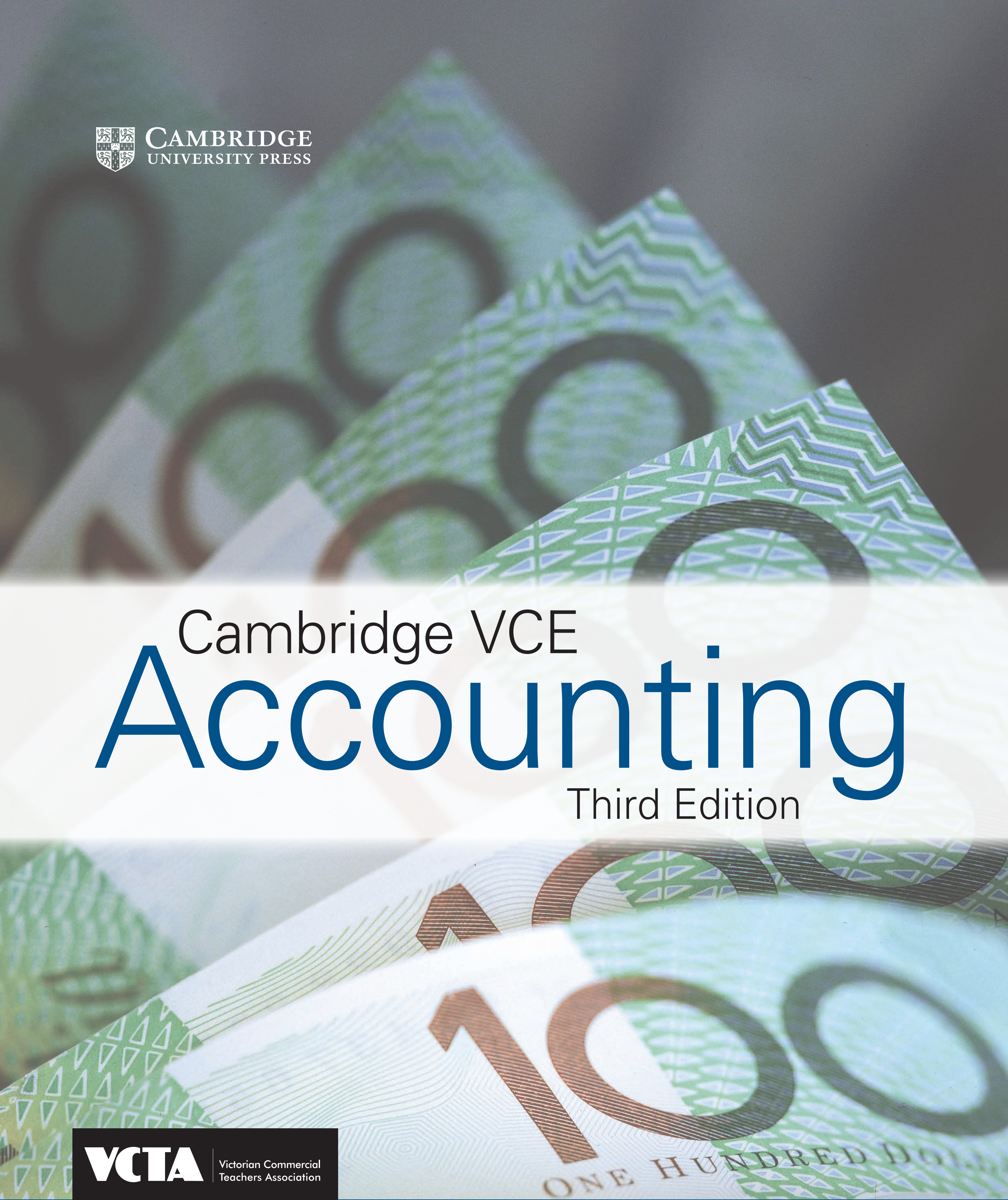

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# Accounting

Third Edition

VCTA Victorian Commercial Teachers Association

Anthony Simmons
Richard Hardy

Units 1&2

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# About the authors

## Anthony Simmons

**Anthony Simmons B.Comm, Dip.Ed, M.Ed (Ed. Management)** is Head of McNab House at Penleigh and Essendon Grammar School. Having spent over 20 years as a teacher of VCE Accounting, he has made important contributions to the understanding of how students learn the discipline and think about Accounting, and how that should influence the way in which the subject is taught. Anthony continues to be involved in all aspects of teaching VCE Accounting, from development of the Curriculum to assessment of student understanding. As evidenced by his involvement in this textbook series, Comview, VCTA professional learning sessions with teachers, student lectures and published articles, Anthony is a leading voice on how Accounting is taught and learned.

## Richard Hardy

**Richard Hardy B.Ec (Accounting), G Dip.Ed, PG EdAdmin, M.Ed (Admin)** is Dean of Academic Administration at Clayfield College. He has taught Accounting for over 20 years and has been a presenter at Comview and VCTA professional development sessions. Richard has also been a VCE Accounting examination assessor and part of the examination writing panel. He continues to instil his passion for Accounting in all of his students.

# Author acknowledgements

Although we have been working on these editions of our textbooks for a year or two, we've been developing our understanding – of both Accounting as well as students and how they learn – for the best part of 50 years between us. And in that time we have had the guidance and support of a whole host of people who, together, have helped these books come into being.

First, we would like to thank our families. Our names might be on the cover but every word herein only exists because of your love, patience and support. You have not only shouldered the extra responsibilities we left every time we sat down to write, but you have given us confidence in our abilities to understand learning, and solve the many challenges that arose along the way. Your names appear in various exercises as a small acknowledgement of your love and support, but to you Kristine and Erin in particular – thank you.

We would also like to thank the school leaders and other teachers at Penleigh and Essendon Grammar School (where we both began this venture), at Balcombe Grammar School and at Clayfield College. These learning communities informed our understanding of how people learn, and this has been a central focus of writing these texts. In particular, we would like to thank Tony Larkin, Matthew Dodd and Kathy Bishop who, as Principals at these schools, provided the leadership that meant we were able to learn from and within great learning communities.

In the world of VCE Accounting our colleagues have provided ideas, feedback and inspiration and for this we thank them all, but especially (in chronological order) Seb Italia, Jacqui Birt, Keith King, Neville Box, Greg Gould, Diana Russo, Sue Lenz, Erin McEwan, Darrell Cruse, Steve Davis, Vicki Baron and Celia Mara. We are also indebted to our students for providing us with insights and feedback (especially when we got it wrong), not to mention inspiration (and not a few names) for the exercises.

Our very special thanks to all the staff at Cambridge University Press: Nick Alexander, Linda Kowarzik, Thuong Du, Amy Robson and our editor Karen Jayne for managing us and the whole project and its various components. Nick – without your gentle pressure applied relentlessly we'd never have finished.

Finally, thank you for choosing this resource. We hope it helps you to understand Accounting as a discipline, and that as a result of using it you are able to think a little bit more like an Accountant, so that your decisions are just a little more informed, and help you in making your own sound financial decisions.

*Anthony and Richard*

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# Foreword

Cambridge Accounting for Units 1 and 2 Third Edition written for the current study design by Anthony Simmons and Richard Hardy, represents an excellent reflection and interpretation of the course. Each chapter follows and collates all the relevant key knowledge into one comprehensive chapter allowing students to gain a complete and in depth understanding of the relationships between the various key knowledge points.

Examples and scenarios provided in each chapter enable students and teachers to be guided as to the process and provide detailed explanations of the whys with links to accounting assumptions, qualitative characteristics and the ever-important new concept of ethical considerations in decision-making.

Above all else, the main features of the original text remain. The layout with margin definitions, study tips and review questions throughout each chapter guide students in their learning and alert them to key information.

I am pleased to be able to recommend this as an excellent resource for VCE Accounting teachers and their students.

Vicki Baron
2018

# Features of this resource

**Chapter openers:** Each chapter opens with a summary of what is to come (*Where are we headed?*) as well as a list of Key terms for you to familiarise yourself with.

**Glossary terms and definitions:** All of the glossary terms in each chapter are defined for you in the margin and in the glossary at the end of the book. The glossary is also marked with page references for ease of use.

**Use of colour:** Colour has been used to make it easy for you to follow particular transactions through the Accounting process. You can simply track what impact a transaction had in the journals, the ledger and in various reports.

**Review questions:** Review questions are placed at the end of each section within each chapter, giving you the opportunity to review and reinforce your understanding as you work through the book.

**Study tips:** Study tips are included in the page margin to draw attention to particular issues, provide a technique for understanding or remembering an element of the course content.

**Ethical considerations:** Ethical considerations are highlighted in the page margin to draw attention to this particular element of the course.

**End of chapter sections:** At the end of each chapter, you will find a chapter summary (*Where have we been?*) and exam-style Exercises, each of which is linked with an icon to the corresponding Workbook proforma.

**Downloadable Exercise proformas:** In the Interactive Textbook you will find downloadable versions of all Review questions, as well as Exercise proformas in both Excel and Word formats.

To access a list of websites and links related to this book, go to:
*www.cambridge.edu.au/vceaccounting12*

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# Role of Accounting in business

# Unit 1

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

Chapter 1

# The nature and role of Accounting in business

## Where are we headed?

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

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 firm. 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 which 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 also 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

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

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- *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 Tax 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.

## 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, cheque butts, 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

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 things 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.

**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

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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:

- 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.

**ethical considerations** the social and environmental consequences of a financial decision

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.

**Study tip**

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

### 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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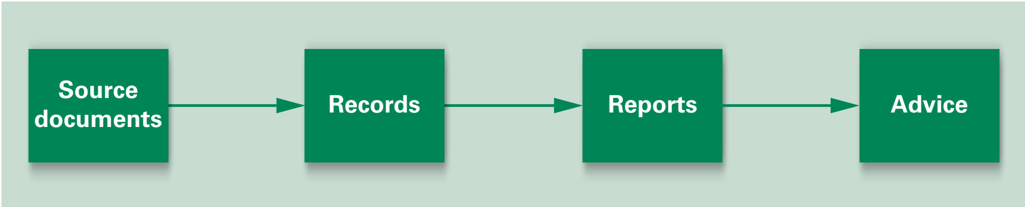
## 1.2 The Accounting process

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




### Stage 1: source documents

Also known as the *input stage*, this is where the business collects the source documents relating to its **transactions**.

**transaction**
an exchange of goods or services with another party for payment

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

**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 EFTPOS and BPay) and Bank Statements* – provide evidence of cash received by the business
- *cheque butts, 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.

EFTPOS is an acronym for Electronic Funds Transfer Point of Sale – which means that when a customer uses a card to make a payment, cash is transferred from their account to the business as soon as the transaction has been processed. 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.

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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.

### Stage 2: recording

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

**recording**
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 on credit)
- *inventory cards*, which record all the movements of inventory (stock) in and out of the business.

### Stage 3: reporting

The *output stage* of the Accounting process 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 he or she can understand. **Reporting** involves the preparation of financial statements that communicate financial information to the owner, so that decisions can be made.

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

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.

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

#### 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. (Have you ever received a cheque?)
3. **State** and **describe** two types of Accounting records.
4. **State** and **describe** three types of Accounting reports.

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**Study tip**

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

## 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** the generally accepted rules that govern the way Accounting information is recorded

**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
- Going concern assumption
- Period assumption
- Accrual basis assumption.

### Accounting entity assumption

**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

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.

### 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

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.

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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.)

**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

## Accrual basis assumption

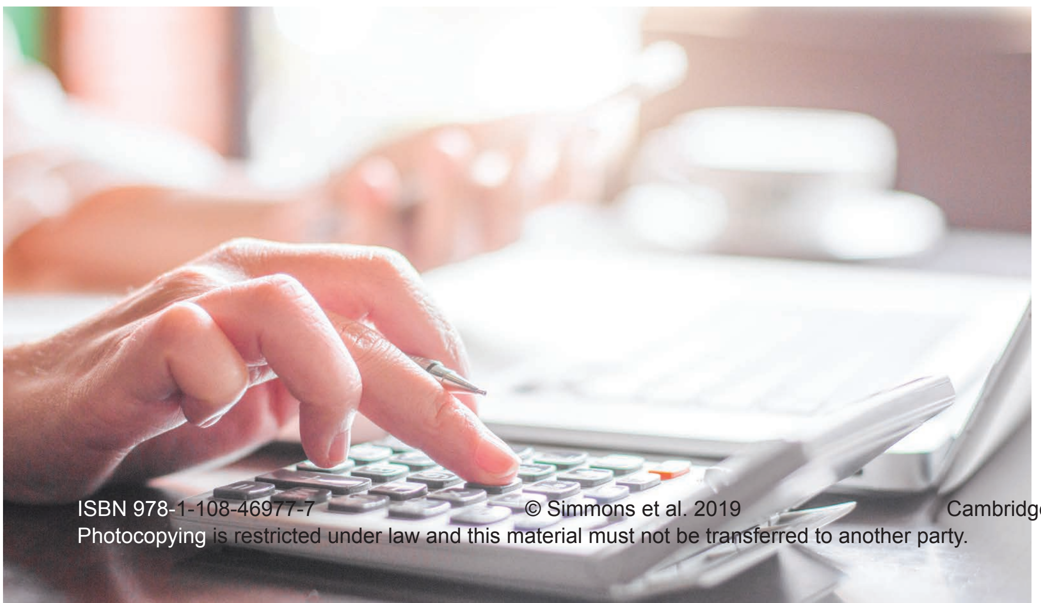
Because it recognises elements of the reports when they meet their respective definitions, the **Accrual basis assumption** will calculate profit by subtracting *expenses incurred* from *revenue earned* in a particular reporting period. Revenue is recognised as earned when the expected inflow of economic 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'.

Importantly, the Accrual basis 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 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.

**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

### 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 also 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

**Study tip**

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

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*.

### Relevance

**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

**Relevance** states that financial information must be capable of making a difference in 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.

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.

**Study tip**

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

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 user's 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 successful 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.

### Faithful representation

**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)

**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 quality 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 based on that information without the fear of being misled.

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## 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.

**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

**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 representation of an 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.

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

## Timeliness

**Timeliness** states that stakeholders must have financial information available in time that is able 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.

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

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

### 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.

#### 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, 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

WB page 3

### The Accounting process

**Reorder** the following stages of the Accounting process:

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

### Exercise 1.2

WB page 4

### The Accounting process

**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

WB page 5

### Accounting assumptions

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 cheque 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 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, 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 revenue but a year's worth of expenditure.

### Exercise 1.4

WB page 7

### Qualitative characteristics

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 2019, the reports were prepared using the modified cash method, but in 2020 the accrual 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 cheque book, 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 2020, Pat was using financial statements from 2016 to 2017 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.

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## Exercise 1.5

WB page 9

### Qualitative characteristics

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*

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

---

## Exercise 1.6

WB page 10

### Accounting assumptions and Qualitative characteristics

During July 2024, 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 2024.

*Required*

**a** Referring to one Qualitative characteristic, **explain** why the owner must not include this transaction in the reports for July 2024.

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

---

## Exercise 1.7

WB page 11

### Accounting assumptions and Qualitative characteristics

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.

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Chapter 2

# The Accounting equation

## Where are we headed?

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 owners' 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

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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.

## 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<br><br>**TOTAL ASSETS** | Liabilities<br>Plus Owner's equity<br>**TOTAL EQUITIES** |

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:

**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

**Figure 2.1** Balance Sheet for a service firm

**HANDSOME HAIR**
**Balance Sheet as at 31 December 2025**

| | $ | $ | | $ | $ |
|---|---|---|---|---|---|
| **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 | 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 2025). This reference to **as at** 31 December 2025 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

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.

**classifying/classification**
grouping together items that have some common characteristic

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 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 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

**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

The same 12 month test applies to liabilities. Items such as obligations to Accounts Payable, which are expected to be settled sometime *in the next 12 months* 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 $3 000 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 2025**

| | $ | $ | | $ | $ |
|---|---|---|---|---|---|
| **Current Assets** | | | **Current Liabilities** | | |
| Cash at Bank | 3 000 | | Accounts Payable | 7 000 | |
| Inventory of shampoo | 9 000 | | Loan – PSA Bank | 3 000 | 10 000 |
| Accounts Receivable | 4 000 | 16 000 | | | |
| | | | **Non-Current Liabilities** | | |
| **Non-Current Assets** | | | Loan – PSA Bank | | 9 000 |
| Fixtures and fittings | | 18 000 | | | |
| | | | **Owner's equity** | | |
| | | | Capital – Henrietta | | 15 000 |
| **Total Assets** | | **34 000** | **Total Equities** | | **34 000** |

In this example, the Loan – PSA Bank for $12 000 has been split between current and non-current liabilities: $3 000 must be repaid in the next 12 months, with the remaining $9 000 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.)

**Study tip**

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

### 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 three 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 2025.
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

**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 2025**

| | $ | | $ |
|---|---|---|---|
| **Assets** | | **Liabilities** | |
| Bank | 16 000 | nil | |
| | | **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 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:

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

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

**Figure 2.4** Balance Sheet (2)

**RUPERT'S ROOF REPAIRS**
**Balance Sheet as at 2 January 2025**

| | $ | | $ |
|---|---|---|---|
| **Assets** | | **Liabilities** | |
| Bank | 16 000 | Accounts Payable – Vic Traders | 23 000 |
| 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 2025**

| | $ | | $ |
|---|---|---|---|
| **Assets** | | **Liabilities** | |
| Bank | 2 000 | Accounts Payable – Vic Traders | 23 000 |
| 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 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)

$$\textbf{Working Capital Ratio (WCR)} = \frac{\textbf{Current Assets}}{\textbf{Current Liabilities}}$$

$$= \textbf{Number of times : 1}$$

**Example**

As at 28 February 2025, 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 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

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

**Example**

As at 30 June 2025, 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

$$\begin{aligned}\textbf{Debt Ratio} &= \frac{\text{Total Liabilities}}{\text{Total Assets}} \times 100 \\ &= \frac{\$170\,000}{\$200\,000} \times 100 \\ &= \textbf{85\%}\end{aligned}$$

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.

### 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.

**Study tip**

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

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### 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

WB page 13

### Assets, liabilities and owner's equity

**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

WB page 14

### Accounting equation

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 $20 000 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

WB page 15

### Accounting equation

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 $3 000 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.

### Exercise 2.4

WB page 16

### Classification

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

**a** Acounts 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

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## Exercise 2.5

WB page 17

### Accounting equation

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

WB page 18

### Classified Balance Sheet

As at 31 May 2025, 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.

*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 2025.
* **c** **Prepare** a classified Balance Sheet for Paris for Hair as at 31 May 2025.
**d** Referring to your answer to part 'c', **explain** your treatment of Office equipment.

## Exercise 2.7

WB page 19

### Classified Balance Sheet

Noel Season is the owner of Noel's Plumbing and has provided the following list of assets and liabilities as at 1 February 2025:

| | |
|---|---|
| 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. 2025) | $20 000 |
| Company vans | $30 000 |
| Accounts Receivable | $1 500 |
| Owner's equity | ? |

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*Required*

* **a** **Prepare** a Balance Sheet for Noel's Plumbing as at 1 February 2025.

**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

W B page 21

### Classified Balance Sheet

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 2025:

| | |
|---|---|
| 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 | ? |

*Required*

**a** **Calculate** Rob's owner's equity as at 31 December 2025.

* **b** **Prepare** a Balance Sheet for Rob's CD Library as at 31 December 2025.

**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

W B page 23

### Transactions and the Accounting equation

Jan Philpott is the owner of Jan's Public Relations and has supplied the following details relating to the firm's transactions for February 2025:

| | | |
|---|---|---|
| Feb. | 1 | Purchased office supplies on credit from EZ Supplies $1 000 |
| | 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 2025 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.

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### Exercise 2.10

W B **page 25**

## Transactions and the Accounting equation

Murray Cook is the owner of Cook's Catering and has supplied the following details relating to the firm's transactions for April 2025:

| | | |
|---|---|---|
| April | 1 | Purchased ingredients worth $3 000 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 $1 200.) |
| | 5 | Borrowed $1 000 from the Patterson Bank |

*Required*

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

**b** Referring to one Qualitative characteristic, **explain** why the transaction on 4 April 2025 results in an increase in Owner's equity.

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

### Exercise 2.11

W B **page 27**

## Working Capital Ratio

As at 30 June 2025, 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 2025.

**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

W B **page 28**

## Debt Ratio

As at 31 January 2025, 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 2025.

