and Sow.
b. **Record** the transactions for the first six days of May 2030 in the General Ledger of Reap and Sow.
c. Referring to the definitions, **explain** why the transaction on 3 May 2030 creates a liability for Reap and Sow.
d. Referring to one Accounting assumption, **explain** why the transaction on 6 May 2030 must be recorded in the accounts of Reap and Sow.

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Exercise 19.3
Recording in the General Ledger

page 369

Phil Meecup just commenced business as Quick Perk, a company that sells coffee machines. The following transactions occurred during the first week of November 2030:

Nov. 1 Phil contributed $25 000 cash to commence business
2 Took out a mortgage from the Bank of RLM for $154 000 and then used the cash to purchase premises for $140 000 plus GST.
3 Purchased inventory worth $50 000 plus GST on credit from NewCaffe Supplies
4 Paid wages to office manager $1 900
5 Phil withdrew $1 000 cash for personal use
6 Paid $4 000 plus GST for advertising that will not begin until December 2030
7 Paid NewCaffe Supplies $1 500

Required

a. **Prepare** an Analysing Chart to show the double entry required to record each entry in the General Ledger of Quick Perk.
b. **Record** the transactions for the first week of November 2030 in the General Ledger of Quick Perk.
c. **Explain** how the *Going concern assumption* affects the recording of the transaction on 2 November 2030.
d. Referring to the definitions, **explain** why the advertising should be recognised as a current asset as at 7 November 2030.

Exercise 19.4
Cash sales in the General Ledger

page 372

Melita Anogra just opened Melita Mows, a shop specialising in the sale of mowers. The firm's transactions for the first week of January 2030 showed the following:

Jan. 1 Contributed capital to commence business – $15 000 cash and one vehicle worth $22 000
2 Paid rent of $660 including GST for January 2030
3 Purchased mowers on credit for $45 000 plus GST from Havana Mowers
4 Sold one mower for $700 cash (cost price $500)
5 Paid wages of assistant $150
6 Sold two mowers for $700 plus GST cash (cost price $500) each
7 Paid $2 500 to Havana Mowers

Required

a. **Explain** why the vehicle contributed on 1 January 2030 **cannot** be valued at the price paid by the owner.
b. **Prepare** an Analysing Chart to show the double entry required to record each entry in the General Ledger of Melita Mows.
c. **Record** the transactions for the first week of January 2030 in the General Ledger of Melita Mows.
d. **State** the effect on the Accounting equation of the transaction on 4 January 2030.
e. **Explain** how valuing inventory at its cost price ensures Faithful representation in the Balance Sheet.
f. **Calculate** Gross Profit for Melita Mows for the first week of January 2030.

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Exercise 19.5
Cash and credit sales in the General Ledger

page 375

Kim Swood just opened her own spare parts shop called Monaro Motors. Transactions for August 2030 showed the following:

Aug. 1 Capital contribution of $10 000 inventory and $30 000 cash
2 Purchased premises worth $150 000 plus GST paying a $10 000 cash deposit with the balance funded by a mortgage from QV Bank
3 Cash sale of parts for $440 including GST (cost price $200)
4 Paid $2 500 plus GST to Wilson Fittings for shelving
5 Purchased inventory on credit from HolFord Parts for $2 860 including GST
6 Sold parts on credit to Lemon Rentals for $900 plus GST (cost price $450)
7 Paid wages of apprentice $600
8 Kim Swood took home inventory worth $1 500
9 Received $500 cash from Lemon Rentals

Required

a. **Prepare** an Analysing Chart to show the double entry required to record each transaction in the General Ledger of Monaro Motors.
b. **Record** the transactions for August 2030 in the General Ledger of Monaro Motors.
c. **Explain** how the *Accrual basis assumption* affects the reporting of the transaction on 6 August 2030.
d. **State** the purpose of preparing a Trial Balance.
e. **Foot** the accounts and **prepare** a Trial Balance as at 9 August 2030.

Exercise 19.6
Opening balances in the General Ledger

page 379

Finoula O'Riley owns a small shop called Hot Doggies that sells dog-grooming products. Finoula has been operating for three years, but on 1 June 2030 decided to adopt a double-entry recording system. Her opening account balances on 1 June 2030 were Bank $1 500, Inventory $5 000, Accounts Receivable $8 000, Shelving $16 000, GST payable $2 000, Loan – CF Bank $6 000 and Capital – O'Riley $22 500.
Transactions for June 2030 showed the following:

June 1 Received $2 000 cash from Accounts Receivable (Lynx) for inventory sold in May 2030
2 Finoula contributed to the business her laptop valued at $2 500
3 Inventory was sold on credit to Allendale Kennels for $1 000 plus GST (cost price $650)
4 Paid wages $900
5 Purchased inventory worth $1 900 plus GST on credit from Laminar Products
6 Cash sales of $132 including GST (cost price $80)
7 Received $500 from Allendale Kennels
8 Purchased extra shelving for $3 520 including GST using cash
9 Cash sales of $230 plus GST (cost price $150)
10 Paid $700 off the principal of the Loan – CF Bank
11 Inventory was sold on credit to Joanie's Dog Wash for $550 including GST (cost price $380)
12 Paid wages $900