**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.

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## Exercise 2.13

WB page 29

### Indicators

Quick as a Flash processes photos and has presented the following report as at 31 May 2025:

**QUICK AS A FLASH**

**Balance Sheet as at 31 May 2025**

| | $ | $ | | $ | $ |
|---|---|---|---|---|---|
| **Current Assets** | | | **Current Liabilities** | | |
| Processing supplies | 3800 | | Accounts Payable | 2000 | |
| Accounts Receivable | 1000 | | Mortgage | 18000 | 20000 |
| Bank | 200 | 5000 | | | |
| | | | **Non-Current Liabilities** | | |
| **Non-Current Assets** | | | Mortgage | | 85000 |
| Imaging equipment | 45000 | | | | |
| Premises | 160000 | 205000 | **Owner's equity** | | |
| | | | Capital – Bright | | 105000 |
| **Total Assets** | | **210000** | **Total Liabilities** | | **210000** |

*Required*

**a** **Calculate** the Working Capital Ratio for Quick as a Flash as at 31 May 2025.

**b** **Comment** on the liquidity of Quick as a Flash as at 31 May 2025.

**c** **Calculate** the Debt Ratio for Quick as a Flash as at 31 May 2025.

**d** **State** one action the owner could take to improve both the Working Capital Ratio and the Debt Ratio.

## Exercise 2.14

WB page 30

### Indicators

Maria Khallouff owns Checked Pages, an editing business, and has provided the following report as at 31 August 2025:

**CHECKED PAGES**

**Balance Sheet as at 31 August 2025**

| | $ | $ | | $ | $ |
|---|---|---|---|---|---|
| **Current Assets** | | | **Current Liabilities** | | |
| Bank | 14000 | | Accounts Payable | 12000 | |
| Accounts Receivable | 6000 | | Mortgage – ANZ | 6000 | 18000 |
| Inventory of materials | 16000 | 36000 | | | |
| | | | **Non-Current Liabilities** | | |
| **Non-Current Assets** | | | Mortgage – ANZ | | 72000 |
| Vehicle | 10000 | | | | |
| Printing equipment | 59000 | | **Owner's equity** | | |
| Land and building | 120000 | 189000 | Capital – Khallouf | | 135000 |
| **Total Assets** | | **225000** | **Total Liabilities** | | **225000** |

*Required*

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

**b** **Calculate** the Working Capital Ratio for Checked Pages as at 31 August 2025.

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

**d** **Calculate** the Debt Ratio for Checked Pages as at 31 August 2025.

**e** After inspecting the Balance Sheet, Maria has decided to use $11 000 cash to purchase another vehicle. **State** the effect (increase/decrease/no effect) of this decision on:

- Working Capital Ratio
- the Debt Ratio.

## Exercise 2.15

WB page 31

## Classified Balance Sheet

The unclassified Balance Sheet for Andrew's Painting Service as at 30 September 2025 showed the following information:

**ANDREW'S PAINTING SERVICE**

**Balance Sheet (unclassified) as at 30 September 2025**

| Assets | $ | Liabilities | $ |
|---|---|---|---|
| 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 Liabilities** | **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 2026) |
| | 3 | Received $400 from an Account Receivable |
| | 4 | Bought more 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 2025.

**b** **Show** the effect on the Accounting equation of each transaction for October 2025.

* **c** **Prepare** a classified Balance Sheet for Andrew's Painting Service as at 8 October 2025.

**d** **Explain** one benefit Andrew will derive by classifying the Balance Sheet.

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Chapter 3

# Business ownership

## Where are we headed?

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
- limited liability
- goodwill
- franchise
- franchisee
- franchisor
- capital gain
- income stream
- term deposit
- bond
- debenture
- security/collateral
- prospectus
- yield
- negative gearing
- capital gains tax
- managed property fund
- share
- dividend
- franking credit
- capital loss
- managed share fund
- rate of return.


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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 Statisitics 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 over 200 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? At the end of 2016–17, there were 2 238 299 businesses operating within Australia of which 868 248 were engaged in employing people other than themselves.

Therefore, there are more than 2.2 million private sector small businesses, and this represents roughly 97% of all private sector businesses.


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| Type of Business | |
|---|---|
| **Non–employing** | **1 370 051** |
| **Employing** | |
| Micro | 608 733 |
| Small | 203 351 |
| Medium | 52 249 |
| Large | 3 915 |
| **Total employing** | **868 248** |
| **Total** | **2 238 299** |

Source: Businesses by employment size range: June 2013 – June 2017, ABS

Small businesses play a vital role in the Australian economy as they employ almost 5 million people, which is almost half of all private sector employment. They also contribute strongly to Australia's level of economic activity and production, and 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.

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### 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).

### 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

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- *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.

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 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 which address specific aspects of running a small business, from food handling and Occupational Health and Safety (OHS) 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, Retail Traders Association.
- *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 also has its own website, which provides a wealth of information in regards 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 questions 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 determines 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 marked-up selling price. Trading businesses sell just about everything including clothing, hardware, CDs and hi-fi equipment, groceries and books, and 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

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 his or her 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 $36 for one year and $84 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.
- 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.

**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 personally liable for the debts of the business

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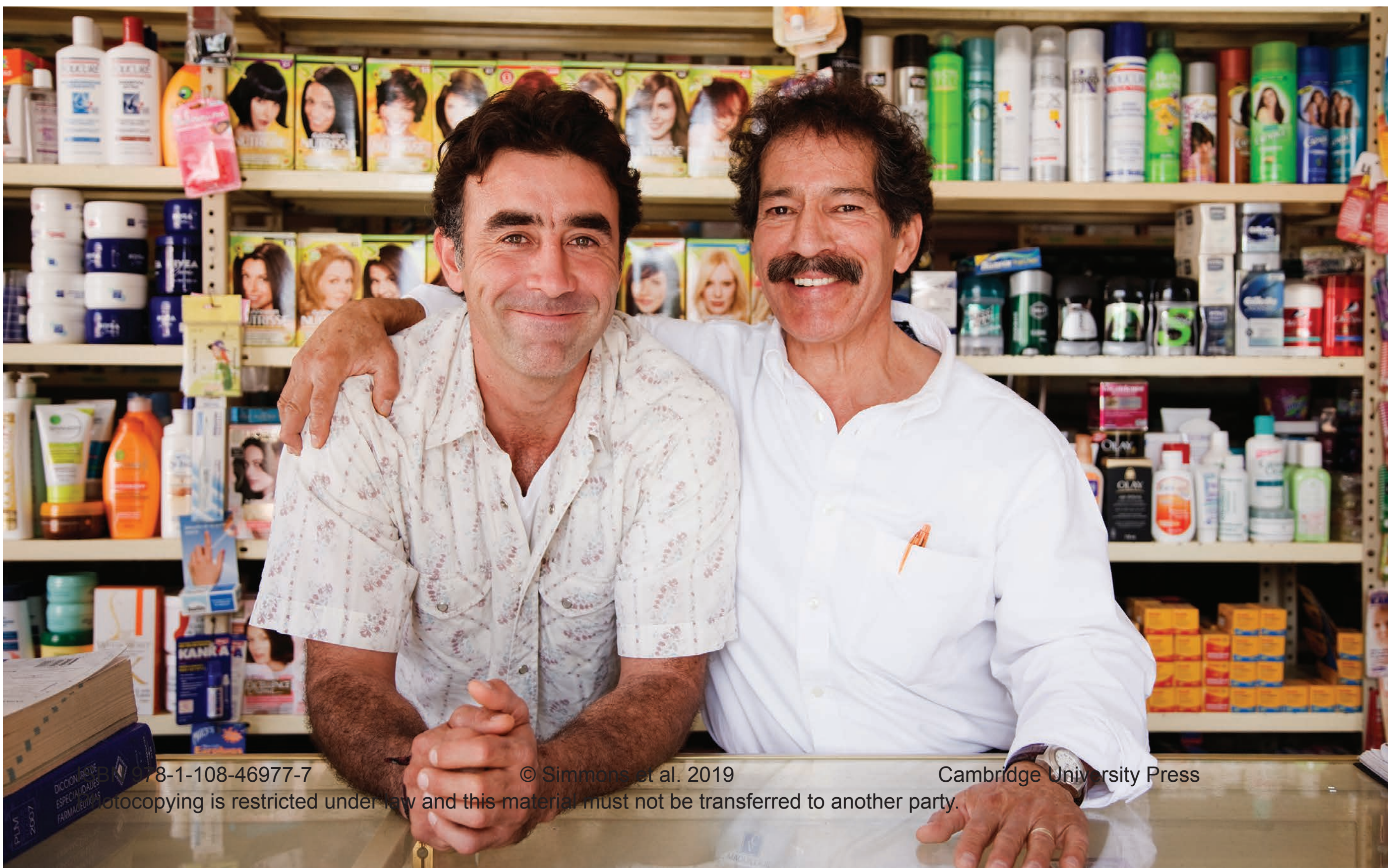
## Partnership

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 *VIC – 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 $84 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.
- 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. It has 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 Musical Inspiration 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 $462 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' (family 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 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.

### 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 financial reports are required to be externally audited or reviewed.
- 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

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.

**Study tip**

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

### Starting a new business

Starting a new business involves starting a new business from scratch, and if there is no business for sale, 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

- 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.

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

#### Disadvantages

- No track record, so greater risk of failure.
- No customer base – could mean low cash inflows in first months 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.

#### 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.

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### 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 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.

### 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.

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## 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 it 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 don't have the required level of expertise; for example, legal or financial matters
  - friendly and fair – when dealing with the public whether employees or customers
  - resilience – the ability to withstand failures, learn from mistakes and resolve issues and move on.

Unfortunately, approximately 80% of all small businesses fail within their first five years of operation, 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!
- **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.


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- **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, 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 80% of small businesses fail in the first five years of operation.

## 3.9 Ethical considerations when commencing a business

**Ethical considerations**

When commencing a business, the owner(s) have decisions to make which will ultimately 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. Recently, some convenience stores have received a lot of negative publicity in regards 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, 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.

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 – 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.

- **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 is 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 stocks 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.


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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).

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

The difficulty is that, 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 rate of return. 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 also has to consider the liquidity of the investment: how easily it can be converted back into cash if the individual needed their funds urgently.

There are three main asset groups that can be used as investment options:

- cash
- property
- shares.

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.

**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

### 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 potential 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 on-call 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 deposit**
an investment option that requires the investor to agree to invest for a specified length of time

**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 three months to five 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.

### Bonds

**bond**
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 rate of interest should exceed the rate paid on the bond then the value of the bond could fall below its face value (purchase price).

### Debentures

**debenture**
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 gearing and risk associated with the company before investing. Because debentures are associated with a higher level of risk, they need to offer a higher rate of return 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.

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### 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).

## Calculating interest

Aside from government bonds, the only return to be gained from investing in cash is the interest earned on the investment. But even in relation to interest there are choices to be made.

### Simple/flat rate interest

This method calculates interest based on the original amount invested. Some term deposits or other investments such as bonds will only pay interest on the face value of the investment (its initial value) and thus interest is kept separate from the investment. Therefore, the investor will receive the same return year after year.

### Compounding interest

This method allows any interest already earned to be added to the original investment amount, so that interest is calculated on the current balance of the investment. In effect, the investor can earn interest on their interest.

**Example**

Allenby Plumbing has $10 000 that Al Allenby is planning to invest for the next 6 years, and Al has found the following investment options:

- QuickFin term deposit 5% p.a. simple interest
- CC Investment account 5% p.a. compounding, paid yearly

The interest earned on each investment is shown in Figure 3.1:

**Figure 3.1** Simple versus compound interest

| | QuickFin term deposit | | CC Investment account | |
|---|---|---|---|---|
| **Year** | **Simple interest** | **Interest earned** | **Compounding interest** | **Interest earned** |
| 1 | 10 000 × 5% | 500.00 | 10 000.00 × 5% | 500.00 |
| 2 | 10 000 × 5% | 500.00 | 10 500.00 × 5% | 525.00 |
| 3 | 10 000 × 5% | 500.00 | 11 025.00 × 5% | 551.25 |
| 4 | 10 000 × 5% | 500.00 | 11 576.25 × 5% | 578.81 |
| 5 | 10 000 × 5% | 500.00 | 12 155.06 × 5% | 607.75 |
| 6 | 10 000 × 5% | 500.00 | 12 762.81 × 5% | 638.14 |
| Total interest earned | | $3 000.00 | Total interest earned | $3 400.95 |

Using simple interest, the interest earned is the same every year, as it calculates interest on the original investment of $10 000. (Any interest earned is paid to another account held by the investor.) However, using compound interest, any interest already earned is added to the initial investment before the next interest calculation is made. This means that as the investment grows, so too does the interest earned. In this example, the CC Investment account has earned $400.95 more interest, because it has earned interest on its interest.

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Obviously, the more times interest is compounded, the greater the effective return an investor could achieve. Had the same \$10 000 been invested at 5% compounded half-yearly, it would mean that interest would be calculated – and compounded – twice a year for 6 years, i.e. 12 times rather than 6. Rather than make 12 calculations, the formula shown in Figure 3.2 can be used to calculate the future value of the investment – its value at the end of the 6 years:

**Figure 3.2** Formula: Future value

**Future value = $P(1 + i)^n$**

where: P = principal: initial amount invested
i = interest rate per compounding period
n = number of compounding periods over the life of the investment

In our example, \$10 000 is being invested, but because the investment is compounding half-yearly, the interest rate per half-year will be 2.5% (half the yearly rate of 5%), and over the 6 years, there will be 12 compounding periods.

Figure 3.3 shows the calculation of the value of the investment at the end of 6 years:

**Figure 3.3** Calculation: Future value

**Future value** = $10\,000\,(1 + 0.025)^{12}$
= \$13 448.89

The total interest earned on the investment is thus \$3 448.89 (\$13 448.89 future value less the \$10 000 initial investment), which is \$47.94 higher, simply by compounding more frequently.

Using a compounding interest rate where the interest is reinvested allows the investor to earn a higher effective interest rate (referred to as the **yield**), and as the rate of compounding increases so does the effective interest earned.

**yield**
the effective interest rate on an investment that pays compounding interest

## 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.
6 **Explain** the difference between simple and compounding interest.
7 **Create** a template in Excel, or another spreadsheet program, which will calculate:
   - simple interest
   - compounding interest
   - future value.
8 **Explain** why more frequent compounding of interest leads to a higher return.

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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.

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### 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 120 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

## 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:

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.

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

### 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.

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## 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

#### 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. Whereas negative screening would highlight companies, for example, involved in mining (e.g. oil, coal or uranium), tobacco, logging and gambling. 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.

### 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

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

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.)

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

### 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 consideration**

## 3.14 Measuring the performance of investments: Rate of Return

The Return on Owner's Investment (ROI) 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 **rate of return** on each of these alternative investments. Figure 3.4 shows the formula to calculate the Rate of Return on an investment:

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

**Figure 3.4** Formula: Rate of Return (ROR)

$$\textbf{Rate of Return (RoR)} = \frac{\textbf{Income/capital gain}}{\textbf{Amount invested}} \times 100$$

Presenting the return in this manner allows different types of investments – with different types of return and different initial investments – to be compared on a common basis.

**Example**

In 2020, Byron's Beds made three separate investments of $10 000 each in:

- a five-year term deposit earning 8% p.a. (simple interest), which by 30 June 2025 had earned $4 000 interest
- a portfolio of Australian shares, which by 30 June 2025 was worth $22 000 (dividends were reinvested in more shares.)
- a managed property fund, which by 30 June 2025 was worth $7 000 (the fund made no dividend payments).

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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 3.5 shows the rate of return on each investment:

**Figure 3.5** Comparing rates of return

| Investment | Income/Capital gain | Rate of Return |
|---|---|---|
| Term deposit | $4000 interest | $4000 / 10000 × 100 = 40% |
| Share portfolio | $22000 current value less $10000 investment = $12000 capital *gain* | $12000 / 10000 × 100 = 120% |
| Managed property fund | $7000 current value less $10000 investment = $3000 capital *loss* | $3000 / 10000 × 100 = (30)% |

Clearly, the share portfolio has earned a higher rate of return, but the level of risk associated with each investment must also be considered. The term deposit has a lower rate of return, 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 3.14

1. **State** the two types of return that can be generated by an investment.
2. **Show** the formula to calculate the Rate of Return.
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% of all private sector businesses, employ almost 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.
- Business 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.
- There are three main asset groups that can be used as alternative investment options to starting a small business: cash, property and shares.
- Compounding interest pays a higher return than simple interest because any interest already earned is added to the initial investment before the next interest calculation is made.
- Investors must consider the correlation between the level of risk and the rate of return, the term, and the liquidity of any alternative investment.

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## Exercises

### Exercise 3.1

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### Business ownership

In 2018, Travis Sands left his job at a call centre to start his own landscape design business called Environ Landscape. 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 2018.

*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

WB page 36

### Nature of operations

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

WB page 37

### Partnerships

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 2018 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.
**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**

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## Exercise 3.4
WB page 38

### Partnerships

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 2020, 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
WB page 39

### Companies

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.

## Exercise 3.6
WB page 41

### Business issues

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.

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## Exercise 3.7

W B page 42

### Business issues

Until 2020, Jane Bronte was employed as a journalist with a local broadsheet newspaper. Although she was quite happy with her job, on 1 December 2020 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 2022, 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 2023. On 1 January 2023, the business purchased $500 worth of books for the library service.

*Required*

**e** **Explain** the nature of the operations of Bronte's Books in January 2023.
**f** **Explain** why the books purchased on 1 January 2023 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 2023.
**h** **Explain** one circumstance in which the books should be reported as a non-current asset as at 31 January 2023.

## Exercise 3.8

W B page 44

### Alternate investments

M. Young has $20 000 which he was planning to invest in starting his own business. Kathy his friend stated he should invest it for 5 years at 6% p.a. simple interest as it was a safer option.

*Required*

**a** **Calculate** the total interest that would be earned on the investment.
**b** **Calculate** the total interest that would be earned on the investment if it was compounding yearly.
**c** **Explain** two factors other than the rate of return that must be considered when evaluating an investment option.

## Exercise 3.9

W B page 45

### Cash investments

At the end of January 2020, Mairead had saved $8 000 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. simple interest. |
| Option 3 | Invest the cash in a term deposit with Bank of Brunswick for five years at 4.8% p.a. compounding yearly. |

*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** **Calculate** the interest earned on Options 2 and 3.
**d** Given that the interest rate is lower, **explain** why the interest earned on Option 3 is higher.

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## Exercise 3.10

WB page 46

### Cash investments

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. compounding quarterly, at call
Option 2 Debenture – 6.5% p.a. simple interest
Option 3 Unsecured note – 7% p.a. compounding yearly

*Required*

**a** **Explain** what is meant by the term 'at call'.
**b** **Calculate** the interest earned on each investment option.
**c** **Explain** one difference between a debenture and an unsecured note.
**d** **State** which option Con should choose. **Justify** your answer.

## Exercise 3.11

WB page 47

### Cash and property investments

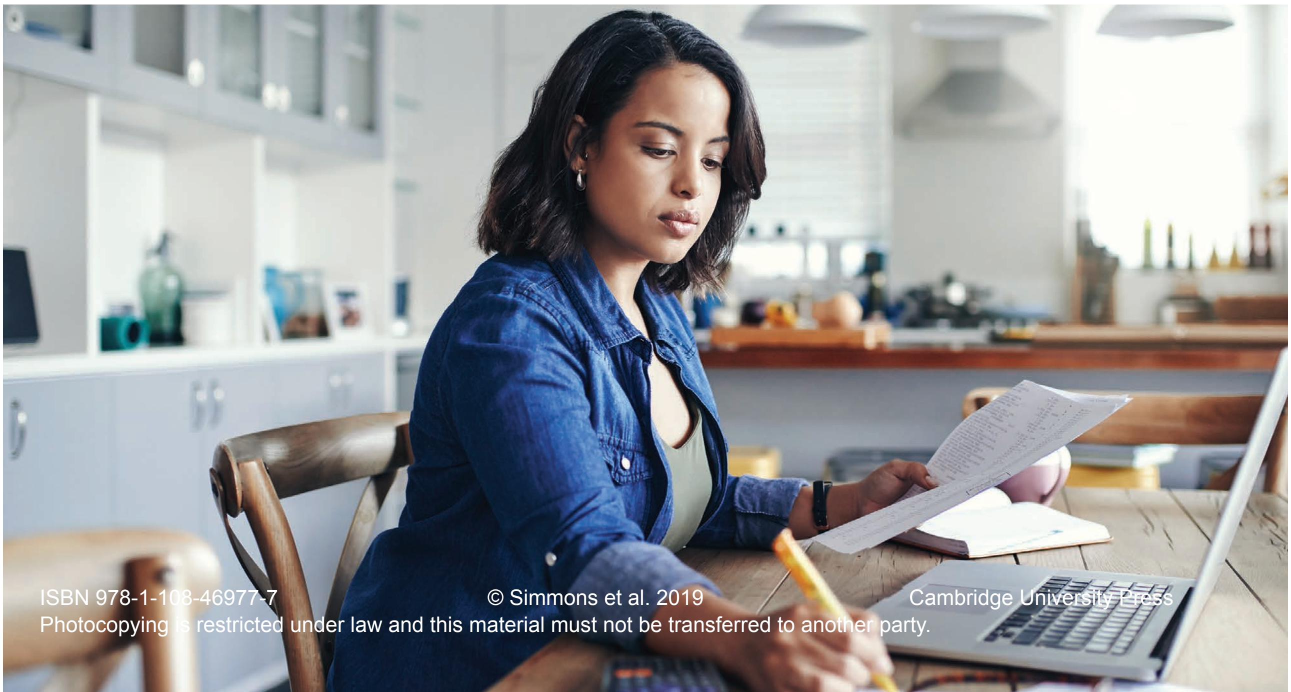
Adeline has saved \$120 000 to commence her own business, Hilltop Art Supplies, her friend states that running your own business is too much hard work and risky, and that she should invest her savings. Adeline's friend gave her the following options to consider:

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

*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.



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### Exercise 3.12

W B page 48

## Property investments

On 1 July 2020, Frank Litzenburg invested $240 000 in property instead of commencing his own business. As at 30 June 2024, the property was worth $300 000.

*Required*

**a** **Calculate** the capital gain on the property.
**b** **Calculate** the Rate of Return on the property:
- over the four years
- per year.

**c** **Explain** why it may be too soon to assess the rate of return 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

W B page 49

## Cash and property investments

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 2024 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 2024 amounted to $15 000). A third option is to invest in a term deposit, which earns 5.6% p.a. simple interest.

*Required*

**a** **Calculate** the Rate of Return Molly would earn on each investment if the businesses were as profitable in 2025 as they were in 2024.
**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.

---

### Exercise 3.14

W B page 51

## Alternate investments

As at 31 December 2020, David Farrugia decided not to commence his own business and put his savings into the following investments:

| | |
|---|---|
| Investment 1 | Government bonds – 5% p.a. simple interest. |
| Investment 2 | Factory – purchased for $150 000 at the start of 2020; worth $162 000 as at 31 December 2021; rental income for 2020 and 2021 was $9 000. |
| Investment 3 | Share portfolio – purchased for $20 000 at the start of 2011; worth $53 000 as at 31 December 2021. |

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 rate of return on each investment 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 of his funds in the shares.

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## Exercise 3.15

WB page 53

### Alternate investments

As at 30 June 2020, Michael Langton had the following investments:

| | |
|---|---|
| Investment 1 | Debentures – $20 000 earning 5% p.a. compounding quarterly |
| Investment 2 | Shares – $90 000 (worth $65 000 one year ago) |
| Investment 3 | Unsecured notes – $80 000 earning 9% p.a. simple interest |
| Investment 4 | Cash management account – $10 000 at 4.5% p.a. compounding monthly |

*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 on each investment for the year ended 30 June 2020.
- **d** **Calculate** the rate of return on each investment for the year ended 30 June 2020.
- **e** **Explain** one benefit of a diversified investment portfolio.
- **f** **Explain** one weakness in the way Michael has structured his investment portfolio.
- **g** **Explain** two benefits Michael would derive by selling 50% of his shares and investing the proceeds in his friend's business, a well-established business, which is looking to expand and is currently returning 20% on capital invested.
- **h** Referring to your answer to part 'g', **state** one disadvantage of this course of action.
- **i** **Advise** an alternate 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

## Where are we headed?

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** interest for simple and reducing balance loans
- **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
- simple interest
- reducing balance interest
- 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** 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.

**internal finance**
funds generated by and within the firm

#### Capital contribution

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.

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

Advantages:

- no set repayment date
- no interest charge

Disadvantages:

- limited to the resources of the owner

#### Retained earnings

**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 drawings, this will mean that most profits are retained, providing a source of finance for other activities.

**retained earnings**
an internal source of finance consisting of funds generated from business profits that are not taken as drawings by the owner

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**
funds generated from sources outside the business

**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.

### Trade credit

**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

**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** (sometimes known as a 'creditor') 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 which accompanies the goods/services.

Advantages:
- allows immediate access to goods/services
- allows businesses time to generate sales before payment is required
- no interest charge if credit terms are met
- discounts are available from some suppliers for early payment

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

### Bank overdraft

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

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 (normally attached to a cheque account) 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.

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 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.

**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

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

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.

**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

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 which is used to calculate the interest charge is also important. (This will be covered later in this chapter.)

### 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 which 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 a firm's 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:*
  - Statement of Receipts and Payments 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.

### 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:
   - Statement of Receipts and Payments
   - Income Statement
   - Balance Sheet.

## 4.4 Calculating interest

As was noted earlier, the interest charge represents the cost of borrowing, and should be a key consideration in selecting finance. But it is not only the *rate* of interest which must be considered, the *method* for calculating interest is also important.

**simple interest**
interest calculated as a percentage of the original amount borrowed

### Simple interest (flat rate)

**Simple interest** calculates the interest charge on the original amount borrowed, regardless of how much of the principal has been repaid.

**Example**

Hawkesburn Fencing has agreed to borrow $12 000 from Yarra Bank, with interest charged at a flat rate of 6% p.a. The loan will be repaid over five years.

**Figure 4.1** Formula: Interest charge

**Total interest charge = P × I × T**

where:

| | | | |
|---|---|---|---|
| **P** | = | Principal | (the original amount borrowed) |
| **I** | = | Interest rate | (%) |
| **T** | = | Time | (measured in years) |

Therefore, the total interest charged over the 5 years would be:

**Figure 4.2** Calculation: Interest charge

**Total interest charge** = P × I × T
= $12 000 × 6% × 5 years
= $3 600

**Study tip**

An interest rate of 8% is really 8/100, which equals 0.08: make sure that you get the decimal point in the right place!

The total interest charge on this loan is thus $3 600. Therefore, the total amount that needs to be repaid by the business to the lender is:

**Figure 4.3** Calculation: Total repayable

**Total repayable** = Principle + Interest
= $12 000 + $3 600
= $15 600

That is, the borrower must repay a total of $15 600, which includes the principal of $12 000 and interest of $3 600.

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Assuming equal repayments are made every month:

**Figure 4.4** Calculation: Instalments

$$\textbf{Instalments} = \frac{\text{Total repayable}}{\text{Number of instalments}}$$
$$= \frac{\$15\,600}{12 \text{ per year} \times 5 \text{ years}}$$
$$= \frac{\$15\,600}{60}$$
$$= \textbf{\$260 per month}$$

Each **$260** monthly instalment will include some of the principal, and some interest.

**Study tip**

A flat rate loan does not mean there will be no instalments: it means the lender ignores those repayments when calculating interest.

### Increasing the term

Should the loan be taken out over a longer period, the interest charge may well increase, but the amount of each instalment will probably decrease. Assuming the loan was taken out over 10 years rather than 5 years:

**Figure 4.5** Calculation: Increasing the term

$$\textbf{Total interest charge} = \$12\,000 \times 6\% \times 10 \text{ years}$$
$$= \textbf{\$7\,200}$$
$$\textbf{Total repayable} = \$12\,000 + \$7\,200$$
$$= \textbf{\$19\,200}$$
$$\textbf{Instalments} = \frac{\$19\,200}{12 \text{ per year} \times 10 \text{ years}}$$
$$= \frac{\$19\,200}{120}$$
$$= \textbf{\$160 per month}$$

Rather than repaying **$260** per month for 5 years, this option allows the business to repay **$160** per month, for 10 years. The longer the term, the lower the monthly repayments will be; however, the overall interest paid is greater. The business must assess how much it can repay per month, and then set the term of the loan accordingly.

## Reducing balance

Whereas a simple interest loan calculates interest as a percentage of the *original amount borrowed*, regardless of any repayments that have been made, a **reducing balance loan** calculates interest on the *actual balance owing* at that particular date.

**reducing balance interest** interest calculated as a percentage of the current balance owing on the loan

**Example**

Hawkesburn Fencing has agreed to borrow $12 000 from Yarra Bank, with interest charged at 6% p.a. *reducing yearly*. The loan will be repaid over 5 years.

In this example, 'reducing yearly' means that interest will be calculated on the principal remaining at the *end of each year*. Therefore 5 interest calculations (5 years × 1 interest calculation per year) will be required, and it will be necessary to calculate the balance

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owing at the end of every year. Assuming the borrower makes equal repayments off the principal (as well as paying off the interest for that year):

**Study tip**

As long as the borrower is making repayments off the principal, the amount owing will be lower than the amount borrowed, meaning that the interest charge on a reducing balance loan should be lower than that charged on a simple interest loan.

**Figure 4.6** Calculation: Equal instalments off the principal

$$\textbf{Principal instalments} = \frac{\text{Principal}}{\text{Total number of instalments}}$$

$$= \frac{\$12\,000}{12\text{ per year} \times 5\text{ years}}$$

$$= \frac{\$12\,000}{60}$$

$$= \textbf{\$200 per month}$$

Note that this figure is lower than the instalment calculated in Figure 4.3, because it doesn't include any interest. In 12 months, the borrower will make 12 such repayments meaning that the balance owing, and the amount on which the interest is calculated, will reduce by $2 400 each time interest is calculated.

**Figure 4.7** Reducing balance interest

| | | | |
|---|---|---|---|
| Year 1 | $12 000 × 6% × 1 year | = | $720 |
| Year 2 | $9 600 × 6% × 1 year | = | $576 |
| Year 3 | $7 200 × 6% × 1 year | = | $432 |
| Year 4 | $4 800 × 6% × 1 year | = | $288 |
| Year 5 | $2 400 × 6% × 1 year | = | $144 |
| | **Total Interest Charge** | = | $2 160 |

Note that it is the frequency at which the loan is *reducing* that determines the number of interest calculations and the amount of interest on the loan, not the number of repayments. The number of repayments shows how much and how often loan payments are made:

| Number of times reducing | Interest calculations per year | Each calculation must be multiplied by |
|---|---|---|
| Yearly | 1 | 1 |
| Half yearly | 2 | $\frac{1}{2}$ |
| Every four months | 3 | $\frac{1}{3}$ |
| Quarterly | 4 | $\frac{1}{4}$ |
| Monthly | 12 | $\frac{1}{12}$ |

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Obviously, the more often interest is calculated on a lower principal the less the overall interest charge will be. The total amount repayable and the amount of each instalment would thus be:

**Figure 4.8** Calculation: Total repayable and instalment amount

$$\textbf{Total repayable} = \$12\,000 + \$2\,160$$
$$= \$14\,160$$
$$\textbf{Instalments} = \frac{\$14\,160}{12 \text{ per year} \times 5 \text{ years}}$$
$$= \frac{\$14\,160}{60}$$
$$= \textbf{\$236 per month}$$

Comparing the flat rate and reducing balance loans, both at 6% p.a., reveals the following:

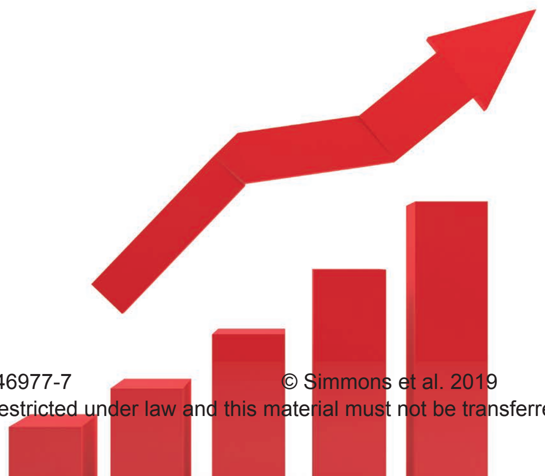
**Figure 4.9** Comparison of flat and reducing balance interest

| Reducing balance | | Flat rate | |
|---|---|---|---|
| **Year** | **Interest** | **Year** | **Interest** |
| 1 | 720 | 1 | 720 |
| 2 | 576 | 2 | 720 |
| 3 | 432 | 3 | 720 |
| 4 | 288 | 4 | 720 |
| 5 | 144 | 5 | 720 |
| **Total** | $2 160 | **Total** | $3 600 |

The reducing balance loan is much cheaper as it calculates interest on the amount owing at the time, whereas the simple interest loan always calculates interest on the original (principal) amount borrowed.

## Review questions 4.4

1. **Explain** the difference between a simple interest loan and a reducing balance loan.
2. **State** one cost and one benefit of taking out a loan over a longer period.
3. **Explain** how a reducing balance loan can be modified to reduce the amount of interest paid.
4. **Explain** why the interest charge on a simple interest loan is likely to be higher than the interest charge on a reducing balance loan.



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## 4.5 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 4.10 shows the formula to calculate the Debt Ratio:

**Figure 4.10** Formula: Debt Ratio

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

**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 4.11:

**Figure 4.11** Calculation: Debt Ratio

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

This means 75% of the finance used to purchase the assets 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.

### 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.

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**Review questions 4.5**

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.

## 4.6 Debt Ratio and Return on Owner's Investment

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 4.12 shows the formula to calculate the 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

**Figure 4.12** Formula: Return on Owner's Investment

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

**Example**

The owner of Glendale Plumbing has provided the following information:

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

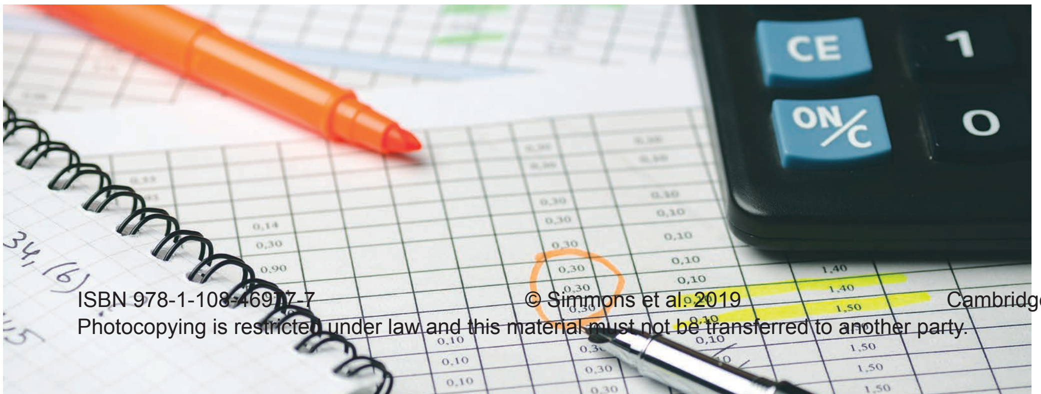
The Return on Owner's Investment would be calculated as is shown in Figure 4.13:

**Figure 4.13** 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 on 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 2025:

| | 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% |

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 4.6

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.
- A simple interest loan calculates the interest charge on the original amount borrowed, regardless of how much of the principal has been repaid.
- A reducing balance loan calculates the interest charge on the actual balance owing at that particular date.
- 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 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

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### Sources of finance

In 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 – 2 years)
- **d** wages
- **e** vehicle (modifications necessary)
- **f** GST settlement
- **g** franchise license (start-up).

### Exercise 4.2

WB page 58

### Sources of finance

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

WB page 59

### Sources of finance and interest

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 – 10% flat interest rate
- lease – $100 per week for five years.

*Required*

- **a** **State** one advantage of using the loan as a source of finance.
- **b** **Calculate** the total amount of interest that would be paid on the loan.
- **c** **Explain** why the interest rate is effectively higher than 10%.
- **d** **Calculate** the overall cost of using the loan if the vehicle is sold after five years.
- **e** **Calculate** the cost of leasing the vehicle over the five-year period. **Show** all workings.
- **f** **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

WB page 60

### Sources of finance and interest

Gigantor Gym has decided to borrow $3600 to finance the purchase of new equipment. The loan is to be repaid over two years with equal repayments being made quarterly. The owner has discovered three loan options:

- 16% p.a. simple interest
- 16% p.a. reducing annually
- 16% p.a. reducing quarterly.

*Required*

**a** **Calculate** the number of instalments that will be made over the life of the loan.

**b** **Calculate** how much of the principal will be repaid each quarter.

**c** For each loan option, **calculate**:
  - the total interest charged
  - the total amount repaid
  - the amount of each instalment.

---

## Exercise 4.5

WB page 61

### Interest

Speedy Deliveries has decided to buy a delivery van and found the following loan options available if the business borrowed $24000 for two years, with equal repayments every month, if interest is calculated at:

- 12% p.a. simple interest
- 12% p.a. reducing half yearly
- 12% p.a. reducing every four months.

*Required*

**a** **Calculate** the number of instalments that will be made over the life of the loan.

**b** **Calculate** how much of the principal will be repaid each month.

**c** For each loan option, **calculate**:
  - the total interest chargd
  - the total amount repaid
  - the amount of each instalment.

---

## Exercise 4.6

WB page 62

### Sources of finance and interest

Voracious Vines is seeking to expand by purchasing a new van. The van will require modification to ensure the safe transport of the owner's plants, and (including the modifications) it is expected to cost $30000. After some investigation, the owner has identified the following financing options:

- retained earnings
- three-year term loan from the ANZ at 8% p.a. simple interest
- three-year term loan from the nab at 10% p.a. reducing half yearly.

*Required*

**a** **State** one limitation of using retained earnings as a source of finance.

**b** **Calculate** the total amount of interest that would be paid on each of the loans.

**c** **Explain** why the total interest charge on the nab loan is lower than the ANZ loan.

**d** **Explain** one reason why it may be inappropriate to use a lease to obtain the van.

---

### Exercise 4.7
WB page 63

## Sources of finance and interest

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 – 10% p.a., reducing yearly.

*Required*

**a** **State** one advantage and one disadvantage of using the 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** **Calculate** the total amount of interest that would be paid on the loan.
**e** **Calculate** the total cost of the loan over the four-year period.
**f** Referring to the information provided, **explain** why the cheapest option is not necessarily the most suitable.

### Exercise 4.8
WB page 65

## Debt Ratio

As at 31 December 2025, 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 2025.
**c** **Explain** why a high Debt Ratio indicates high risk.
**d** **State** the effect on Debt Ratio if Holding Architecture purchases new equipment using:
- a capital contribution
- external finance.

### Exercise 4.9
WB page 66

## Debt Ratio and Return on Owner’s Investment

As at 1 January 2025, Feline Grooming had Owner’s equity worth $75 000. The firm’s Balance Sheet as at 31 December 2025 revealed the following:

| | |
|---|---|
| Total Assets | $125 000 |
| Total Liabilities | $40 000 |
| Profit (for 2025) | $10 000 |

*Required*

**a** **Calculate** the Debt Ratio of Feline Grooming as at 31 December 2025.
**b** **Calculate** the Return on Owner’s Investment (ROI) for Feline Grooming for 2025.
**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.

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## Exercise 4.10

WB page 67

### Debt Ratio and Return on Owner's Investment

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 he achieved a Return on Owner's Investment of 20% in the last financial year. The Balance Sheet as at 31 March 2025 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 2025) | $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 2025.

**c** **Calculate** the Return on Owner's Investment (ROI) for Woodie's Tree Surgeons for the quarter ending 31 March 2025.

**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 4.11

W B page 68

### Sources of finance, interest and Debt Ratio

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 2025, the firm had the following assets and liabilities:

**TRAVELLER'S FRIEND**

**Balance Sheet as at 30 June 2025**

| | $ | $ | | $ | $ |
|---|---|---|---|---|---|
| **Current Assets** | | | **Current Liabilities** | | |
| Accounts Receivable | 6 500 | | Bank overdraft | 6 000 | |
| GST receivable | 300 | | Accounts Payable | 1 000 | |
| Inventory of brochures | 200 | 7 000 | Mortgage – nab | 3 000 | 10 000 |
| | | | | | |
| **Non-Current Assets** | | | **Non-Current Liabilities** | | |
| Vehicle | 26 000 | | Mortgage – nab | | 44 000 |
| Computer equipment | 5 000 | | | | |
| Premises | 82 000 | 113 000 | **Owner's equity** | | |
| | | | Capital – Avalon | | 66 000 |
| **Total Assets** | | **120 000** | **Total Equities** | | **120 000** |

**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 $12 000.

*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 2025.
**d** Referring to your answer to part 'c', **explain** whether this WCR 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 2025.

Imelda has decided to obtain a new computer network at a cost of $8 000 and has identified the three best options as:

| | |
|---|---|
| Option A | Lease the computer network at a cost of $35 per month for two years. |
| Option B | Borrow $8 000 from St Jim Finance at 7% p.a. (reducing every six months), with equal repayments every six months for two years. |
| Option C | Make a capital contribution of $8 000 cash. |

*Required*

**g** **Calculate** the total cost of the lease in Option A.
**h** **Calculate** the total interest charge in Option B.
**i** **Explain** the effect of Option B on the Return on Owner's Investment of Traveller's Friend.
**j** **Explain** the effect of Option C on the Debt Ratio of Traveller's Friend.
**k** **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

## Where are we headed?

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:

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


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## 5.1 Pricing and profit

Once a firm has been legally established, has organised its finance and 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.

### 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.

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

**Example**

Mark Griggs has decided to leave paid employment to go into business. As a grounds keeper 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 are 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

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

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 be inclusive, that is include, GST.

### Competitors' prices

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

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 cheaper 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.

### Market reaction

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

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 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.)

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**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

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.

**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

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.


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**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.

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** |

**Study tip**

Obviously, the quote would not disclose the owner's desired profit, as this would be the first item the customer would want to renegotiate!

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

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:

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

**Figure 5.3** Formula: Applying a percentage mark-up

**Selling price = Cost price × (1 + mark-up/100)**

**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

**Mark-up price** = $30 × (1 + 50/100)
= **$45**

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


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**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!

The final selling price would be determined as follows:

**Figure 5.5** Calculation: Selling price

**Selling price** = mark-up price + 10% 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.

## 5.5 Cost-volume-profit analysis

**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

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 neither makes a profit nor a loss – profit is zero.)

### 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** costs that vary directly with the level of activity

**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.

#### Fixed costs

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

**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

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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 allows for the production and sale of 100 units per month and then he or she wants to expand production and sales to 200 units per month, they will have to upgrade to a bigger premises. This will result in a changed cost.

**Study tip**

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

## Cost-volume-profit formula

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

**Figure 5.6** Formula: Cost-volume-profit

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

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 equal 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.)

**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

**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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**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.

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.