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Required

a. **Record** the opening balances in the General Ledger of Hot Doggies as at 1 June 2030.
b. **Record** the transactions for June 2030 in the General Ledger of Hot Doggies.
c. Referring to the definitions of the elements of the reports, **explain** why the cash received from Lynx on 1 June 2030 should **not** be reported as revenue for June 2030.
d. **Explain** the effect on the Accounting equation of Hot Doggies if the transaction on 6 June 2030 had **not** been recorded.
e. **Foot** the accounts and **prepare** a Trial Balance for Hot Doggies as at 12 June 2030.
f. **State** one error that would cause the Trial Balance to **not** balance.

Exercise 19.7
Opening balances in the General Ledger

page 383

Paul McMartin is the owner/operator of Bright Camping, a business that sells camping gear. On 1 October 2030, Paul decided to adopt a double-entry recording system. The firm's balances on that date were as follows: Inventory $70 000, Accounts Receivable $34 000, GST receivable $900, Shop fittings $17 000, Premises $100 000, Loan Highland Bank $90 000, Accounts Payable $51 000, Bank overdraft $1 000 and Capital $79 900. The transactions for October 2030 were as follows:

Oct. 1 Credit sale to Sleepy Hollow Caravan Park for $11 000 including GST (cost price $5 000)
2 Purchased new shop fittings for $5 000 plus GST using a short-term loan from Punkah Credit Co.
3 Received $8 000 cash from Accounts Receivable (Milawa Adventures)
4 Cash sales of $2 000 plus GST (cost price $1 000)
5 Paul paid $143 including GST for the firm's advertising using cash from his own personal bank account
6 Purchased camping gear on credit from Hardy Camp Gear for $12 000 plus GST
7 Paid wages of $700
8 Received $4 000 cash from Sleepy Hollow
9 Sold inventory on credit to High Peak Adventures for $3 850 including GST (cost price $1 750)
10 Paid $7 000 to Accounts Payable (Jillaroo's Choice)

Required

a. **Record** the opening balances in the General Ledger of Bright Camping.
b. **Record** the transactions for October 2030 in the General Ledger of Bright Camping.
c. **Explain** the importance of a cross-reference when recording transactions in ledger accounts.
d. Referring to the definitions of the elements of the reports, **explain** why the transaction on 7 October 2030 should be reported as an expense.
e. **Foot** the accounts and **prepare** a Trial Balance for Bright Camping as at 10 October 2030.
f. **State** two errors in the General Ledger that will **not** be detected by a Trial Balance.

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Exercise 19.8
Identifying transactions

page 387

Mira Van Sanden is a photographer who owns and operates a shop in Melbourne called Perfect Photographs. The firm's General Ledger for December 2030 showed the following:

General Ledger
Bank (A)

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
Dec. 1	**Balance**	1 000	Dec. 3	Office equipment/GST Clearing	110
2	Sales/GST Clearing	990	Dec. 6	Repairs/GST Clearing	165
7	Accounts Receivable	300			

Inventory (A)

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
Dec. 1	**Balance**	5 000	Dec. 2	Cost of Sales	600
8	Accounts Payable	800	5	Cost of Sales	400

Accounts Receivable (A)

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
Dec. 1	**Balance**	1 700	Dec. 7	Bank	300
5	Sales/GST Clearing	660			

Office equipment (A)

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
Dec. 1	**Balance**	4 000	Dec. 4	Drawings	250
3	Bank	100			

Accounts Payable (L)

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
			Dec. 1	**Balance**	1 100
			8	Inventory/GST Clearing	880

GST Clearing (L)

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
Dec. 3	Bank	10	**Dec. 1**	**Balance**	2 600
6	Bank	15	2	Bank	90
8	Accounts Payable	80	5	Accounts Receivable	60

Capital (Oe)

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
			Dec. 1	**Balance**	8 000

Sales (R)

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
			Dec. 2	Bank	900
			5	Accounts Receivable	600

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Cost of Sales (E)

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
Dec. 2	Inventory	600			
5	Inventory	400			

Drawings (–Oe)

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
Dec. 4	Office equipment	250			

Repairs (E)

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
Dec. 6	Bank	150			

Required

a. Using the General Ledger, **describe** each transaction (in date order).
b. **Calculate** the rate of mark-up that is applied to sales of inventory.
c. **Prepare** a Trial Balance for Perfect Photographs as at 8 December 2030.

On 9 December 2030, Mira paid $200 plus GST for office equipment. The transaction was posted into the General Ledger as follows:

Ledger account	Debit $	Credit $
Office expenses	200	
GST Clearing	20	
Bank		220

d. **State** whether the Trial Balance would identify this error. **Justify** your answer.
e. **Explain** the effect on the Accounting equation of Perfect Photographs if this error was **not** corrected.
f. **Show** the debit and credit entries necessary to correct this error.

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Exercise 19.9
Transactions to reports

page 389

Turning Points is a firm that sells exercise machinery. Its owner, Tracey Nicole, has decided to adopt a double-entry recording system. At 1 July 2030, the firm's assets and liabilities were as follows:

Accounts Payable	$7 500	Inventory	$52 000
Accounts Receivable	2 000	Mortgage – JH Finance	85 000
Bank	1 200 DR	Office equipment	10 000
GST Clearing	3 400 DR	Premises	190 000

The firm's transactions for July 2030 showed the following:

July 1	Cash sale* to R. Donnegan (cost price $400)	$880
3	Paid for electricity*	495
6	Credit sales* to Lowdown Gym (cost price $2 700)	5 940
7	Purchased exercise machinery* on credit from Havilland Machines	4 400
9	Paid wages	500
11	Credit sales* to St Martin's Hospital (cost price $3 500)	7 700
14	Received cash from Walkers' World for goods sold in June 2030	1 600
17	Paid cash to Havilland Machines	1 000
19	Made monthly payment on mortgage (including $200 interest)	700
20	Tracey took home an exercise machine for her son	600
23	Paid wages	500
25	Cash sale* to J. Notts (cost price $290)	638
27	Received cash from Lowdown Gym	5 940
31	Paid for 6 months, advertising, which will begin in August 2030	6 600

* Amounts include GST

Required

a. **Calculate** Tracey's capital as at 1 July 2030.
b. **Record** the opening balances in the General Ledger of Turning Points.
c. **Record** the transactions for July 2030 in the General Ledger of Turning Points.
d. **Balance** the accounts (where appropriate) and **prepare** a Trial Balance as at 31 July 2030.
e. Referring to one Accounting assumption, **explain** why the transaction on 14 July 2030 is **not** considered to be revenue for July 2030.
f. **State** the effect on the Accounting equation of Turning Points if the transaction on 19 July 2030 was **not** recorded.
g. **Prepare** an Income Statement for Turning Points for July 2030.
h. **Prepare** a classified Balance Sheet for Turning Points as at 31 July 2030.
i. Referring to one Qualitative characteristic, **explain** why the advertising must be reported in the Balance Sheet as at 31 July 2030.

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Glossary

Accounting [p. 6]
the collecting and recording of financial data to produce and report financial information to assist business owners in decision-making

Accounting assumptions [p. 11]
the generally accepted rules that govern the way Accounting information is recorded

Accounting entity assumption [p. 11]
the assumption that the records of assets, liabilities and business activities of the entity are kept completely separate from those of the owner of the entity as well as from those of other entities

Account Payable [p. 79]
a supplier who is owed a debt by the business for goods or services purchased from them on credit

Account Receivable [p. 193]
a customer who owes a debt to the business for goods or services sold to them on credit

Accounts Payable record [p. 306]
a subsidiary Accounting record that records each individual transaction with each individual Account Payable, and shows the balance owing to that Account Payable at any point in time

Accounts Payable Schedule [p. 307]
a listing of the name and balance of each Accounts Payable record

Accounts Payable Turnover (APTO) [p. 373]
an efficiency indicator that measures the average number of days it takes for a business to pay its Accounts Payable

Accounts Receivable record [p. 335]
a subsidiary Accounting record that details each individual transaction with each individual Account Receivable, and shows the balance owed by that Account Receivable at any point in time

Accounts Receivable Schedule [p. 336]
a listing of the name and balance of each Accounts Receivable record

Accounts Receivable Turnover (ARTO) [p. 376]
an efficiency indicator that measures the average number of days it takes for a business to collect cash from its Accounts Receivable

Accrual Accounting [p. 363]
calculating profit by comparing revenue earned against expenses incurred in a particular reporting period

Accrual basis assumption [p. 11]
the assumption that the elements of the reports are recognised when they satisfy the definitions and recognition criteria, meaning profit is calculated as revenue earned in a particular period less expenses incurred in that same period

Accumulated depreciation [p. 401]
the value of a non-current asset that has been consumed over its life so far

Adjusted Gross Profit [p. 280]
Gross Profit less Inventory loss (or plus Inventory gain)

advice [p. 10]
the provision to the owner of a range of options appropriate to their aims/objectives, and recommendations as to their suitability

analysing [p. 454]
examining the financial reports in detail to identify changes or differences in performance

asset [p. 24]
a present economic resource controlled by the entity (as a result of past events) that has the potential to produce future economic benefits

asset register [p. 394]
a document that shows the assets that a business owns

Asset Turnover (ATO) [p. 409]
an efficiency indicator that assesses how productively a business has used its assets to earn revenue

Australian Business Number (ABN) [p. 50]
a unique 11-digit number used to identify a business

bad debt [p. 343]
an expense incurred when a debt is written off because it is deemed to be irrecoverable