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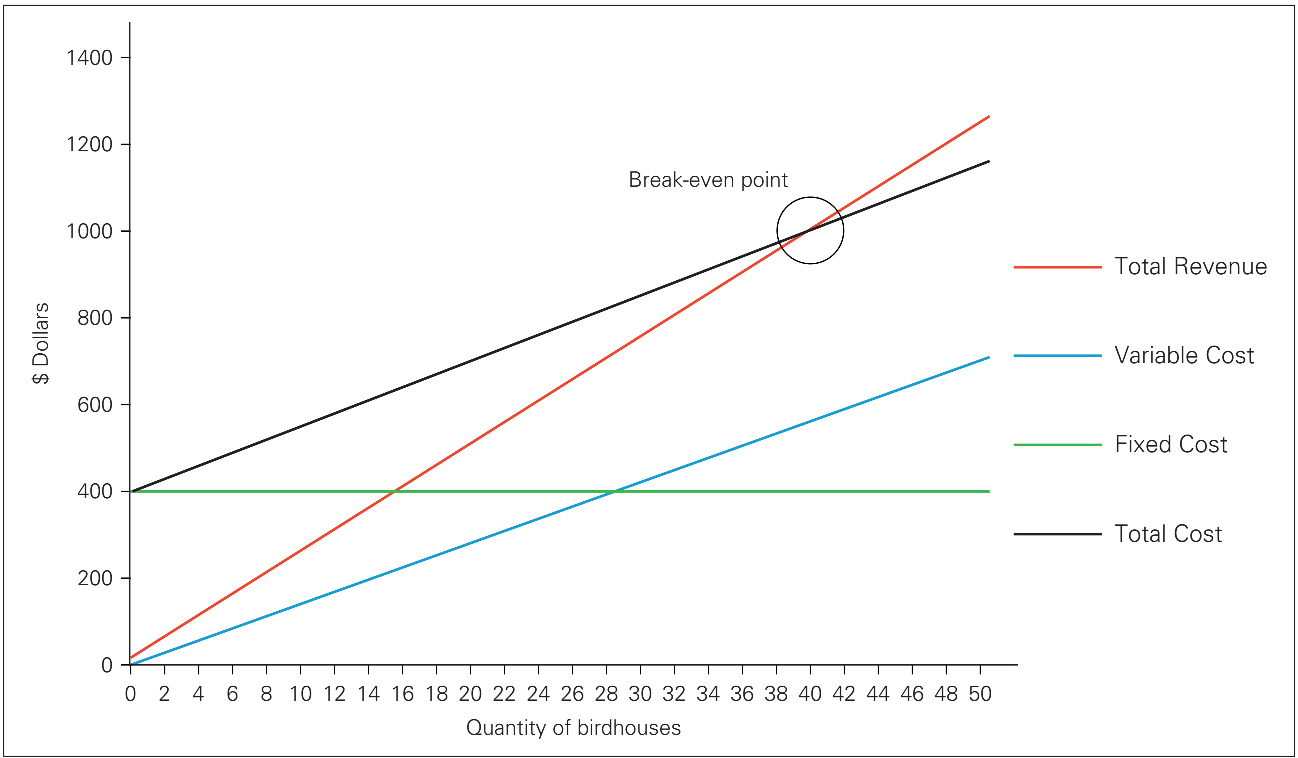
This can be highlighted graphically as shown in Figure 5.10:

**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 which 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

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

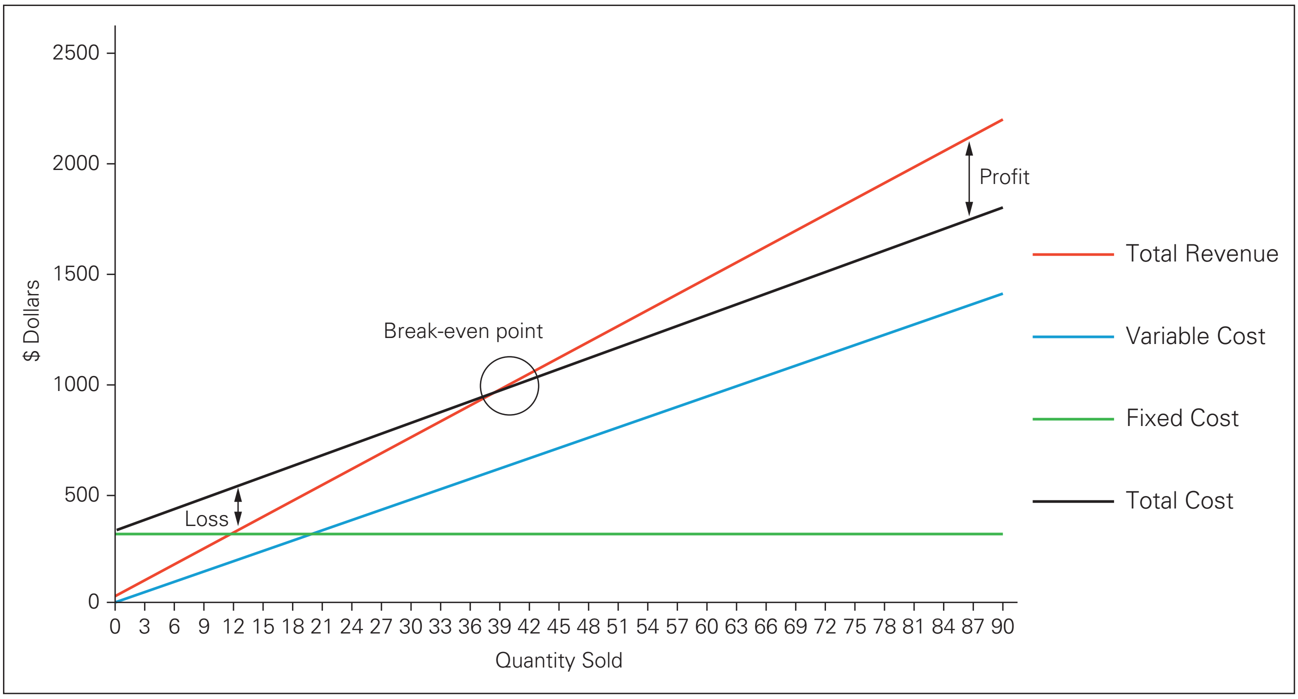
$$= \frac{\$900}{\$10}$$

$$= 90 \text{ birdhouses}$$

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

As shown below:

| Variable Costs | | | Fixed Costs | |
|---|---|---|---|---|
| Timber | 9 | | Rent | 300 |
| Varnish & Paint | 4 | | Hire | 60 |
| Nails, screws & Handle | 2 | | Transport | 40 |
| | | | | |
| | | | | |
| | 15 | | | 400 |
| | | | | |
| | | | | |
| Selling Price | 25 | | | |
| Desired Profit | | | | |
| | | | | |
| | | | | |
| Break Even / Profit Point | 40 | Units | | |

**Study tip**

To show all formulas in Excel, press CTRL + ~ (tilde). Do this again to return to numbers.

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 | | |

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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 |

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 won't 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 don't 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 |

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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 provides 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

$$50 = \frac{\$400 + \$500}{\text{Selling price} - \$15}$$

$$(\text{Selling price} - \$15) \times 50 = \$900$$

$$\text{Selling price} - \$15 = \frac{\$900}{50}$$

$$\text{Selling price} - \$15 = \$18$$

$$\text{Selling price} = \$18 + \$15$$

$$= \$33 \text{ per birdhouse}$$

**Study tip**

As a short cut, 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 2025. 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 2025**

| | $ | $ |
|---|---|---|
| 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** |

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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.

## 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 he or she wants 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

WB page 71

### Quotes

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

WB page 72

### Quotes

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 $3 200 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.

## Exercise 5.3

WB page 73

### Quotes

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

WB page 74

### Percentage mark-up

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%

  (You may wish to present this information as a table.)

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

---

## Exercise 5.5

WB page 75

### Percentage mark-up

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 include GST.
**d** **Explain** why not all businesses can use a percentage mark-up to set selling prices.

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## Exercise 5.6

WB page 76

### Cost-volume-profit analysis

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 5 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

WB page 78

### Cost-volume-profit analysis

Molly Sprout earned $8400 a year as a part-time florist, but her passion is pottery so at the end of 2024 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 ten (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

WB page 80

### Cost-volume-profit analysis

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.)

*Required*

**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.

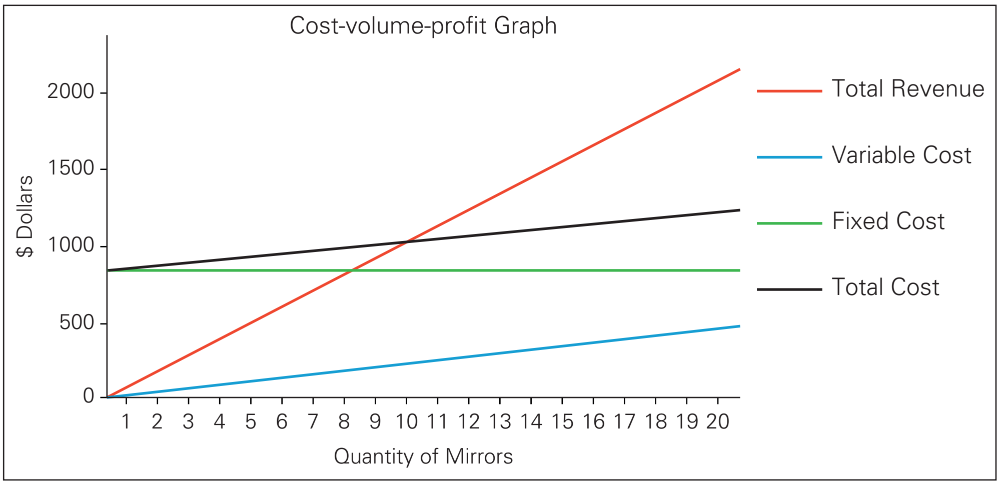
## Exercise 5.9

WB page 82

### Cost-volume-profit graphs

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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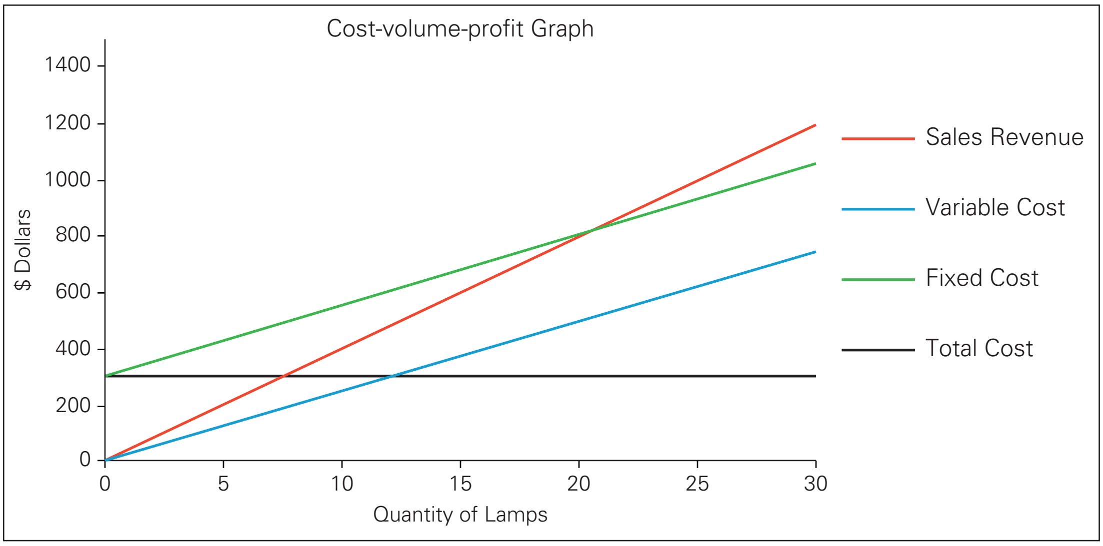
## Exercise 5.10

WB page 83

## Graphical representations

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.

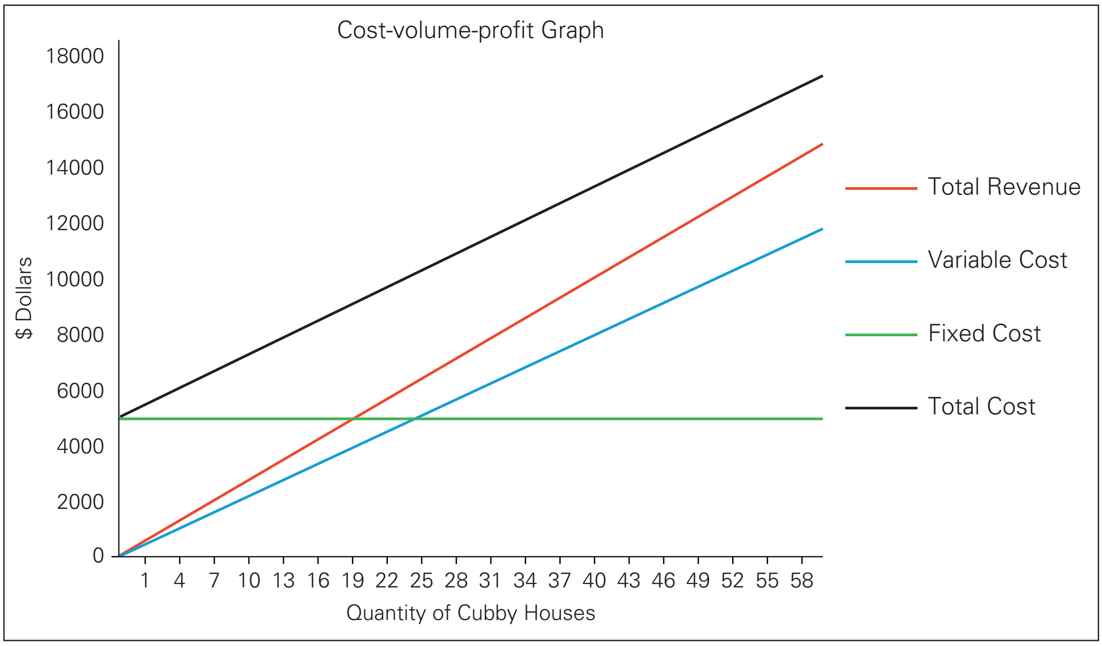
## Exercise 5.11

WB page 84

## Graphical representations

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

## Exercise 5.12

WB page 85

## Income Statement

Kapila Neelaweera is the owner and operator of Candle Power, a small business that sells candelabras. The Income Statement for April 2025 showed the following:

**CANDLE POWER**

**Income Statement for April 2025**

| | $ | $ |
|---|---|---|
| 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 2025.

**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.

*Required*

**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

WB page 86

### Income Statement

Wally White operates Flying High, a kite shop in the windy northern suburb of Greenvale and has provided the following Income Statement for May 2025:

**FLYING HIGH**
**Income Statement for May 2025**

| | $ | $ |
|---|---|---|
| Sale of kites | 1800 | |
| Less Cost of kites | 1000 | |
| **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 2025 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 Wally in May 2025.
- **g** Wally has been notified that the rent on the shop will be $400 a month as from 1 June 2025 and that wages will increase by 5% from that date. **Calculate** how many more kites have to be sold in order to break even. (Assume that the selling price remains the same.)

## Exercise 5.14

WB page 88

### Cost-volume-profit analysis

Jerome Wishart makes garden benches from his home under the imaginative business name of Jerome's Garden Furniture. The Income Statement for January 2025 showed the following:

**JEROME'S GARDEN FURNITURE**
**Income Statement for January 2025**

| | $ |
|---|---|
| Sales revenue | 15000 |
| Less Total variable costs | 6000 |
| **Variable Profit** | **9000** |
| **Net Profit** | **2000** |

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 2025.
- **c** **Calculate** the number of benches sold in January.

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Projections for February 2025 suggest that variable costs will remain at $40 per bench, but that 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.

*Required*

**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 2025 to break even.
**g** **Calculate** how many more benches the firm must sell in February 2025 to earn the desired profit.
**h** Assuming that the firm can sell 100 benches, **prepare** an Income Statement for February 2025.
**i** Assuming that Jerome could sell 60 benches and all other costs remained the same, **calculate** the selling price that would need to be charged to break even.

## Exercise 5.15

WB page 90

## Cost-volume-profit analysis

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.

*Required*

**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

## Where are we headed?

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
  – cheque butt
  – Bank Statement
  – 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
- drawee
- drawer
- payee
- not negotiable
- cheque butt
- Bank Statement
- invoice (sales/purchase)
- credit note
- Statement of Account
- delivery docket
- shipping and order confirmation
- memo.


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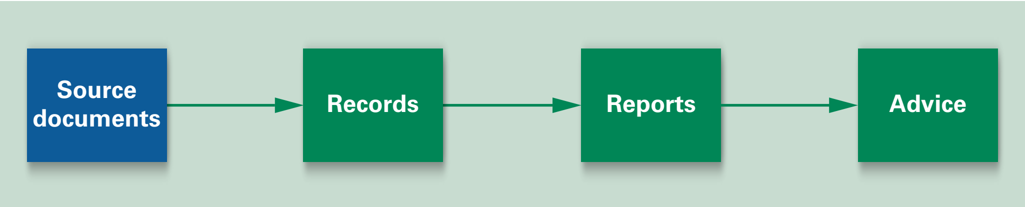
## 6.1 The role of source documents

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 Tax Office relating to the firm's income tax and Goods and Services Tax obligations.

### Storing source documents

Because of their importance, source documents must be stored and filed in a safe and organised manner. 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. 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 hard copies of documents they have been sent by suppliers and other trading partners.

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## The Goods and Services Tax

**Goods and Services Tax (GST)**
a 10% tax levied by the federal government on sales of goods and services

One of the more recent challenges for owners of small businesses has been the introduction of the **Goods and Services Tax (GST)**, which applies to most goods (except fresh food) and 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.

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

**tax invoice**
a source document that contains specific information required by the ATO to substantiate GST amounts

The source document used to verify a transaction involving the 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.)

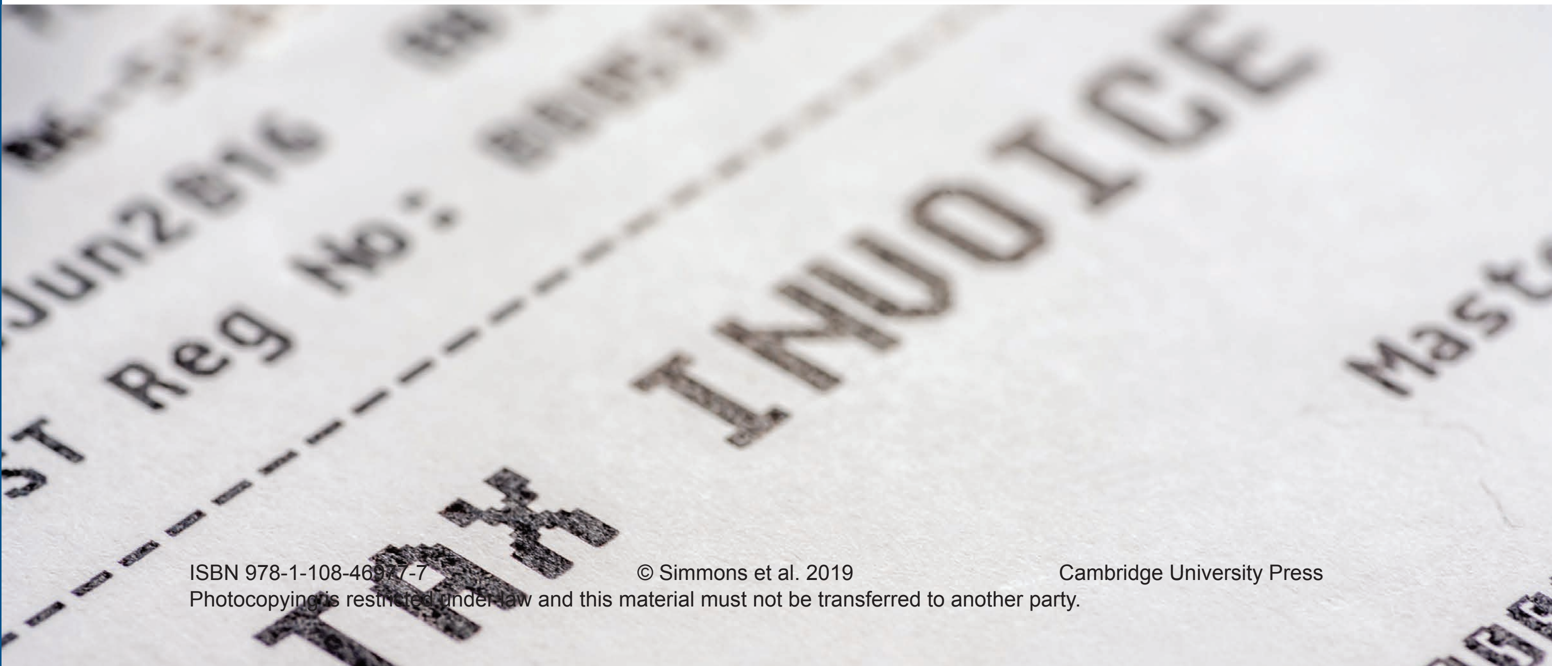
Without these details, the source documents cannot be used to substantiate GST transactions, and the business may end up paying to the ATO more GST than is required.

**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.

**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.

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## 6.2 Evidence of cash transactions

The vast majority of the transactions of a small business will be conducted in cash, 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 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. With improving 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.

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 above for tax invoices. In most cases, the customer will be given the original, while the business will retain a copy for its own records.

**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

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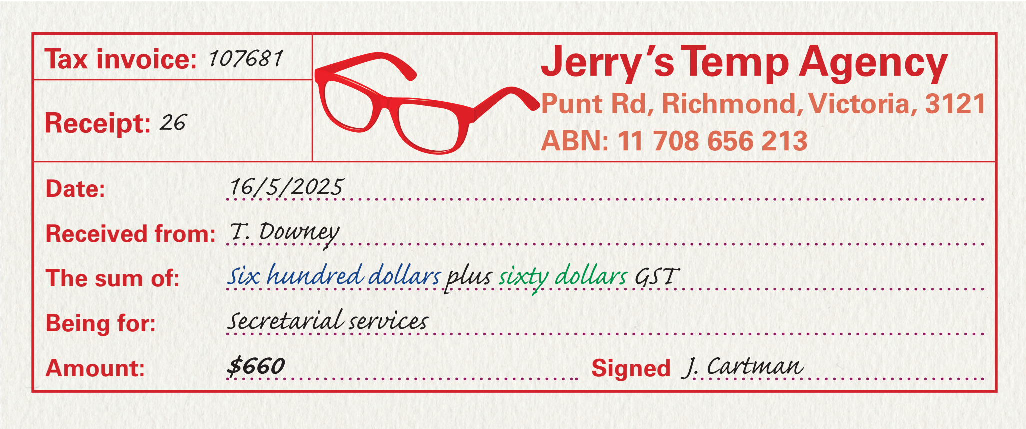
**Example**

On 16 May 2025, Jerry's Temp Agency provided a secretary for the week to T. Downey – Lawyer for $600 plus $60 GST (Rec. 26.)