Balance Sheet [p. 27]
an Accounting report that details a firm's financial position at a particular point in time by reporting its assets, liabilities and owner's equity

bank overdraft [p. 79]
an external source of finance provided by a bank that allows the account holder to withdraw more than their current account balance

bank reconciliation [p. 176]
the process of verifying that the entries in a firm's cash journals are the same as those recorded by the firm's bank on the Bank Statement

Bank Statement [p. 126]
a statement provided to customers by their banking institution that gives details of all cash transactions relevant to the particular account that have occurred over a specific period of time and the resulting balance at the end of that period

benchmark [p. 455]
an acceptable standard against which the firm's actual performance can be assessed

bonds [p. 62]
a mechanism used by governments to raise funds from the general public in return for a fixed interest rate

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break-even point [p. 97]
the level of sales where total revenue equals total expenses and the business makes neither a profit nor a loss

Budgeted Balance Sheet [p. 435]
an Accounting report that predicts assets, liabilities and owner's equity at the end of the budget period

Budgeted Cash Flow Statement [p. 425]
an Accounting report that predicts future cash inflows and outflows, determines the expected cash increase or decrease, and thus estimates the bank balance at the end of the budget period

Budgeted Income Statement [p. 431]
an Accounting report that predicts revenue earned and expenses incurred, and thus the expected Net Profit (or Loss) for the budget period

budgeting [p. 422]
the process of predicting/estimating the financial consequences of future events

capital contribution [p. 78]
an internal source of finance consisting of cash (or other assets) contributed to the business from the personal assets of the owner

capital gain [p. 60]
a return generated from an investment in the form of an increase in the value of an asset that can therefore be sold for more than its purchase cost

capital gains tax [p. 63]
a form of taxation charged when a gain is made on the sale of an asset

capital loss [p. 65]
the loss incurred when an asset is sold at a price less than its initial purchase price

Carrying value [p. 402]
the value of a non-current asset that is yet to be consumed/allocated as an expense, plus any Residual value

cash control [p. 174]
the procedures and strategies used to protect the firm's cash

cash deficit [p. 152]
an excess of cash payments over cash receipts, leading to a decrease in a positive bank balance or an increase in a bank overdraft

Cash Flow Cover [p. 158]
a liquidity indicator that assesses the ability of the business's Operating Cash Flows to meet its short-term debts as they fall due

Cash Flow Statement [p. 153]
an Accounting report that reports all cash flows during a reporting period, classified as Operating, Investing and Financing activities

Cash Flow Statement Variance Report [p. 437]
an Accounting report that compares actual and budgeted cash flows, highlighting variances so that problems can be identified and corrective action taken

Cash Payments Journal [p. 148]
an Accounting record that classifies and summarises all cash paid to other entities during a particular reporting period

cash receipt (1) [p. 120]
a source document used to verify cash received

cash receipt (2) [p. 120]
a transaction that occurs when cash is received from another entity

Cash Receipts Journal [p. 145]
an Accounting record that classifies and summarises all cash received from other entities during a particular reporting period

cash surplus [p. 152]
an excess of cash receipts over cash payments, leading to an increase in a positive bank balance or a decrease in a bank overdraft

classifying/classification [p. 28]
grouping together items that have some common characteristic

Comparability [p. 14]
useful information is provided when the financial reports of a business can be compared over time and compared with similar information of other businesses

competitors' prices [p. 93]
prices charged by businesses competing in the same market

contribution margin [p. 98]
the Gross Profit from each sale that goes towards covering fixed expenses and contributing to Net Profit, calculated by deducting variable costs from the selling price

Cost of Goods Sold [p. 279]
a heading used in the Income Statement for all costs incurred to bring inventory into a location and condition ready for sale

Cost of Sales [p. 241]
the expense incurred when inventory flows out of the business due to a sale

cost price [p. 49]
the original purchase price of inventory

cost-volume-profit analysis [p. 97]
an analysis tool that allows a business to determine a selling price or volume of sales that will let them achieve a specific profit goal

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credit fee [p. 190]
a transaction that involves the provision of a service to a customer who is not required to pay until a later date

credit note [p. 127]
a document that evidences that there is a reduction in the amount owed by a customer

credit purchase [p. 185]
a transaction that involves the acquisition of materials or supplies (or other goods) from a supplier who does not require payment until a later date

credit sale [p. 328]
the provision of inventory to a customer who is not required to pay until a later date

credit terms [p. 299]
the number of days a credit customer has to pay the balance owing, including the number of days to earn a settlement discount and percentage discount offered for early payment

credit transaction [p. 182]
when a service is performed or goods are exchanged but the cash relating to the transaction is not exchanged until some later date, meaning the customer owes a debt to the provider/seller

current asset [p. 28]
a present economic resource controlled by the entity (as a result of a past event) that is expected to be sold, consumed or converted into cash within 12 months after the end of the reporting period

current liability [p. 28]
obligations of the entity (arising from past events) that are reasonably expected to be settled in the next 12 months after the end of the reporting period

debentures [p. 62]
a mechanism used by companies to raise funds from the general public in return for a fixed interest rate

Debt Ratio [p. 33]
measures the proportion of the firm's assets that are funded by external sources

delivery docket [p. 130]
a document used to verify that the goods received are the goods ordered

depreciable asset [p. 396]
a non-current asset that has a finite life, and thus must be depreciated over that life

depreciable value [p. 398]
the total value of the asset that will be consumed by the current entity, and so must be allocated over its Useful life

depreciation [p. 396]
the allocation of the cost of a non-current asset over its Useful life

depreciation expense [p. 396]
the part of the cost of a non-current asset that has been consumed in the current reporting period

direct credit [p. 176]
a deposit of cash directly into a bank account

direct debit [p. 176]
a withdrawal of cash directly from a bank account

discount expense [p. 339]
an expense in the form of a decrease in assets (Accounts Receivable) and owner's equity, incurred when cash is received early from Accounts Receivable and a settlement discount is given by the business

discount revenue [p. 310]
a revenue in the form of a decrease in liabilities (Accounts Payable) and an increase in owner's equity, earned when Accounts Payable are paid early and a settlement discount is given by the supplier

dividend [p. 64]
a share of the profit earned by a company that is distributed to shareholders

efficiency [p. 454]
the ability of the business to manage its assets and liabilities

EFTPOS [p. 120]
Electronic Funds Transfer Point of Sale – an instant electronic transfer of cash from a customer's debit or credit account to the business's bank account at the time of sale

equities [p. 26]
claims on the assets of the firm, consisting of both liabilities and owner's equity

ethical considerations [p. 8]
the social and environmental consequences of a financial decision

expense [p. 207]
a decrease in assets (or increase in liabilities) that reduces owner's equity (except for drawings)

expense control [p. 463]
the firm's ability to manage its expenses so that they either decrease, or in the case of variable expenses, increase no faster than Sales revenue

external finance [p. 79]
funds generated from sources outside the business

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fair value [p. 393]
the price received when selling an asset if it was sold at the time it was acquired by the business

Faithful representation [p. 14]
the financial information reported is a faithful representation of the real-world economic event it claims to represent: complete, free from material error and neutral (without bias)

financial data [p. 7]
raw facts and figures upon which financial information is based

financial indicator [p. 456]
a measure that expresses business performance in terms of the relationship between two different elements of that performance

financial information [p. 7]
financial data that has been sorted, classified and summarised into a more usable and understandable form

Financing activities [p. 153]
cash flows related to changes in the financial structure of the firm

finite life [p. 396]
the limited period of time (usually measured in years) for which a non-current asset will exist

First In, First Out (FIFO) [p. 251]
the assumption that the inventory that is purchased first will be sold first

fixed costs [p. 97]
costs that do not vary with the level of activity

franchise [p. 55]
an arrangement under which one party (the franchisor) grants to another party (the franchisee) certain rights, including the use of the franchise name and business practices

franchisee [p. 55]
the entity that purchases the right to operate under the franchise agreement

franchisor [p. 55]
the entity that holds (and sells to the franchisee) the rights to operate under the franchise agreement

franking credit [p. 64]
dividend income received by the investor on which the company has already paid tax

gearing [p. 459]
the extent to which the business relies on borrowed funds to finance the purchase of its assets

Going concern assumption [p. 12]
the assumption that the business will continue to operate in the future, and its records are kept on that basis

Goods and Services Tax (GST) [p. 117]
a 10% tax levied by the federal government on sales of goods and services

goodwill [p. 54]
an intangible asset representing the value of the firm's reputation, clientele, viability and future growth prospects

Gross Profit [p. 239]
the profit earned purely from the purchase and sale of inventory, measured by deducting Cost of Sales from Sales revenue

Gross Profit Margin (GPM) [p. 282]
a profitability indicator that measures the average mark-up by calculating the percentage of Net Sales revenue that is retained as Gross Profit

GST payable [p. 156]
GST owed by the business to the ATO when the amount of GST the business has received on its fees is greater than the GST it has paid to its suppliers

GST receivable [p. 157]
GST owed to the business by the ATO when the amount of GST the business has paid to its suppliers is greater than the GST it has received on its fees

GST refund [p. 157]
a cash receipt from the AT0 to clear GST receivable (operating inflow)

GST settlement [p. 156]
a payment made to the ATO by a small business to settle GST payable (operating outflow)

Historical cost [p. 393]
the cost of the asset when purchased

Identified Cost [p. 250]
the actual cost price of the inventory that is purchased and sold is identified and recorded

Income Statement [p. 208]
an Accounting report that details the revenue earned and expenses incurred during the reporting period

Income Statement Variance Report [p. 439]
an Accounting report that compares actual and budgeted revenue and expenses, and highlights variances so that problems can be identified and corrective action taken

income stream [p. 60]
a return generated from an investment in the form of ongoing income such as interest, rent or dividends

indicator [p. 32]
a measure that expresses profitability, liquidity or stability in terms of the relationship between two different elements of performance

intangible assets [p. 392]
assets that do not have a physical form

interest-only loan [p. 81]
a loan that requires the borrower to make regular interest payments before repaying the entire principal in one lump sum on the last day of the loan period