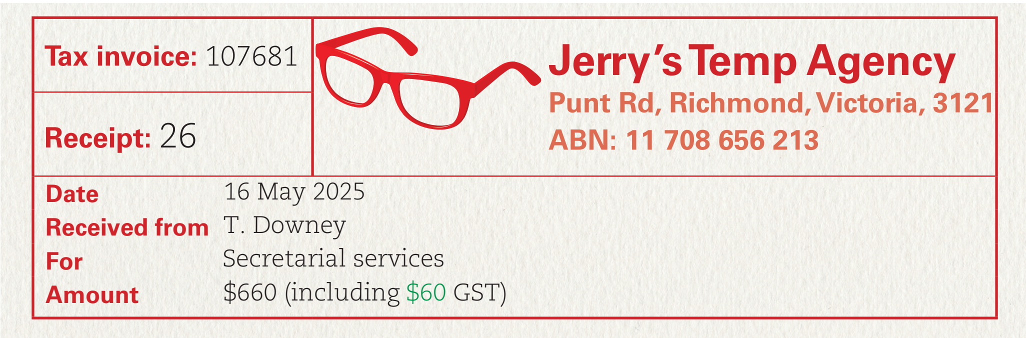
The receipt that would provide evidence of this cash sale is shown in Figure 6.2:

**Figure 6.2** 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: 16/5/2025
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 6.3:

**Figure 6.3** Cash receipt (electronic): cash sale


Tax invoice: 107681
Receipt: 26
Jerry's Temp Agency
Punt Rd, Richmond, Victoria, 3121
ABN: 11 708 656 213
Date 16 May 2025
Received from T. Downey
For Secretarial services
Amount $660 (including $60 GST)

**Study tip**

The ATO refers to 'cash sales' as the cash received either from the sale of a good or provision of a service.

Exactly the same information is provided on both versions:

- 'Tax invoice'
- date of the transaction (16/5/2025)
- the receipt number (26)
- the name and ABN of the seller (Jerry's Temp Agency, ABN: 11 708 656 213)
- a description of what has been provided (Secretarial services)
- 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

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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 6.4:

**Figure 6.4** Cash register receipt

Fashion House
Shop 45

Chadstone Shopping Centre
Chadstone 3148
Telephone 03 9378 3407

| | | |
|---|---|---|
| #36/1/5742/9745 | 21/12/2025 | 14:43 |
| 8934 | 1 floral shirt | $132 |
| | **Total** | **$132** |
| Your payment | EFTPOS DEBIT | $132 |
| GST 10% | Net $120<br>GST $12 | Gross $132 |

**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.

The increasing frequency of electronic transactions is making the technology of EFTPOS accessible to all businesses. Banks have a variety of options that allow the transfer of cash rather than the physical handing over of cash. However, larger businesses that can afford the technology and software can generate a tax invoice and cash receipt within the one docket allowing for an integration of all required information. Smaller businesses may still need to produce a tax invoice through a register system and a separate cash receipt through an EFTPOS system.

## Credit card transactions

You may have noticed above 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 (or if necessary a separate EFT or credit card receipt from the EFTPOS machine, see Figure 6.5). 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 not the business as shown in Figure 6.6.

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**Figure 6.5** Credit card receipt

**Offiz Werks**
Drop Kick Rd, Richmond,
Victoria, 3121
**ABN:** 13 618 962 444

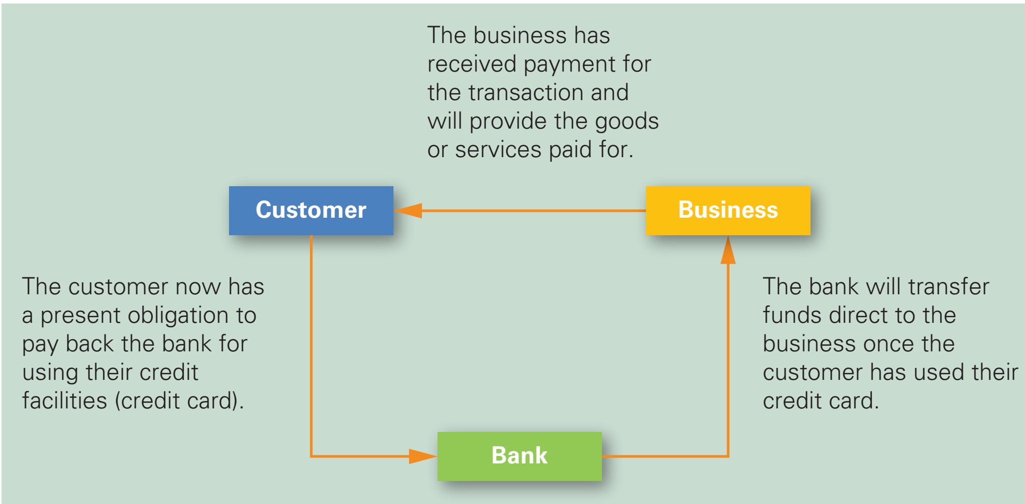
**TAX INVOICE**

**Served by:** Victor Receipt: 7227
**Date:** 16 March 2025 Time: 9.18 am

| **Description** | |
|---|---|
| Reflux A4 Copy paper Carton<br>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!

**Figure 6.6** Credit card transaction indicating credit relationship with bank




## Cash sales and the GST

At the time a cash sale is made, 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 it sales creates a GST liability to the Australian Tax Office (ATO).

### 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.

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## 6.3 Cash payments and cheque butts

Just like cash receipts, all cash payments for goods and services should be evidenced by a source document, and for most cash payments this should be a cheque butt.

### Paying by cheque

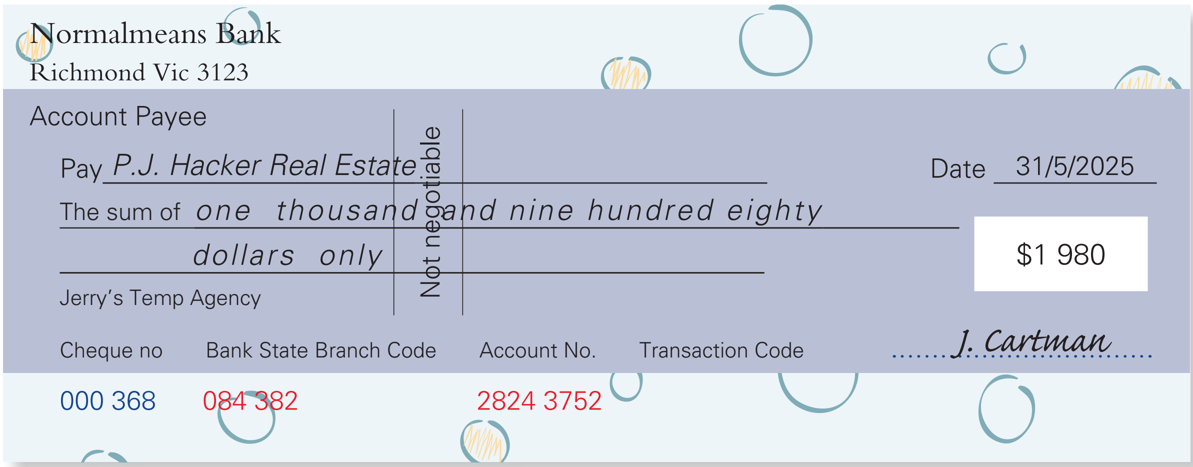
When a business pays by cheque, the cheque itself is given as payment and the cheque butt is retained by the business. This process can seem a little quaint, but the use of cheques as a method of cash payment provides a level of protection that is not possible with actual notes and coins. Firstly, cheques mean the owner can avoid carrying around large amounts of cash. Second, cheques can be traced to identify the business or individual who deposited the funds into their account. And lastly, the cheque butt that is retained after every payment provides evidence of the amount and use of the cash.

**Example**

On 31 May 2025, Jerry's Temp Agency paid $1 980 for rent $1 800 plus $180 GST (Chq. 368.)

The cheque that would be given to P. J. Hacker Real Estate to present to their bank is shown in Figure 6.7:

**Figure 6.7** Cheque




The cheque itself is a document informing the bank (Normalmeans Bank), the **drawee**, to transfer funds from the account of the **drawer** (Jerry's Temp Agency) to the bank and account of the **payee** (P. J. Hacker Real Estate). The drawer actually hands the cheque to the payee, who then presents it at their own bank.

Cheques should not be made out for cash when paying for business costs because if the cheque is lost then it can be cashed or deposited into any account. It is a sensible business practice to nominate the payee and cross it **not negotiable**. A cheque that is marked 'Not negotiable' can only be deposited into the account of the nominated payee.

Note that although the cheque is signed by the owner, the *Entity* assumption assumes that the bank account belongs to the business. The *business* is therefore known as the drawer, as it is the business that is drawing on its account to pay for a purchase.

**drawee**
the financial institution or bank of the drawer

**drawer**
the entity writing the cheque

**payee**
the entity that is receiving the cheque or to whom the cheque is written

**not negotiable**
a control mechanism that ensures that the cheque can only be deposited into the account of the nominated payee

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The cheque also has a number of other significant features:

Cheque number: 000 368

This is the number by which the cheque can be identified, allowing it to be traced. If anything should happen to the cheque (i.e. if it were reported lost/stolen), the drawer could inform their bank and have that particular cheque cancelled.

Account number: 084 382 2824 3752

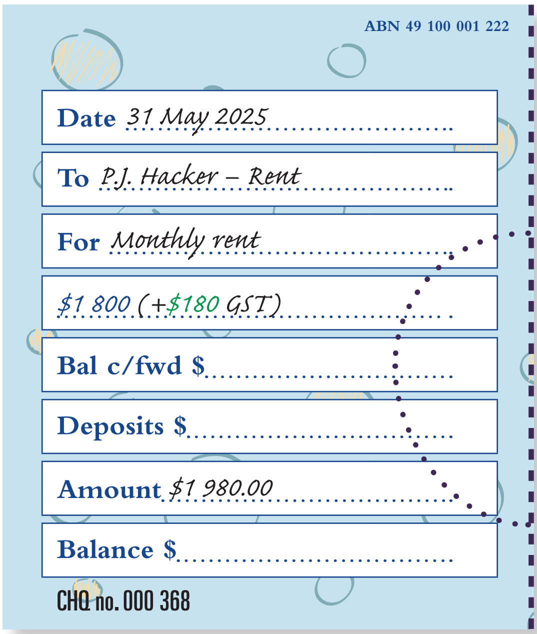
This is the number of the drawer's bank account. The first six digits identify the bank, state and branch at which the account is held (this is known as a BSB number). The last eight identify the actual account of the drawer.

It can take three to five working days for cheques to 'clear', where the bank of the payee checks with the bank of the drawer to ensure that there are sufficient funds in the drawer's account. If sufficient funds are available, the drawer's bank will transfer the funds to the payee's account. Obviously, if both parties (the drawer and payee) are with the same bank this process should take less time.

**cheque butt**
a source document used to verify cash payments

Given that the cheque is given to the payee, it is the **cheque butt** that will provide evidence of the cash payment. (Even if a cheque is cancelled, the cheque butt should still be completed to avoid any unnecessary concern that the cheque may have been stolen.) The cheque butt for our example is shown in Figure 6.8.

**Figure 6.8** Cheque butt


ABN 49 100 001 222

Date *31 May 2025*

To *P.J. Hacker – Rent*

For *Monthly rent*

*$1 800 (+$180 GST)*

Bal c/fwd $

Deposits $

Amount *$1 980.00*

Balance $

CHQ no. 000 368

## Cash payments and the GST

**Study tip**

The cheque butt provides all the relevant information, but to satisfy the ATO the business would also need to keep the tax invoice that was issued by the supplier: P.J. Hacker – Real Estate.

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 documented on the cheque butt. In this example, Jerry's Temp Agency has paid $1 800 for the rent *plus* $180 GST. This means its bank account will decrease by **$1 980** 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. (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.

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## Other forms of payment

In spite of the benefits it provides, it is not always possible to pay by cheque. Many businesses will not accept cheques unless a prior arrangement has been made, and in some cases involving small amounts, paying by cheque is simply not appropriate.

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.

In other cases, the business may use debit or credit cards for purchases or use phone and internet banking to transfer cash electronically from one account to another. (See the explanation in Section 6.2 'Cash Receipts'.) 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.

**Study tip**

Petty cash is not actually part of this course – you don't have to know how to record it.

### Review questions 6.3

1 **State** three reasons why cash payments should be made by cheque.
2 **State** what is meant by the following terms:
- drawee
- drawer
- payee.

3 **Explain** why cheques should be crossed as 'not negotiable'.
4 **State** the document that would show a business of the cheques that had been given out which ones had been processed.
5 **Explain** why GST paid to suppliers reduces the firm's GST liability.
6 **Explain** two situations why cheques are declining in use as a method of payment.
7 **Explain** the role of a petty cash system.
8 **State** two other forms of payment.

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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 shows 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 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 Identify transactions that you 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 6.9 provides an example of a Bank Statement, which we will look at in more detail in Chapter 8.

**Figure 6.9** 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 |
| | Direct deposit | | 990 | 2 240 CR |
| 2 | W/draw online Officewerks | 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 | Cash/Cheques | | 308 | 2 610 CR |
| 18 | W/Draw online | 360 | | 2 250 CR |
| 20 | Interest | | 25 | 2 275 CR |
| 20 | Cheque 437 | 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 doesn't 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 6.10, shows that the Jerry's Temp Agency has provided a bookkeeper to its customer, A. N. Accountant, who now owes the agency **$1 760**: $1 600 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 6.10** Sales invoice

**Jerry's Temp Agency**
Punt Rd, Richmond, Victoria, 3121
ABN: 11 708 656 213

**TAX INVOICE**
**Date:** 15/04/2025
**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 | 1 600 |
| | | GST | 160 |
| | | TOTAL | **$1 760** |

### 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 6.11** Credit note

**Jerry's Temp Agency**
Punt Rd, Richmond, Victoria, 3121
ABN: 11 708 656 213

**Date:** 28/4/2025
**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 6.11 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 6.12, 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.

**Figure 6.12** 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:** 25/4/2025

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 | 80 | 900 |
| | | GST | 108 |
| | | TOTAL | **$1 188** |

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 the Jerry's Temp Agency with the copy retained by the seller (Offiz Werks) for its recording purposes. Jerry's Temp now owes Offiz Werks **$1 188**: $1 080 for various office supplies plus $108 GST.

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## Statement of Account

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.

**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

**Figure 6.13** 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<br>Lakeside Dve,<br>Sth Melb., Vic, 3205 | | For period: April 2025 | |
| **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 2025 | | | **$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 6.14), 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 the Jerry's Temp Agency with the copy being retained by the seller (Offiz Werks).

**Figure 6.14** 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 | 25/4/2025 |

| Code | Description | Quantity Ordered | Quantity Received |
|---|---|---|---|
| WP456 – white | Box of 2500 reams of A4 | 10 | |
| RC x926 | Printer cartridge refills | 15 | |

| Stock 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 confirmation** 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.

**shipping and order confirmation**
a document that indicates that an order has been dispatched (sent) and can be expected at some point

**Figure 6.15** Shipping and order confirmation

From: shipping_confirmation@posttrak.com
To: jerry.robertson@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:** 23/4/25

| 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 above 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 stock transactions).

**memo**
a source document used to verify internal 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.

Figure 6.16 shows a common layout for a memo:

**Figure 6.16** Memo


**Jerry's Temp Agency** memo 13

**Date:** 24 May 2025

**From:** Jerry

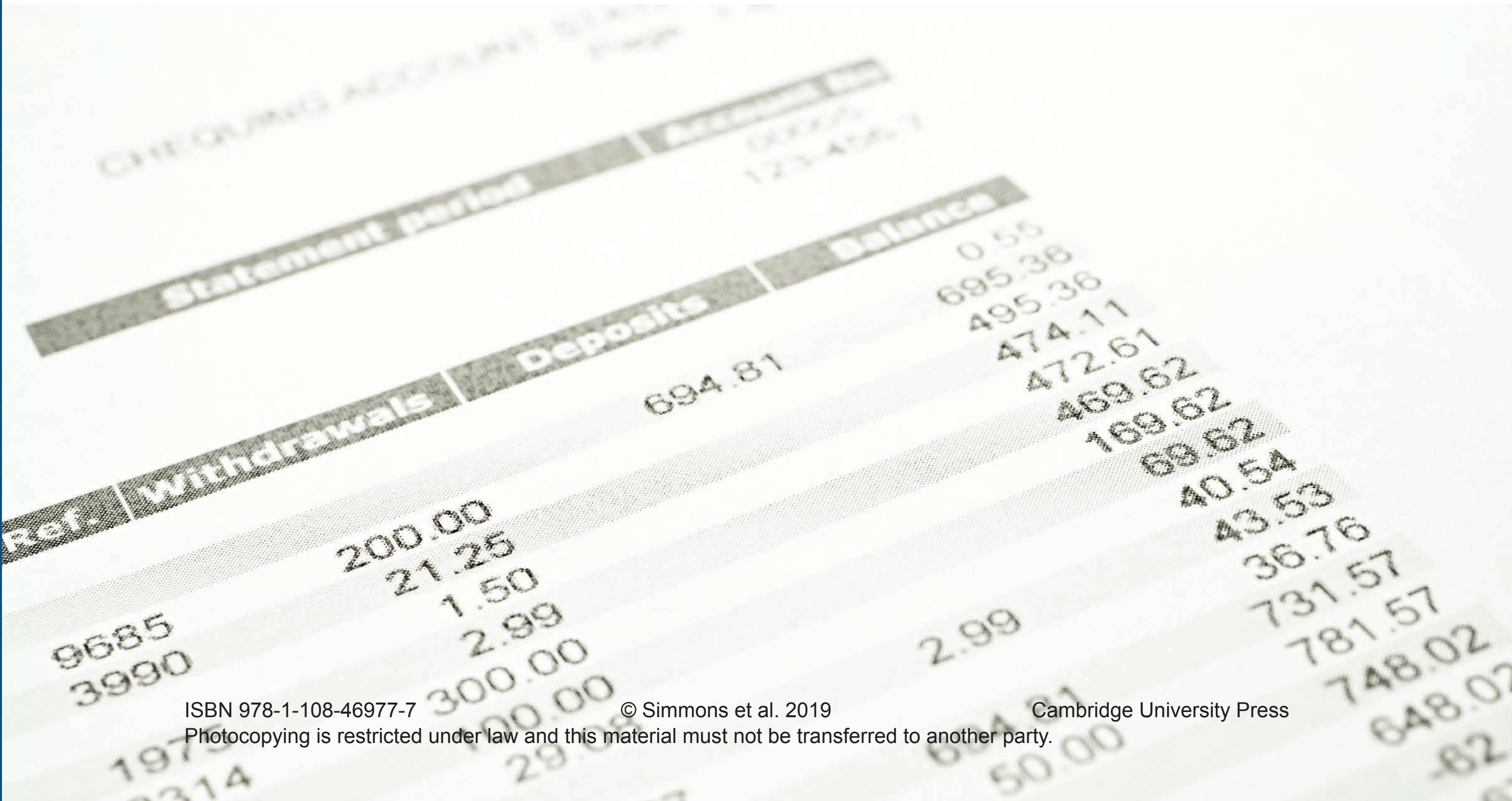
**To:** Accounting Dept.

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.

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## 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 or 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 a cheque butt, 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.

## Exercises

### Exercise 6.1

W B page 93

### Cash transaction

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. 2025 |
| 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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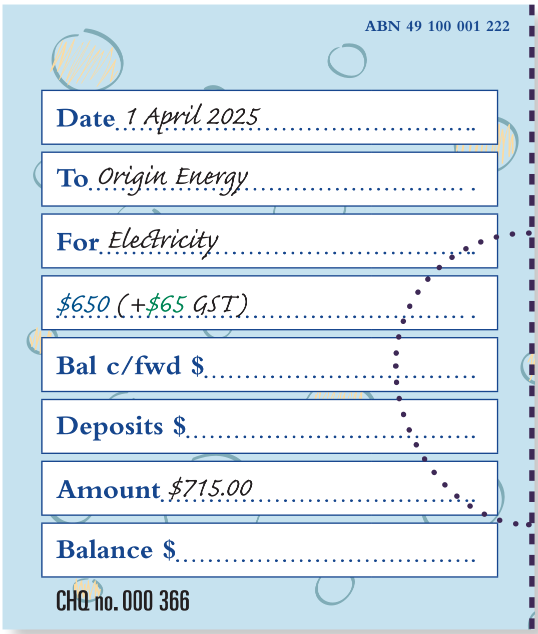
## Exercise 6.2

## Cash transaction

WB page 94

The manager of Sally's Alteration Shop discovered the following source document:


ABN 49 100 001 222

Date 1 April 2025

To Origin Energy

For Electricity

$650 (+$65 GST)

Bal c/fwd $

Deposits $

Amount $715.00

Balance $

CHQ no. 000 366

*Required*

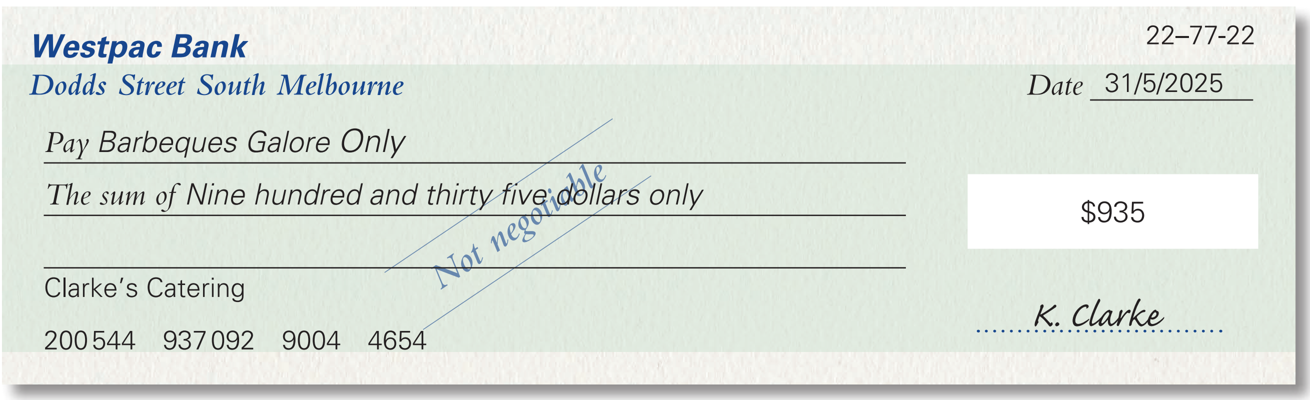
- **a** **State** whether source documents take place at the input, processing or output stage of the Accounting process.
- **b** **Identify** the source document above and **describe** the transaction.
- **c** **Explain** the effect of this transaction on the GST liability of Sally's Alteration Shop.
- **d** **State** two reasons why payments should not be made using cash from the cash register.
- **e** **State** two reasons why this document would not satisfy the requirements of a tax invoice.