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internal control [p. 172]
the procedures and strategies used to protect the firm's assets from fraud, theft, damage and misuse

internal finance [p. 78]
funds generated by and within the firm

interpreting [p. 454]
examining the relationships between the items in the financial reports in order to explain the cause and effect of changes or differences in performance

inventory [p. 236]
goods purchased by a trading firm for the purpose of resale at a profit

inventory card [p. 239]
a subsidiary Accounting record that records each individual transaction involving the movement in and out of the business of a particular line of inventory

inventory gain [p. 255]
a revenue that occurs when the physical count shows more inventory on hand than is shown in the inventory card

inventory loss [p. 254]
an expense that occurs when the physical count shows less inventory than is shown on the inventory cards

inventory sheet [p. 283]
a listing of the quantity and value of each line of inventory on hand

Inventory Turnover [p. 285]
an efficiency indicator that measures the average number of days it takes for a business to convert its inventory into sales

Investing activities [p. 153]
cash flows related to the purchase and sale of non-current assets

invoice [p. 127]
a source document used to verify credit transactions

journal [p. 143]
an Accounting record that classifies and summarises transactions during a particular reporting period

lease [p. 80]
a written agreement that grants to the lessee the right to use a particular asset for a specified period of time in return for periodic payments to the lessor

lessee [p. 80]
the entity that is leasing the non-current asset

lessor [p. 80]
the entity that provides the non-current asset for lease

liability [p. 25]
a present obligation of the entity (as a result of past events) to transfer an economic resource

limited liability [p. 52]
the legal status of a company that exists as a separate legal entity, so the owners have no further responsibility for liabilities incurred by the business

liquidity [p. 32]
the ability of the business to meet its short-term debts as they fall due

managed property fund [p. 64]
an investment option that pools the resources of a number of investors to purchase property

managed share fund [p. 65]
an investment option that pools the resources of a number of investors to purchase shares in a variety of companies

market reaction [p. 93]
the response of customers in a particular marketplace to price levels for a particular good or service

market value [p. 393]
the price an asset can be sold for

mark-up [p. 96]
determining selling prices by adding to the cost price a predetermined profit margin

memo [p. 132]
a source document used to verify internal transactions

minimum desired profit [p. 92]
a lowest acceptable profit figure, usually similar to previous income plus a return on the amount invested

mortgage [p. 80]
a loan that is secured against property

negative gearing [p. 63]
a strategy used by investors to reduce their taxable income by purchasing property that generates rental income that is less than the costs it incurs

Net Profit Margin (NPM) [p. 220]
a profitability indicator that assesses expense control by calculating the percentage of Sales revenue that is retained as Net Profit

Net Sales [p. 279]
Total Sales less Sales returns

non-current asset [p. 28]
a present economic resource controlled by the entity (as a result of a past event) that is expected to be used by the business for a number of years and is not held for the purpose of resale

non-current liability [p. 28]
obligations of the entity (arising from past events) that are not expected to be settled in the next 12 months after the end of the reporting period

non-financial information [p. 7]
any information that cannot be found in the financial statements, and is not expressed in dollars and cents, or reliant on dollars and cents for its calculation

Operating activities [p. 153]
cash flows related to day-to-day trading activities

owner's equity [p. 25]
the residual interest in the assets of the entity after the liabilities are deducted

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partnership [p. 51]
a business owned by two or more persons in business together with a view to making a profit

Period assumption [p. 12]
the assumption that reports are prepared for a particular period of time, such as a month or a year, in order to obtain comparability of results

perpetual inventory system [p. 239]
system of Accounting for inventory that involves the continuous recording of inventory movements in inventory cards

physical count [p. 254]
the process of counting every item of inventory on hand to verify the accuracy of the inventory cards and detect any inventory loss or gain

principal and interest loan [p. 81]
a loan that requires the borrower to make regular repayments of both the principal and interest over the life of the loan

profitability [p. 220]
the ability of a business to earn profit as expressed in relative terms by comparing profit against a base like sales, assets or owner's equity

proprietary company [p. 52]
a business that exists as a separate legal entity that is entitled to do business in its own right

prospectus [p. 62]
a document that provides information about a financial product to assist the investor to make an informed decision

purchase invoice [p. 183]
a source document that verifies a credit purchase (usually of inventory)

purchases [p. 239]
the inventory bought by a trading firm for the purposes of resale

Purchases Journal [p. 185]
an Accounting record that summarises all transactions involving the purchase of materials or supplies on credit

Qualitative characteristics [p. 13]
the qualities of the information in Accounting reports

Quick Asset Ratio (QAR) [p. 471]
a liquidity indicator that assesses the firm's ability to meet its immediate debts by measuring the ratio of quick assets to quick liabilities

quote [p. 94]
a method of determining a selling price by estimating the costs involved with a particular job, and then adding on a certain amount to provide for profit

recommended retail price (RRP) [p. 93]
a selling price that is recommended by the manufacturer or wholesaler

recording [p.10]
sorting, classifying and summarising the information contained in the source documents so that it is more usable