## Exercise 6.3

## Cash transaction

WB page 95

The following cheque was written by the owner of Clarke's Catering:


Westpac Bank

Dodds Street South Melbourne

22–77–22

Date 31/5/2025

Pay Barbeques Galore Only

The sum of Nine hundred and thirty five dollars only

$935

Not negotiable

Clarke's Catering

200544 937092 9004 4654

K. Clarke

*Required*

- **a** **Describe** the transaction evidenced by the document above.
- **b** **Explain** why Clarke's Catering could not use this document to verify its cash payments.
- **c** **Identify** the drawee, the payee and the drawer.
- **d** **Explain** how added security is provided when the cheque is crossed 'not negotiable'.
- **e** **State** two benefits of paying by cheque.

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## Exercise 6.4
### Credit transaction

WB page 96

The accountant for Music Tuition Services came across the following source documents in a drawer:

**Document A**

**Music Tuition Services**
34 Bayside Rd, Kew 3101
ABN: 67 765 333 623

Invoice: 154
**11 May 2025**
Net 30 days
**Tax invoice**

Customer: Lakeside Primary School
103 Balmain Rd, Lakeside, Victoria, 3941
**Attn:** **Principal Pete**

| Description | Qty | Unit cost | Total |
|---|---|---|---|
| Individual half-hour lessons | 15 | 30 | 450 |
| Plus GST 10% | | | 45 |
| **Total** | | $ | 495 |

**Document B**

**Office Plan**
Punt Road
Richmond, 3121
ABN: 34 799 631 089

TAX INVOICE
Invoice: x65
Terms: 6/7, n/30

Customer: Music Tuition Services
Mitcham 3133

| 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 |

*Required*

**a** **Identify** documents A and B above 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.

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## Exercise 6.5
### Credit note

WB page 98

The following source documents was discovered by Peta's Party Hire:

**Peta's Party Hire**
Dandy Rd, Eltham, Victoria, 3095
ABN: 13 719 667 324
Credit Note: T923 Date: 15/6/2025

Customer: B. W. Lawyers
Lakeside Dve, Albert Park Vic, 3206

| 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.

## Exercise 6.6
### Delivery docket

WB page 99

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 | | 6/6/25 |

| Code | Description | Quantity Ordered | Quantity Received |
|---|---|---|---|
| BLT 24 | Large broad leaf tropical | 15 | |
| SFT 12 | Small flowering tropical | 30 | |
| RB 8 | Rose Bushes | 18 | |

| Stock Receipt Confirmation | |
|---|---|
| Docket Number DS 901 | Full Name (printed) |
| Julie's Modelling Agency | Receipt signature |
| Purchase Order Reference | Date Order Received |
| Comments: | |

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*Required*

**a** **Identify** the source socument on the previous page, and **explain** the purpose of the document.

**b** **State** whether Julie's Modelling Agency would have the original or copy of the above document. **Justify** your response.

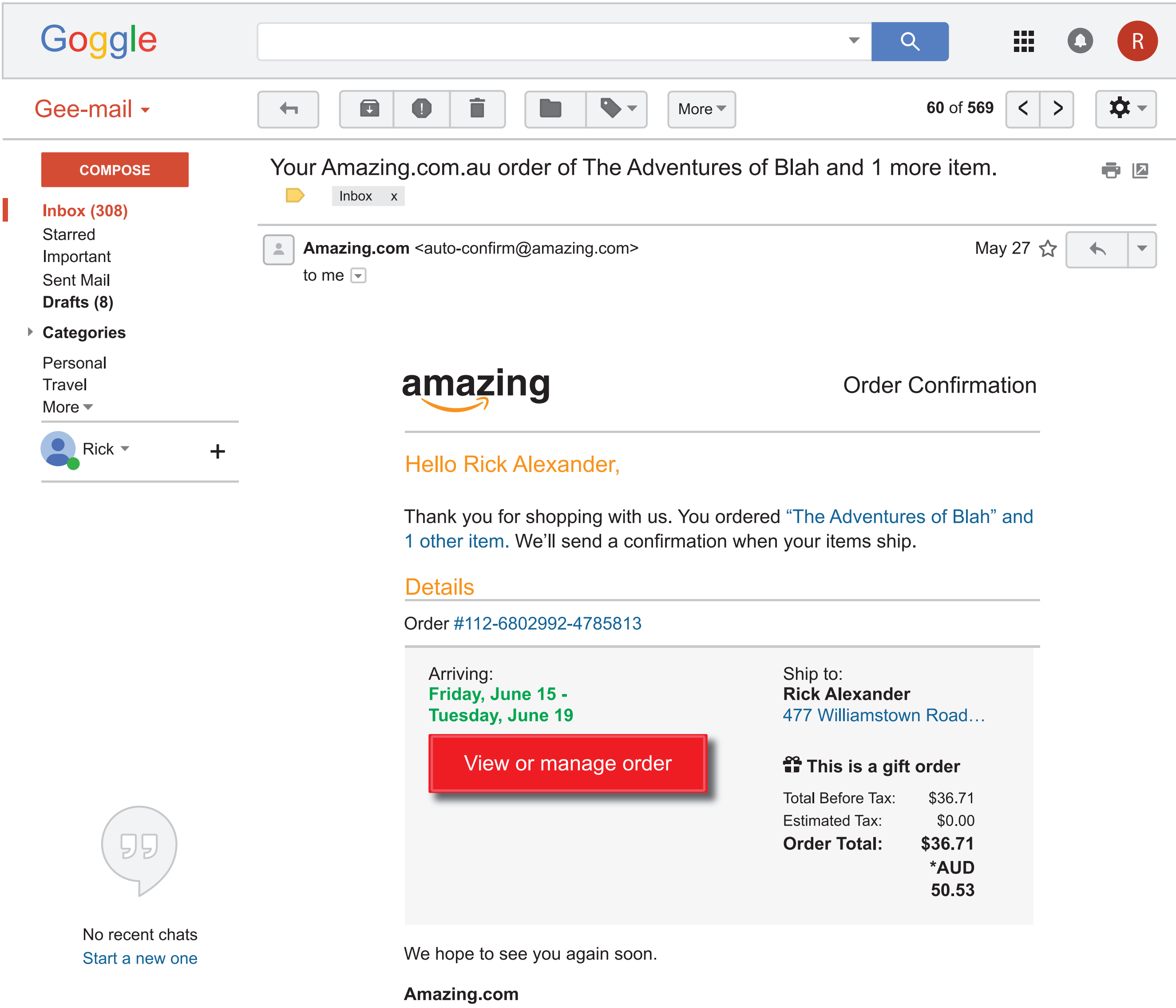
**c** **Explain** why there are no amounts listed on this source document.

**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.)

## Exercise 6.7

WB page 100

## Shipping and order confirmation


Goggle

Gee-mail

More

60 of 569

COMPOSE

Inbox (308)
Starred
Important
Sent Mail
Drafts (8)
Categories
Personal
Travel
More

Rick

No recent chats
Start a new one

Your Amazing.com.au order of The Adventures of Blah and 1 more item.

Inbox x

**Amazing.com** <auto-confirm@amazing.com> May 27
to me

amazing Order Confirmation

Hello Rick Alexander,

Thank you for shopping with us. You ordered "The Adventures of Blah" and 1 other item. We'll send a confirmation when your items ship.

Details

Order #112-6802992-4785813

Arriving:
**Friday, June 15 -**
**Tuesday, June 19**

View or manage order

Ship to:
**Rick Alexander**
477 Williamstown Road…

**This is a gift order**

| | |
|---|---|
| Total Before Tax: | $36.71 |
| Estimated Tax: | $0.00 |
| **Order Total:** | **$36.71** |
| | ***AUD 50.53** |

We hope to see you again soon.

**Amazing.com**

*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

WB page 101

## Memorandums

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

**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

## Where are we headed?

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 cheques or 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, cheques convert into cash after a couple of days (unless they bounce) 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** three items that are treated as 'cash' in an Accounting system.

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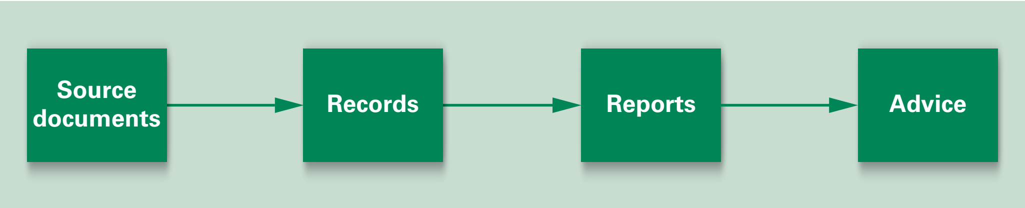
## 7.2 Single-entry Accounting

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 which are used to verify cash transactions are:

| Cash received | Cash paid |
|---|---|
| Cash receipt<br>Cash register roll<br>Bank Statement<br>Electronic Funds Transfer (EFT) receipt<br>Credit card receipt | Cheque butt<br>Bank Statement<br>Electronic Funds Transfer (EFT) receipt |

Small businesses need to keep these source documents so that they can satisfy the Australian Tax Office (ATO) and verify the information they record in their cash journals. (See Chapter 6 for a detailed discussion of source documents.)

**journal**
an Accounting record that classifies and summarises transactions during a particular reporting period

### 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.

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.

**Study tip**

In Accounting, 'recording' means writing down data in an organised format.

### 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**.

**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

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## 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.

## 7.3 The Cash Receipts Journal

**Cash Receipts Journal** an Accounting record that classifies and summarises all cash received from other entities during a particular reporting period

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**.

**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 2025:

| | | |
|---|---|---|
| March | 1 | EFT transfer of $1 600 plus $160 GST from E. Aplin for house painting (EFT Rec. 1052) |
| | 8 | Received via Credit card $1 100 (including $100 GST) from A. Stephens for fence painting (EFT Rec. 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] | Rec No.[1] | Bank[2] | Painting fees[3] | Sundries[4] | GST[3] |
|---|---|---|---|---|---|---|
| Mar. 1 | Painting fees | EFT 1052 | 1 760 | 1 600 | | 160 |
| 8 | Painting fees | EFT 1053 | 1 100 | 1 000 | | 100 |
| 19 | Capital contribution | 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, BPay will have a transaction ID.

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Notes for recording in the Cash Receipts Journal:

**1 Date/Details/Rec. No.**

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.)

**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 **$5210** (cash) during March 2025.

**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 ($4100 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.

**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.

## 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 7.3 shows this mechanism:

**Figure 7.3** Double-checking mechanism: Cash Receipts Journal

| | | | | |
|---|---|---|---|---|
| **Bank** | **5210** | = | Painting fees | 4100 |
| | | + | GST | 410 |
| | | + | Sundries | 700 |
| **Total** | **$5210** | | **Total** | **$5210** |

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 2025 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.

**Study tip**

In this course you will not have to remember this list because if GST is to be received, it will always be identified in the question.

### Review questions 7.3

1. **Explain** the function of the Cash Receipts Journal.
2. Referring to two Qualitative characteristic, **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

Just as cash receipts are recorded in a Cash Receipts Journal, cash payments are classified and summarised in a **Cash Payments Journal**.

**Cash Payments Journal**
an Accounting record that classifies and summarises all cash paid to other entities during a particular reporting period

**Example**

Goghs' Painting Service has provided the following list of payments for March 2025:

| | | |
|---|---|---|
| March | 1 | Paid wages of $450 (Chq. 101) |
| | 5 | Owner withdrew $500 cash (ATM Rec. 155) |
| | 7 | Purchased new equipment for $1 500 plus $150 GST (EFT Rec. 5168) |
| | 12 | Purchased paint costing $250 plus $25 GST (EFT Rec. 434) |
| | 16 | Paid $450 wages (Chq. 102) |
| | 20 | Purchased paint costing $400 plus $40 GST (EFT Rec. 485) |
| | 22 | Owner withdrew $400 cash (ATM Rec. 206) |
| | 25 | Purchased paint costing $150 plus $15 GST (EFT Rec. 535) |
| | 28 | Van was serviced for $200 plus $20 GST (EFT Rec. 824) |
| | 30 | Paid wages of $450 (Chq. 103) |

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] | Doc.[1] | Bank[2] | Wages[3] | Drawings[3] | Paint[3] | Sundries[4] | GST[3] |
|---|---|---|---|---|---|---|---|---|
| Mar. 1 | Wages | 101 | 450 | 450 | | | | |
| 5 | Cash Drawings | ATM 155 | 500 | | 500 | | | |
| 7 | New equipment | EFT 5168 | 1 650 | | | | 1 500 | 150 |
| 12 | Paint | EFT 434 | 275 | | | 250 | | 25 |
| 16 | Wages | 102 | 450 | 450 | | | | |
| 20 | Paint | EFT 485 | 440 | | | 400 | | 40 |
| 22 | Cash Drawings | ATM 206 | 400 | | 400 | | | |
| 25 | Paint | EFT 535 | 165 | | | 150 | | 15 |
| 28 | Van service | EFT 824 | 220 | | | | 200 | 20 |
| 30 | Wages | 103 | 450 | 450 | | | | |
| | **TOTALS** | **$** | **5 000** | **1 350** | **900** | **800** | **1 700** | **250** |

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 such as the cheque number that is identifiable from the cheque butt and all EFT and ATM transactions will have a reference number. All cheque numbers should be recorded, even if the cheque has been cancelled, so that all cheques are accounted for.

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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 **$5000** during March 2025.

**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 | 5000 | = | | Wages | 1350 |
| | | | + | Drawings | 900 |
| | | | + | Paint | 800 |
| | | | + | GST | 250 |
| | | | + | Sundries | 1700 |
| **Total** | **$5000** | | | **Total** | **$5000** |

**Study tip**

It is consumers who end up 'paying' the GST, because they cannot claim GST credits.

## 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 2025 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's 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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Notice that there are two transactions in the Cash Payments Journal for March 2025 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.

**Study tip**

As with cash receipts, you will not have to remember this list because when GST is to be paid it will always be identified.

**Review questions 7.4**

1. **Explain** the function of the Cash Payments Journal.
2. **Explain** why cancelled cheques should be recorded in the Cash Payments Journal.
3. **Explain** why a Cash Payments Journal usually has more classification columns than a Cash Receipts Journal.
4. **Explain** why GST paid to suppliers reduces the GST liability.
5. **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 2025 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.

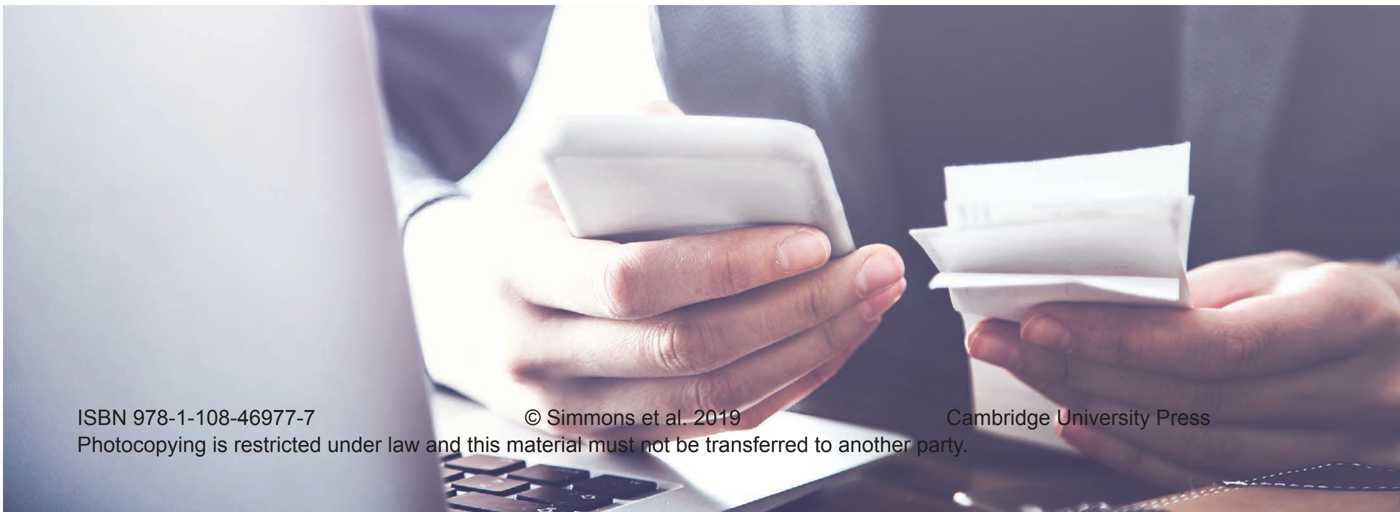

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Figure 7.6 shows the Statement of Receipts and Payments for Goghs' Painting Service for March 2025:

**Figure 7.6** Statement of Receipts and Payments

**GOGHS' PAINTING SERVICE**
**Statement of Receipts and Payments for March 2025**

| | $ | $ |
|---|---|---|
| **Cash Receipts** | | |
| Painting fees | 4 100 | |
| GST | 410 | |
| Capital contribution | 700 | **5 210** |
| **Less Cash Payments** | | |
| Wages | 1 350 | |
| Drawings | 900 | |
| Paint | 800 | |
| GST | 250 | |
| New equipment | 1 500 | |
| Van service | 200 | **5 000** |
| **Cash Surplus (Deficit)** | | 210 |
| **Add Bank Balance at start (1 March 2025)** | | 420 |
| **Bank Balance at end (31 March 2025)** | | 630 |

**Study tip**

There is little point in using a journal to summarise transactions, unless the totals are reported.

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 2025). Note that the period is for March 2025, 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 long, or as short, as the owner desires.)

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.

## Surplus (Deficit)

**cash surplus**
an excess of cash receipts over cash payments, leading to an increase in a positive bank balance or 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

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.

**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.

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### 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 its level of cash on hand.

**Review questions 7.5**

1 **State** three pieces of information regarding a firm's cash position, which 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

**Cash Flow Statement** an Accounting report that reports all cash flows during a reporting period, classified as Operating, Investing and Financing activities

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.

### Operating activities

**Operating activities** cash flows related to day-to-day trading 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, 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.

### Investing activities

**Investing activities** cash flows related to the purchase and sale of non-current assets

**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).

### Financing activities

**Financing activities** cash flows related to changes in the financial structure of the firm

**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 Services is shown in Figure 7.7.

### 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.

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.

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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 2025**

| | $ | $ |
|---|---|---|
| **CASH FLOWS FROM OPERATING ACTIVITIES** | | |
| Painting fees | 4100 | |
| GST Received | 410 | 4510 |
| Wages | (1350) | |
| GST Paid | (250) | |
| Paint | (800) | |
| Van service | (200) | (2600) |
| **Net Cash Flows from Operations** | | 1910 |
| **CASH FLOWS FROM INVESTING ACTIVITIES** | | |
| New equipment | | (1500) |
| **Net Cash Flows from Investing activities** | | (1500) |
| **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 2025)** | | **420** |
| **Bank balance at end (31 March 2025)** | | **630** |

**Study tip**

Interest is always Operating, as it is a payment for an expense.

**Study tip**

When classifying cash flows, work from the bottom up. That is, identify Financing and Investing activities first, so the remainder must be Operating.

## 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 which 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

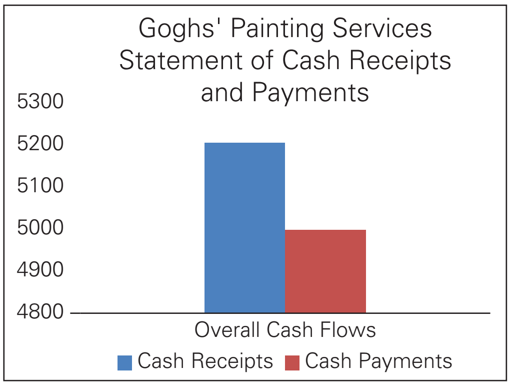
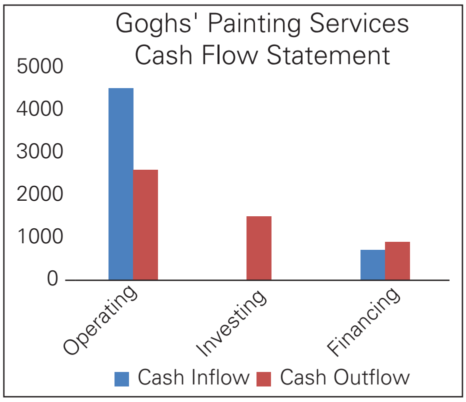



**Figure 7.9** Graph: Cash Flow Statement




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.

**Study tip**

GST and Bank can both be current assets or current liabilities.

**Example**

During March 2025, 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 Services would be calculated as is shown in Figure 7.10:

**Figure 7.10** Calculation: GST balance

| | |
|---|---|
| Opening GST balance | nill |
| 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 GST payable of **$160**.

### 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 an outflow of economic benefits (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.

**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)


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**Example**

On 1 April 2025, Goghs' Painting Service settled its GST payable from March by paying $160 to the ATO (Chq. 11).

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 | Doc. | Bank | Wages | Drawings | Paint | Sundries | GST |
|---|---|---|---|---|---|---|---|---|
| April 1 | GST settlement | 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.

## 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.

**Example**

On 1 July 2025, 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 | Rec. No. | Bank | Painting fees | Sundries | GST |
|---|---|---|---|---|---|---|
| July 1 | GST refund | 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, 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

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**:

**Cash Flow Cover** a liquidity indicator that assesses the firm's ability of the business's Operating Cash Flow to meet its short-term debts as they fall due

**Figure 7.13** Formula: Cash Flow Cover

$$\textbf{Cash Flow Cover} = \frac{\textbf{Net Cash Flow from Operations}}{\textbf{Average Current Liabilities}}$$

This indicator assesses liquidity by calculating the number of times average Current Liabilities can be met using Net Cash Flows from Operations.

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 2025 was $2 000 and as at 31 March 2025 was $1 600.

The Cash Flow Cover Ratio would be calculated as is shown in Figure 7.14:

**Figure 7.14** Calculation: Cash Flow Cover

$$\begin{aligned}\textbf{Cash Flow Cover} &= \frac{\text{Net Cash Flow from Operations}}{\text{Average Current Liabilities}}\\ &= \frac{\$1\,910}{((\$2\,000 + \$1\,600)/2)}\\ &= \frac{\$1\,910}{\$1\,800}\\ &= 1.06 \text{ times}\end{aligned}$$

A Cash Flow Cover of 1.06 times means that the business can pay (cover) every dollar of current liabilities just over 1 time. 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 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
- invest to increase cash revenue streams and have a back up to provide support in case of economic downturns.

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However, a Cash Flow Cover of less than 1 times 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 Flow 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 Ratio.
2 **Show** the formula to calculate the Cash Flow Cover Ratio.
3 **Explain** why the Cash Flow Cover should be greater than 1 time.
4 **Explain** two courses of action if the Cash Flow Cover Ratio is high.
5 **State** two actions the owner may be required to take if Cash Flow Cover Ratio 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, cheques, 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 cheque butts 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 due.
- 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

WB page 103

During the month of May 2025, 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 Rec. 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 equipment for $500 plus $50 GST on credit (Inv. X 12) | 550 |
| 18 | Paid for detergents and wax including $3 GST (EFT Rec. 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 Rec. 312) | 132 |
| 26 | Paid for detergents and wax including $4 GST (EFT Rec. 422) | 44 |
| 27 | Paid for water recycling including $25 GST (Chq. 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 2025, the business had $750 in the bank.

*Required*

*a **Record** the cash transactions for May 2025 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 2025.

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 2025.

e **Prepare** a Cash Flow Statement for Stan's Car Wash for May 2025.

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## Exercise 7.2
## Cash journals

WB page 106

Sadie La Voce has her own cleaning company, Vac and Sweep, and has provided the following list of transactions for August 2025:

| | |
|---|---|
| Aug. 1 | Received $220 (including $20 GST) for house cleaning (Rec. 42) |
| 2 | Paid rent for the coming month: $4 000 plus $400 GST (Chq. 221) |
| 5 | Received $220 including $20 GST for house cleaning (Rec. 43) |
| 6 | Paid wages of $1 500 (Chq. 222) |
| 7 | Purchased cleaning supplies for $350 plus $35 GST (EFT Rec. 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 (Chq. 223) |
| 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 Rec. 145) |
| 29 | Received $407 including $37 GST for home cleaning (Rec. 48) |
| 30 | Paid $600 for advertising plus $60 GST (Chq. 224) |

At the start of August 2025, the business had $6 000 cash in its bank account.

*Required*

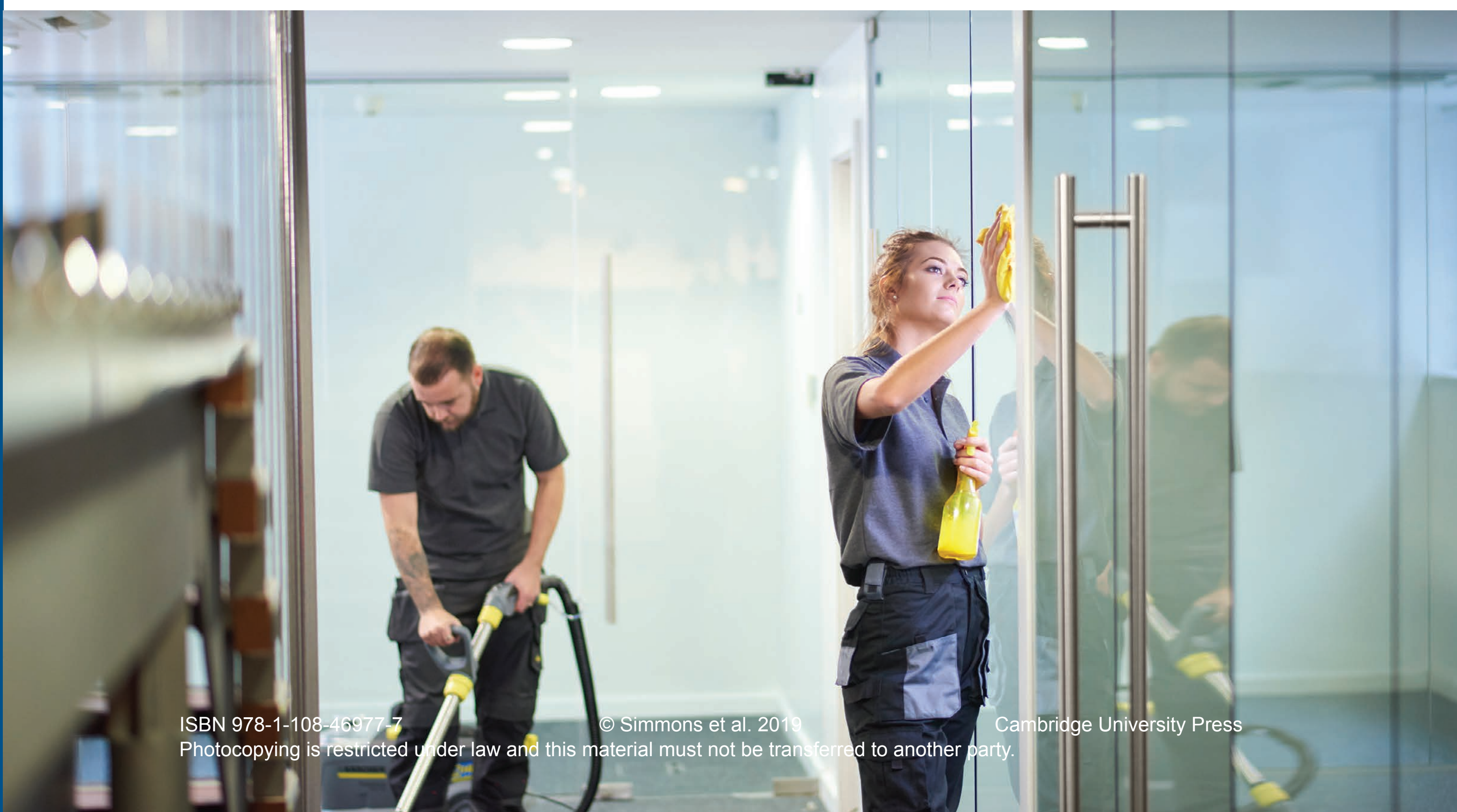
*a **Record** the transactions for August 2025 in the cash journals of Vac and Sweep. **Total** the journals.

*b **Prepare** a Cash Flow Statement for Vac and Sweep for August 2025.

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 2025.

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 2025.



## Exercise 7.3

WB page 109

### Cash journals

Minor Mechanics is an automotive repair shop owned and run by Patrick Minor. Patrick has provided the following list of transactions for July 2025:

| | |
|---|---|
| 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 (Chq. 302) |
| 7 | Withdrew $600 cash for personal use (Chq. 303) |
| 9 | Received $352 including $32 GST for tune up (Rec. 14) |
| 12 | Purchased office furniture $1 500 plus $150 GST (Chq. 304) |
| 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 (Chq. 305) |
| 19 | Received $610 plus $61 GST for repair work (Rec. 16) |
| 21 | Withdrew $300 cash and $70 parts for personal use (Chq.306) |
| 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 a business cheque (Chq. 307) |
| 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 2025 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 2025.

d **State** two actions that Patrick could have taken to avoid incurring an overdraft in July 2025.

e **Calculate** the GST balance for Minor Mechanics as at 31 July 2025.

f Referring to your answer to part 'e', **explain** how the GST balance would be reported in the Balance Sheet as at 31 July 2025.

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## Exercise 7.4

### Cash journals and source documents

WB page 112

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 2025, the business had $1 500 in its bank account and GST payable of $720. The following transactions occurred during April 2025:

| | | |
|---|---|---|
| April 1 | Paid GST settlement to ATO (BPAY Rec. 025) | |
| 2 | Paid for photography materials worth $850 plus $85 GST (EFT Rec. 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 on investment (BS) | 110 |
| 12 | Received $880 including $80 GST for wedding shoot (Rec. 203) | 880 |
| 16 | Paid wages (Chq. 646) | 500 |
| 18 | Received $385 including $35 GST for portraits (Rec. 204) | 385 |
| 22 | Paid for photography materials $750 plus $75 GST (EFT Rec. 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 Rec. 216) | 2 145 |
| 28 | Received $220 including $20 GST for portrait (Rec. 207) | 220 |
| 29 | Paid wages (Chq. 647) | 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 2025

| 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 2025.

**c** **Explain** the effect on the Balance Sheet of Sweethearts Photography of the GST settlement on 1 April 2025.

*__d__ **Prepare** a Cash Flow Statement for Sweethearts Photography for April 2025.

**e** **Calculate** the GST balance for Sweethearts Photography as at 30 April 2025.

**f** **Calculate** the Cash Flow Cover for Sweethearts Photography as at 30 April 2025 if average current liabilities was $1 500.

**g** **Comment** on the ratio's suitability.

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## Exercise 7.5

WB page 115

### Cash journals and source documents

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 2025, the business had a bank overdraft of $1 000 and GST receivable of $720. The following transactions occurred during July 2025:

| | |
|---|---|
| July 1 | Received a GST refund from the ATO (Rec. 44) |
| 2 | Paid travel expenses $500 plus $50 GST (EFT Rec. 307) |
| 3 | Jack withdrew $850 cash (ATM Rec. 004) |
| 5 | Paid $1 500 wages (Chq. 107) |
| | 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 Rec. 356) |
| 15 | Received $3 960 including $360 GST for consultancy fees (Rec. 48) |
| 19 | Paid $1 500 wages (Chq. 108) |
| 21 | Paid travel expenses of $1 000 plus $100 GST (EFT Rec. 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.) |

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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 2025*

To *Image Works*

For *Advertising*
*$300 plus $30 GST*

Bal c/fwd $

Deposits $

Amount *$330.00*

Balance $

CHQ no. 114

**Document B**

**CPX Computers**
35 High St
Preston Vic, 3072
ABN: 15 440 342 188
**Tax Invoice**

Date: 27/7/25
Invoice: 10
Duplicate:
Terms: 30 days

**Charge to:** Polling Times
491 Keilor Rd, Niddrie, 3042
ABN: 23 500 682 112

**Attn:** J. Ryan

| Item | Qty | Unit cost | Total |
|---|---|---|---|
| Apple i-Book Laptop – Orange w/software | 1 | 2 500 | 2 500 |
| GST | | | 250 |
| **Total** | | $ | **$2 750** |

**Document C**

National Australia Bank

Date *28th July 2025*

To *Cash*

For *House insurance – Ryan family*
*$500 plus $50 GST*

Bal c/fwd $

Deposits $

Amount *$550.00*

Balance $

CHQ no. 115

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**Document D**

| **Polling Times**<br>491 Keilor Rd<br>Niddrie, 3042<br>ABN: 23 500 682 112 | *Tax Invoice*<br><br><br>**29 July 2025** |
|---|---|
| **Receipt no.** | 50 |
| **Received from** | Victorian Conservative Party ABN: 40 103 665 782 |
| **The sum of** | One thousand, five hundred dollars<br>plus one hundred and fifty dollars GST |
| **Being for** | Cash fees |
| **Amount** | $1 650.00 |
| **Plus GST** | |
| **Signed** | Jack Ryan |

*Required*

**a** **Explain** why Polling Times had GST receivable as at 30 June 2025.

**b** **Explain** the effect of the transaction in Document B on the Balance Sheet of Polling Times.

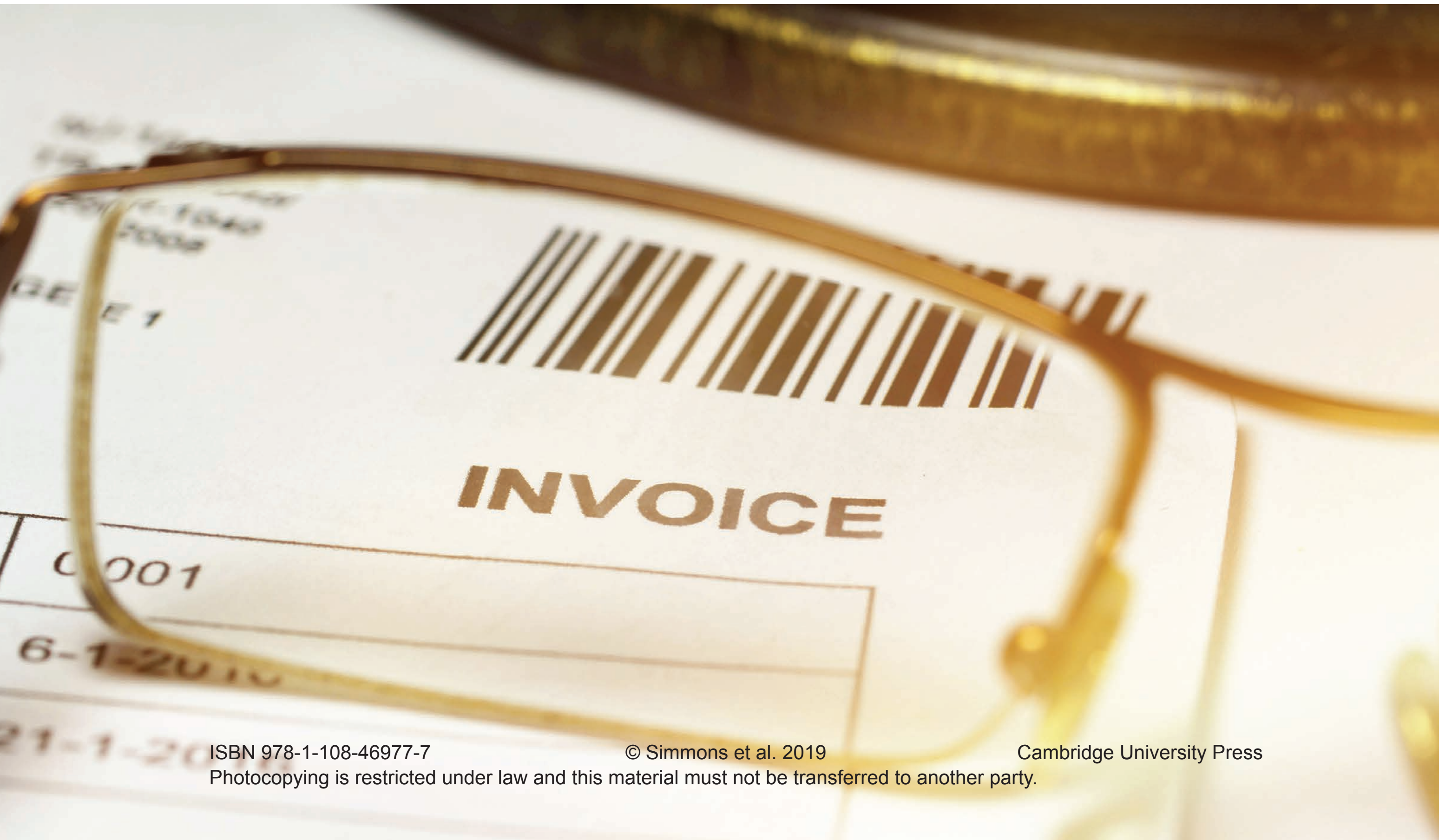
**c** Referring to one Accounting assumption, **explain** why the transaction in Document C leads to a decrease in Jack's owner's equity.

*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 2025.

**f** **Calculate** the Cash Flow Cover for Polling Times for July 2025 if average current liabilities for the period was $3 500.

**g** **Comment** on the ratio's suitability.

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## Exercise 7.6

W B page 119

### Cash journals and source documents

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 2025, the business had $3 500 in its bank account.

The following transactions occurred during June 2025:

| | |
|---|---|
| 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 Rec. 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 Rec. 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<br>Country Rd, Ballarat<br>28 June 2025<br>11.04am | |
|---|---|
| Account: | SAV |
| Restoration supplies | 165.00 |
| Price includes GST of $15.00<br>EFT ref. 003 | |

**Document B**

**Wooden It Be Good**
Furniture Restoration
14 Menzies Ave
Sunbury, 3429
ABN: 33 405 662 310

**TAX INVOICE**
**Receipt:** 55

| | |
|---|---|
| **Date** | 30 June 2025 |
| **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* |

Nik presented the following GST calculation for the quarter ended 30 June 2025:

| | | |
|---|---|---|
| | GST received on carpentry fees | $3 500 |
| Less | GST paid to suppliers | $1 400 |
| | GST payable | $2 100 |

*Required*

*a **Record** the transactions for June 2025 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 2025.

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 2025.

## Exercise 7.7

WB page 122

### Cash journals and source documents

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 2025, and these are shown in the following cash journals:

**Cash Receipts Journal**

| Date | Details | Rec. No. | Bank | Consulting fees | Design fees | Sundries | GST |
|---|---|---|---|---|---|---|---|
| May 2 | Grogan Revell P/L | 904 | 583 | 530 | | | 53 |
| 7 | Tony Trevally | 905 | 462 | | 420 | | 42 |
| 12 | YRE Constructions | 906 | 374 | 340 | | | 34 |
| 16 | Highett Preschool | 907 | 550 | 500 | | | 50 |
| 19 | Hume City Council | 908 | 319 | | 290 | | 29 |
| 24 | Wendell & Assoc. | 909 | 715 | 650 | | | 65 |

**Cash Payments Journal**

| Date | Details | Doc. | 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 Rec. 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 2025 |
| **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* |

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**Document B**

Date 28/5/2025

To F. Darmanin

For Deposit on family holiday to Bali

$300 plus $30 GST

Bal c/fwd $

Deposits $

Amount $1 100 including $100 GST

Balance $

CHQ no. 20107

**Document C**

**Daring Designs**
54 Greenhills Road
Bundoora 3145
**ABN: 33 405 662 310**

**TAX INVOICE**
**Receipt:** 911

| | |
|---|---|
| **Date** | 29 May 2025 |
| **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 D**

Unidraw Supplies
ABN 9873 1324 543
Scribble St, Essendon
30 May 2025
3.08pm

| | |
|---|---|
| Account: | SAV |
| Drawing Supplies | 110.00 |

Price includes GST of $10.00
EFT ref. 714

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**Additional information:**

- As at 1 May 2025, the business had GST payable of $380.
- On 31 May 2025, 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 2025 in the appropriate cash journals. **Total** the journals.
*__g__ **Prepare** a Cash Flow Statement for Daring Designs for May 2025.
**h** **Calculate** the GST balance for Daring Designs as at 31 May 2025.

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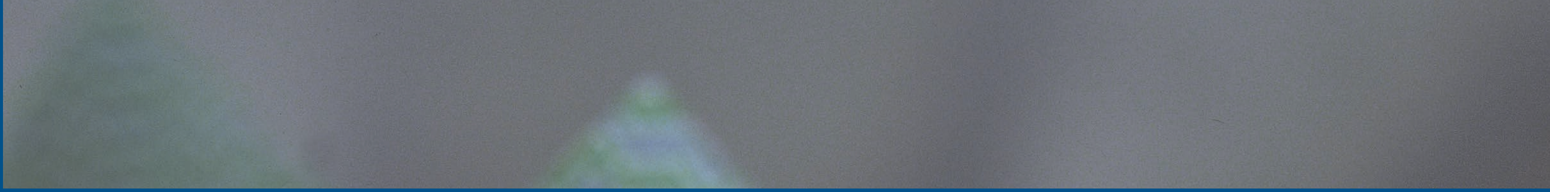

# Chapter 8
# Cash control

## Where are we headed?

After completing this chapter, you should be able to:

- **describe** various methods of internal and cash control
- **explain** the purpose of bank reconciliation
- **identify** direct debits (including dishonoured cheques), direct credits and errors and **record** them in the cash journals
- **identify** deposits not yet credited and unpresented cheques
- **prepare** a Bank Reconciliation Statement.