Relevance [p. 13]
financial information must be capable of making a difference to the decisions made by users by helping them to form predictions and/or confirm or change their previous evaluations

reporting [p. 10]
the preparation of financial statements that communicate financial information to the owner

retained earnings [p. 78]
an internal source of finance consisting of funds generated from business profits that are not withdrawn by the owner

Return on Assets (ROA) [p. 410]
a profitability indicator that assesses how effectively a business has used its assets to earn profit

return on investment [p. 68]
the percentage of the amount invested that is returned to the owner in the form of income or capital gains

Return on Owner's Investment (ROI) [p. 84]
a profitability indicator that measures how effectively a business has used the owner's capital to earn profit

revenue [p. 206]
an increase in assets (or decrease in liabilities) that leads to an increase in owner's equity (except for a capital contribution)

sales [p. 239]
the revenue earned by a trading firm from the sale of inventory

sales invoice [p. 183]
a source document that verifies a credit sale of inventory

Sales Journal [p. 190]
an Accounting record that summarises all transactions involving the sale/performing of services on credit during a reporting period

security/collateral [p. 62]
an asset that is used to guarantee the repayment of a debt and must be given if the organisation is unable to repay the debt

service business [p. 142]
a small business that operates by providing its time, labour, assets or expertise (or a combination of all four) in return for a fee or charge

settlement discount [p. 310]
a reduction in the amount paid by a credit customer in return for early repayment

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share [p. 64]
a document that verifies part-ownership in a public company

shipping and order confirmation [p. 131]
a document that indicates that an order has been dispatched (sent) and can be expected at some point

single-entry Accounting [p. 144]
the process of recording transactions in journals and then using the summarised information to prepare reports

small business [p. 44]
a business in which the owner and manager is the same person and which employs fewer than 20 people

sole proprietorship [p. 50]
a business owned by a single individual, operating their business in their own right under their own name or a registered business name

source documents [p. 9]
documents that provide both the evidence that a transaction has occurred and the details of the transaction itself

stability [p. 33]
the ability of the business to meet its debts and continue its operations in the long term

stakeholder [p. 6]
a person or organisation that has an interest in the performance of the business and can affect operations or be affected by them

Statement of Account [p. 129]
a statement provided to credit customers to give details of transactions that have occurred over a specific period of time and the resulting balance owing at the end of that period

Statement of Receipts and Payments [p. 144]
an Accounting report that lists cash receipts and payments during a reporting period, the change in the bank balance, and the opening and closing bank balance

tangible assets [p. 392]
assets that have a physical form that can be touched or held

tax invoice [p. 117]
a source document that contains specific information required by the ATO to substantiate GST amounts

term deposit [p. 61]
an investment option that requires the investor to agree to invest for a specified length of time

term loan [p. 80]
a form of external finance provided by banks and other lenders for a specific purpose and repaid over time

Timeliness [p. 15]
financial information should be available to decision-makers in time to be capable of influencing their decisions

trade credit [p. 79]
a form of external finance offered by some suppliers, which allows customers to purchase goods/services and pay at a later date

trading firm [p. 236]
a business that aims to generate profit by purchasing goods and then selling them at a higher price

transaction [p. 9]
an exchange of goods or services with another party for payment

trend [p. 454]
the pattern formed by changes in an item over a number of periods

Understandability [p. 15]
financial information should be understandable or comprehensible to users with a reasonable knowledge of business and economic activities, and presented clearly and concisely

unlimited liability [p. 50]
the legal status of sole proprietorships and partnerships is that they are not recognised as separate legal entities, so the owner(s) is/are personally liable for the debts of the business

variable costs [p. 97]
costs that vary directly with the level of activity

variance [p. 437]
the difference between an actual figure and a budgeted figure, expressed as 'favourable' or 'unfavourable'

variance report [p. 437]
an Accounting report that compares actual and budgeted figures, highlighting variances so that problems can be identified and corrective action taken

Verifiability [p. 14]
ensures that different knowledgeable and independent observers can reach the same conclusion that a particular representation of an event is faithfully represented

vertical analysis [p. 467]
a report that expresses every item as a percentage of a base figure (in this case, Sales revenue)

vertical analysis of the Income Statement [p. 219]
a representation of individual expenses as a percentage of revenue to allow for an assessment of their relative importance

Working Capital Ratio (WCR) [p. 32]
a liquidity indicator that measures the ratio of current assets to current liabilities to assess the firm's ability to meet its short-term debts

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Selected Answers

Chapter 2

2.6	c	Total Assets = $87 900
2.7	a	Total Assets = $148 500
2.8	b	Total Assets = $133 500
2.15	c	Total Assets = $61 500

Chapter 7

7.1	a	Cash Receipts Journal = $3 650
		Cash Payments Journal = $2 915
	b	Bank balance = $1 485
7.2	a	Cash Receipts Journal = $2 145
		Cash Payments Journal = $8 049
	b	Bank balance = $96
7.3	a	Cash ReceiptsJournal = $3 935
		Cash Payments Journal = $5 420
	c	Bank balance = ($1 185)
7.4	b	Cash Receipts Journal = $4 257
		Cash Payments Journal = $6 025
	d	Bank balance = ($268)
7.5	d	Cash Receipts Journal = $19 020
		Cash Payments Journal = $10 041
	e	Bank balance = $7 979
7.6	a	Cash ReceiptsJournal = $4 001
		Cash PaymentsJournal = $3 055
	c	Bank balance = $4 446
7.7	f	Cash ReceiptsJournal = $4 136
		Cash PaymentsJournal = $3 577
	g	Bank balance = $1 400

Chapter 9

9.2	b	Purchases
		Journal = $14 850
9.3	a	Purchases Journal = $1 925
		Cash Payments Journal = $6 990
	c	Accounts Payable balance = $2 905
9.4	a	Purchases Journal = $21 725
		Cash Payments Journal = $36 394
	b	Accounts Payable balance = $24 125
9.6	b	Sales Journal = $2 607
9.7	c	Sales Journal = $8 459
		Cash Receipts Journal = $18 030
	d	Accounts Receivable
		balance = $6 869
9.8	a	Purchases Journal = $8 723
		Sales Journal = $7 524
		Cash Receipts Journal = $6 916
		Cash Payments Journal = $8 759
	b	Accounts Payable balance = $8 173
		Accounts Receivable
		balance = $6 391

Chapter 10

10.2	a	Bank at end = $1 993
	b	Cost of materials used = $2 850
	c	Net profit = $1 830
	f	Owners equity = $34 130
10.3	a	Bank at end = $2 255
	b	Net loss = ($600)
	f	Owners equity = $37 800
10.4	a	Bank at end = $10 057
	b	Net profit = $1 420
	e	Total equities = $60 027
10.5	a	Bank at end = ($130)
	b	Cost of materials used = $4 300
	c	Net profit = $2 950
	e	Total assets = $120 150
10.6	b	Bank at end = $3 860
	c	Net loss = ($350)
	e	Total assets = $86 860
10.7	d	Bank at end = ($2 190)
	e	Net profit = $2 500
	g	Total assets = $53 000
10.8	e	Net loss = ($300)
	h	Total assets = $56 460

Chapter 12

12.3	a	Bank at end = $9 280
		Net profit = $7 000
	c	Owner's equity = $44 500
12.4	a	Net profit = $11 400
	c	Owner's equity = $52 800
12.5	a	Bank at end = ($4 300)
		Net loss = $5 500
	c	Owner's equity = $49 000
12.8	c	Net profit = $8 800
12.9	f	Net profit = $15 350
	g	Owner's equity = $32 050

Chapter 13

13.2	b	Purchase Journal = $17 490
13.3	a	Purchase Journal = $2 343
		Cash Payments Journal = $10 240
13.4	a	Purchase Journal = $32 010
		Cash Payments Journal = $39 362
13.8	b/d	Accounts Payable balance = $13 200
13.9	c/e	Accounts Payable balance = $12 840

Chapter 14

14.2	b	Sales Journal = $5 247
14.3	c	Sales Journal = $5 544
		Cash Receipts Journal = $17 990
14.4	c	Sales Journal = $31 240
		Cash Receipts Journal = $22 402

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14.8 a Sales Journal = $4 400
Cash Receipts Journal = $10 537
b/d Accounts receivable schedule = $990
14.9 c/f Accounts receivable balance = $6 600
14.10 a Sales Journal = $3 762
Purchase Journal = $10 670
Cash Receipts Journal = $5 588
Cash Payments Journal = $8 794

Chapter 15

15.1 a Bank = $1 740
b Net profit = $2 400
f Total assets = $135 580
15.2 a Bank = $3 500
b Net profit = $24 230
h Total assets = $77 640
15.3 a Net loss = ($760)
f Total assets = $41 330
15.9 c Net profit = $15 250
f Total assets = $102 740
15.10 b Net loss = $640
g Current assets = $34 535

Chapter 16

16.6 c Bank at end = $5 030
d Net loss = $8 450
g Total assets = $264 480
16.7 c Net profit = $7 952
g Total assets = $146 032
16.8 c Net loss = $6 620
e Total assets = $64 855

Chapter 17

17.1 c Budgeted Bank at end = ($7 000)
17.2 c Budgeted Bank at end = $60 993
17.3 d Budgeted Bank at end (Oct)= ($12 049)
Budgeted Bank at end (Nov)= ($12 692)
Budgeted Bank at end (Dec)= ($12 544)
17.4 a Net Profit = $22 530
17.5 b Net loss = $3 502
17.6 b Budgeted Bank at end = $9 087
d Net loss = $4 388
g Total assets = $23 387
17.7 b Budgeted Bank at end = $1 060
c Net Profit = $3 888
g Total assets = $180 840

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