## Key terms

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

- internal control
- cash control
- bank reconciliation
- direct credit
- direct debit
- dishonoured cheque
- deposit not yet credited
- unpresented cheque
- Bank Reconciliation Statement.


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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. Therefore, it is essential that every small business has in place **internal control** mechanisms to protect its assets from theft, damage and misuse.

**internal control** the procedures and strategies used to protect the firm's assets from theft, damage and misuse

### 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 for cash, in particular, through the use of safes, lock-boxes and lockable cash drawers. 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.
- **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, but also protects another of the firm's assets – its staff!

**Review questions 8.1**

1 **Define** the term 'internal control'.
2 Briefly **describe** five internal control mechanisms.

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## 8.2 Cash control

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.

**cash control**
the procedures and strategies used to protect the firm's cash

Obviously, the internal control mechanisms mentioned on the previous page 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, EFT receipt or a cheque butt).
- *All payments should be made by cheque or electronic transfer rather than cash* because they are more secure (allowing large payments to be made without the risk of carrying cash), cheques and 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 cheque butt or 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.
- *Use EFTPOS facilities that allow the direct transfer of funds to the business bank account* reducing 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. (This will be covered in detail in the next section.)

### 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 cheque or electronic transfer rather than cash.

3 **Explain** why small payments should be made using a petty cash system rather than straight from the 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, EFT receipts and cheque butts 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 too should 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 cheque 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 2025:

**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 |
|---|---|---|---|---|
| **2025** | | **$** | **$** | **$** |
| July 1 | Balance forward | | | 4830 CR |
| 2 | 501 | 1000 | | 3830 CR |
| 2 | Deposit POS | | 1320 | 5150 CR |
| 5 | Service fee | 15 | | 5135 CR |
| 11 | 502 | 220 | | 4915 CR |
| 13 | CSH/CHQS | | 1100 | 6015 CR |
| 15 | 504 | 1450 | | 4565 CR |
| 20 | 505 | 3960 | | 605 CR |
| 25 | Deposit POS | | 850 | 1455 CR |
| 28 | 506 | 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 2025.

Note that although each cash transaction for July 2025 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 cheque number or transaction ID, and receipts by the abbreviation CSH/CHQS for cash/cheque deposits 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 it is 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.

### 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.


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## 8.4 Bank reconciliation

**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, there are two main reasons why this will not always be the case:

- there may be transactions the bank knows about, but the business does not
- there may be transactions the business knows about, but the bank does not.

**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

### 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.

**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 or sending a cheque.

**direct credit**
a deposit of cash directly into a bank account

**2 Direct debits** occur when cash is withdrawn directly from the firm's account for payments such as interest, bank fees or charges, or government taxes, or regular payments such as loan instalments. This would also be the case if the business deposits a cheque that was later dishonoured.

**direct debit**
a withdrawal of cash directly from a bank account

A **dishonoured cheque** is one that a business accepts from a customer and deposits into its account, only to find out that there are insufficient funds in the customer's account to allow the payment to be made. It is initially credited to the firm's account (as a deposit which increases the balance), but it is recorded as a direct debit (and deducted from the account) when the bank reverses the previous deposit. A business that has the misfortune of receiving a dishonoured cheque must follow up with the customer from whom the cheque was received in the first place and demand payment in some other form.

**dishonoured cheque**
a cheque that cannot be honoured/exchanged for cash because there are insufficient funds in the account of the drawer to allow the payment to be made

These transactions that are not yet recorded in the firm's records must be added to the cash journals.

> Items that the firm does not know about will appear on the Bank Statement but not in the cash journals, and so must be added to the cash journals.

**Study tip**

When a cheque is dishonoured, it is said to have 'bounced'.

### Transactions the bank did not know about

On the other hand, there will be transactions that the firm knows about, but the bank is yet to discover. These transactions will be recorded in the cash journals, but not on the Bank Statement.

**1 Deposits not yet credited**

At certain times, receipts that have been recorded (in the Cash Receipts Journal) – and banked – will not be processed by the bank in time to appear on this month's Bank Statement. This mainly relates to deposits that are made at the end of a month or on the day that the Bank Statement is being prepared. Because they would usually appear in the credit column, they are **deposits not yet credited** (although they should appear on next month's Bank Statement).

**deposit not yet credited**
a cash deposit that is yet to appear on the Bank Statement (usually due to the timing of its preparation)

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**unpresented cheque**
a cheque that has not yet been presented for payment by the payee

**Bank Reconciliation Statement**
an Accounting report that attempts to explain the difference between the bank balance determined in the firm's records and the bank balance reported on the Bank Statement

### 2 Unpresented cheques

**Unpresented cheques** are those that have been written, recorded in the Cash Payments Journal and presented to the intended payees; however, the payee has yet to deposit it into their account, or 'present' the cheque to claim the cash. Until the cheque is presented, the bank will have no knowledge of its existence or that the business has spent that cash.

Unlike the cash journals that can simply be updated, the transactions about which the bank is not yet aware cannot just be scrawled onto the Bank Statement. (The Bank Statement is a legal document.) Instead, they will have to be reported in a **Bank Reconciliation Statement**.

> Items that the bank does not know about will appear in the cash journals but not on the Bank Statement, and so must be reported in a Bank Reconciliation Statement.

### Review questions 8.4

1 **State** the two main reasons for differences between the Bank Statement and cash journals.
2 **Define** the following terms:
   - direct debit
   - direct credit
   - deposit not yet credited
   - unpresented cheque
   - dishonoured cheque.
3 **Explain** the process to account for direct debits and direct credits.
4 **Explain** the process to account for deposits not yet credited and unpresented cheques.
5 **Explain** what action the business should take if a cheque from one of its customers is dishonoured.

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## 8.5 The bank reconciliation process

The process for conducting a bank reconciliation – and comparing the Bank Statement and the firm's cash journals – involves four steps:

1. Compare cash receipts
2. Compare cash payments
3. Update the firm's cash journals
4. Prepare a Bank Reconciliation Statement.

Let's examine each step in detail.

**1 Compare cash receipts**

Check the *Bank* column of the Cash Receipts Journal against the *Credit* column in the Bank Statement. *Tick* the items that appear in both records; *circle* those that appear in only one.

**2 Compare cash payments**

Check the *Bank* column of the Cash Payments Journal against the *Debit* column in the Bank Statement. *Tick* the items that appear in both records; *circle* those that appear in only one.

These comparisons are designed to verify that the journals show all the cash transactions present in the Bank Statement, and vice versa. If a transaction appears in only one record, it will cause the cash journals and the Bank Statement to show a different bank balance.

**3 Update the cash journals**

Items that are circled in the Bank Statement are not yet recorded in the firm's records because the firm did not know about them until it received the Bank Statement. These circled items must be added to the cash journals so that the firm's records are complete.

- Items that are circled in the Credit column of the Bank Statement must be added to the Cash Receipts Journal.
- Items that are circled in the Debit column of the Bank Statement must be added to the Cash Payments Journal.

At this stage, the firm's cash records – its journals – should be complete, and the firm can calculate the bank balance according to its records.

**4 Prepare a Bank Reconciliation Statement**

Items that are circled in the cash journals are not shown on the Bank Statement because the bank does not yet know about them. However, these circled items cannot just be added to the bottom of the Bank Statement: they must be reported in a Bank Reconciliation Statement.

- Items that are circled in the Cash Receipts Journal are reported as deposits not yet credited.
- Items that are circled in the Cash Payments Journal are reported as unpresented cheques.

By reporting these items, the Bank Reconciliation Statement attempts to explain any differences between the bank balance determined in the firm's records and the bank balance reported on the Bank Statement.

### Review questions 8.5

1. **List** the steps involved in the bank reconciliation process.
2. **Explain** the process to account for items that are circled in the:
   - credit column of the Bank Statement
   - debit column of the Bank Statement
   - Cash Receipts Journal
   - Cash Payments Journal.
3. **Explain** the function of a Bank Reconciliation Statement.

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## 8.6 Bank reconciliation example

As at 1 July 2025, Willow's Window Wash had $4830 cash in its bank account. Information relating to the firm's cash transactions has been provided below.

**Cash Receipts Journal**

| Date | Details | Rec. No | Bank | Fees | Sundries | GST |
|---|---|---|---|---|---|---|
| July 1 | Cash fees | CRR771–99 | 1320 ✓ | 1200 | 120 | |
| 12 | Cash fees | CRR799–825 | 1100 ✓ | 1000 | 100 | |
| 24 | Interest on Term Deposit | 826 | 850 ✓ | 850 | | |
| 31 | Cash fees | CRR827–851 | 1430 | 1300 | 130 | |

**Cash Payments Journal**

| Date | Details | Doc. | Bank | Supplies | Drawings | Wages | Sundries | GST |
|---|---|---|---|---|---|---|---|---|
| July 1 | Drawings | ATM 365 | 1000 ✓ | | 1000 | | | |
| 5 | Detergents | EFT 024 | 220 ✓ | 200 | | | | 20 |
| 11 | New equipment | 503 | 1100 | | | | 1000 | 100 |
| 13 | Wages | BS | 1450 ✓ | | | 1450 | | |
| 15 | Prepaid insurance | Bpay 723 | 3960 ✓ | | | | 3600 | 360 |
| 18 | Advertising | EFT 683 | 440 ✓ | | | | 400 | 40 |
| 28 | Cleaning supplies | 504 | 880 | 800 | | | | 80 |

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**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 |
|---|---|---|---|---|
| **2025** | | **$** | **$** | **$** |
| July 1 | Balance forward | | | 4830 CR |
| 2 | ATM W/draw 365 | 1000 ✓ | | 3830 CR |
| 2 | Deposit POS | | 900 ✓ | 4730 CR |
| 2 | CSH/CHQS | | 420 ✓ | 5150 CR |
| 5 | Service fee | 15 | | 5135 CR |
| 6 | EFTPOS W/draw 024 | 220 ✓ | | 4915 CR |
| 13 | Deposit POS | ` | 800 ✓ | 5715 CR |
| 13 | CSH/CHQS | | 300 ✓ | 6015 CR |
| 14 | W/draw online Wages | 1450 ✓ | | 4565 CR |
| 16 | W/draw Bpay 723 | 3960 ✓ | | 605 CR |
| 25 | Deposit online XYZ Bank | | 850 ✓ | 1455 CR |
| 28 | EFTPOS W/draw 683 | 440 ✓ | | 1015 CR |
| 29 | Transaction fee | 10 | | 1005 CR |
| 31 | Interest | | 2 | 1007 CR |
| | TOTALS THIS PAGE | $7095 | $3272 | |
| | **Final Balance** | | **CREDIT** | **$1007** |

### Steps 1 and 2: Compare cash receipts/cash payments

These steps have been completed, with items that appear in both records ticked in both records: these transactions have been verified and provide no cause for concern. However, some items have been circled, indicating that they appear in only one set of records. These items must be accounted for.

### Step 3: Update the cash journals

The items circled in the Bank Statement are direct debits and credits the bank has made on the firm's behalf, receipts and payments that the business did not know about until it received the Bank Statement. In the credit column of the Bank Statement, the Interest received on 30 July 2025 was circled, meaning the firm did not know about it. This item must be added to the Cash Receipts Journal as is shown in Figure 8.2:

**Study tip**

When checking payments, it is essential to check not only the amount but also the cheque number.

**Figure 8.2** Updated Cash Receipts Journal

**Cash Receipts Journal**

| Date | Details | Rec. No. | Bank | Fees | Sundries | GST |
|---|---|---|---|---|---|---|
| July 1 | Cash fees | CRR 771–99 | 1320 ✓ | 1200 | | 120 |
| 12 | Cash fees | CRR799 -825 | 1100 ✓ | 1000 | | 100 |
| 24 | Interest on Term Deposit | 826 | 850 ✓ | | 850 | |
| 31 | Cash fees | CRR 827–851 | 1430 | 1300 | | 130 |
| 31 | Interest received | BS | 2 | | 2 | |
| | **TOTALS** | $ | **4702** | **3500** | **852** | **350** |

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In the debit column of the Bank Statement, the $15 service fee paid on 5 July 2025 and the $10 transaction fee paid on 29 July 2025 were circled, meaning the firm did not know about them. These items must be added to the Cash Payments Journal as is shown in Figure 8.3:

**Figure 8.3** Updated Cash Payments Journal

**Cash Payments Journal**

| Date | Details | Doc. | Bank | Supplies | Drawings | Wages | Sundries | GST |
|---|---|---|---|---|---|---|---|---|
| July 1 | Drawings | ATM 365 | 1 000 ✓ | | 1 000 | | | |
| 5 | Detergents | EFT 024 | 220 ✓ | 200 | | | | 20 |
| 11 | New equipment | 503 | 1 100 | | | | 1 000 | 100 |
| 13 | Wages | BS | 1 450 ✓ | | | 1 450 | | |
| 15 | Prepaid insurance | Bpay 723 | 3 960 ✓ | | | | 3 600 | 360 |
| 18 | Advertising | EFT 683 | 440 ✓ | | | | 400 | 40 |
| 28 | Cleaning supplies | 504 | 880 | 800 | | | | 80 |
| 30 | Service fee | BS | 15 | | | | 15 | |
| | Transaction fee | BS | 10 | | | | 10 | |
| | **TOTALS** | $ | **9 075** | **1 000** | **1 000** | **1 450** | **5 025** | **600** |

At this point, the firm's cash journals show all the cash transactions, so they can be totalled for the firm's bank balance to be calculated.

**Figure 8.4** Calculation of bank balance

| | | |
|---|---|---|
| | Cash receipts (from the Cash Receipts Journal) | $4 702 |
| Less | Cash payments (from the Cash Payments Journal) | 9 075 |
| | Cash surplus/(deficit) | (4 373) |
| | Opening Bank Balance | 4 830 |
| | **Closing Bank Balance** | **$457** |

Once updated, the records of the firm indicate that it has a positive bank balance of **$457** at the end of July. However, the Bank Statement at the same date states that the firm should have $1 007 in its account, so we must prepare a Bank Reconciliation Statement to explain this difference.

**Study tip**

Include all the figures in each total of each journal, even the ones that are circled.

**Step 4: Prepare a Bank Reconciliation Statement**

The Bank Reconciliation Statement attempts to explain the difference between the balance shown in the Bank Statement (which in this case is $1 007) and the firm's records of **$457**. Given that the firm's cash journals have been updated and contain all the cash transactions, any difference should be caused by transactions the bank does not know about. These will include:

- the *deposits not yet credited* circled in the Cash Receipts Journal
- the *unpresented cheques* circled in the Cash Payments Journal.

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**Figure 8.5** Bank Reconciliation Statement

**WILLOW'S WINDOW WASH**

**Bank Reconciliation Statement as at 31 July 2025**

| | | |
|---|---|---|
| **Bank balance as per Bank Statement** | | $ 1 007 CR |
| **Add Deposits not yet credited** | | 1 430 |
| | | 2 437 |
| **Less Unpresented cheques** | | |
| # 503 | 1 100 | |
| # 504 | 880 | 1 980 |
| **Bank balance as per business records** | | **$ 457** |

**Study tip**

Be sure to use the correct 'Balance as per Bank Statement': it should be the last balance on the Bank Statement.

If the Bank Reconciliation Statement balances (or reconciles), then all cash has been accounted for, and the owner will have an accurate and up-to-date assessment of the amount of cash available. However, if the two balances cannot be reconciled, it might indicate theft or fraud, which must be investigated.

## 8.7 Bank reconciliation issues

### Dishonoured cheques

The general approach to updating the cash journals is to record items that are circled in the debit column of the Bank Statement in the Cash Payments Journal. However, a cheque which is dishonoured will appear in the debit column but must be recorded as a *negative cash receipt*. Remember, a dishonoured cheque is originally recorded as a cash receipt; when the business discovers the cheque has been dishonoured, it must reverse that receipt.

**Example**

On 21 January 2025, Tom's Tanning Studio received a cheque from Frank Glebe for $550 (including $50 GST) for tanning fees. Upon receiving the Bank Statement at the end of January, the business discovered that the cheque had been dishonoured.

The dishonoured cheque would be recorded in the Cash Receipts Journal as is shown in Figure 8.6:

**Figure 8.6** Recording a dishonoured cheque in the Cash Receipts Journal

**Cash Receipts Journal**

| Date | Details | Rec. No. | Bank | Fees | Sundries | GST |
|---|---|---|---|---|---|---|
| Jan. 3 | Tanning fees | 12–17 | 330 | 300 | | 30 |
| 12 | Capital contribution | 18 | 1 000 | | 1 000 | |
| 21 | Tanning fees | 19–25 | 550 | 500 | | 50 |
| 29 | Tanning fees | 26–31 | 440 | 400 | | 40 |
| | Dis. Chq. (F. Glebe) | BS | (550) | (500) | | (50) |
| | **TOTALS** | $ | **1 770** | **700** | **1 000** | **70** |

**Study tip**

Dishonoured cheques may be identified on a Bank Statement by abbreviations such as 'Dis. Ch,' or 'Misc. Dr.' (meaning 'Miscellaneous debit').

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## Errors

Occasionally, the process of verifying the transactions recorded in the cash journals will uncover an error regarding an incorrect amount. Once it is established that the error has been made by the business (and not by the bank), the cash journals must be corrected.

**Example**

Upon receiving the Bank Statement at the end of January, Tom's Tanning Studio discovered that a payment for wages, which it had been recorded in the Cash Payments Journal as $230, was actually $320 (Chq. 153).

In this case, an extra $90 must be added to the total cash paid (in the Bank column), and the cash paid for Wages, so the error would be corrected in the Cash Payments Journal as is shown in Figure 8.7:

**Figure 8.7** Correcting an error in the Cash Payments Journal

**Cash Payments Journal**

| Date | Details | Doc. | Bank | Supplies | Drawings | Wages | Sundries | GST |
|---|---|---|---|---|---|---|---|---|
| Jan. 4 | Drawings | ATM W/draw | 500 | | 500 | | | |
| 12 | Wages | 153 | 230 | | | 230 | | |
| 19 | Electricity | Bpay 078 | 264 | | | | 240 | 24 |
| 24 | Supplies | EFT 589 | 220 | 200 | | | | 20 |
| 30 | Error – Chq. 153 | BS | 90 | | | 90 | | |
| | **TOTALS** | $ | **1304** | **200** | **500** | **320** | **240** | **44** |

## Overdrafts

In the case of a bank overdraft, the format of the Bank Reconciliation Statement may be changed. When a business has an overdraft, unpresented cheques will actually increase that (negative) balance, whereas deposits not yet credited will decrease that (negative) balance, therefore the statement can be presented as is shown in Figure 8.8:

**Figure 8.8** Bank Reconciliation Statement – overdraft balance

**TOM'S TANNING STUDIO**

**Bank Reconciliation Statement as at 31 January 2025**

| | | |
|---|---|---|
| **Bank balance as per Bank Statement** | | $ 750 DR |
| **Add Unpresented cheques** | | |
| # 254 | | 264 |
| | | 1014 |
| **Less Deposits not yet credited** | | 440 |
| **Bank balance as per business records** | | $ 574 OD |

### Review questions 8.6

1. **Identify** the column on the Bank Statement in which a dishonoured cheque would be recorded.
2. **Explain** how a dishonoured cheque is recorded in the cash journals.
3. **Explain** the effect on an overdraft balance of a:
   - deposit not yet credited
   - unpresented cheque.

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## 8.8 Bank reconciliation over consecutive periods

Items are reported in a Bank Reconciliation Statement when, at the end of the period, they have not yet appeared on the Bank Statement. However, they should appear on the Bank Statement in the *next* period, and so are the first items that should be identified in the next month's bank reconciliation process.

Specifically, we must check to see whether:

- the deposits not yet credited appear in the *credit* column of the new Bank Statement
- the unpresented cheques appear in the *debit* column of the new Bank Statement.

If a particular item appears on the Bank Statement, tick it off in both the Bank Reconciliation Statement and the Bank Statement. If it fails to appear on the Bank Statement again, it must be reported in the next Bank Reconciliation Statement (again as a deposit not yet credited or unpresented cheque), because the bank still does not know about it.

**Example**

Willow's Window Wash provided the following information relating to its cash transactions for August 2025:

**Study tip**

The previous Bank Reconciliation Statement is checked against the Bank Statement, not the cash journals.

**WILLOW'S WINDOW WASH**
**Bank Reconciliation Statement as at 31 July 2025**

| | | |
|---|---|---|
| **Bank balance as per Bank Statement** | | $1 007 CR |
| **Add Deposits not yet credited** | | 1 430✓ |
| | | 2 437 |
| **Less Unpresented cheques** | | |
| # 503 | 1 100✓ | |
| # 507 | 880 | 1 980 |
| **Bank balance as per business records** | | **$ 457** |

**Cash Receipts Journal**

| Date | Details | Rec. No. | Bank | Fees | Sundries | GST |
|---|---|---|---|---|---|---|
| Aug. 5 | Cash fees | 775–94 | 1 760 ✓ | 1 600 | | 160 |
| 10 | Capital contribution | 795 | 3 000 ✓ | | 3 000 | |
| 24 | Cash fees | 796–807 | 550 ✓ | 500 | | 50 |
| 31 | Cash fees | 807–823 | 1 980 | 1 800 | | 180 |

**Cash Payments Journal**

| Date | Details | Doc. | Bank | Supplies | Drawings | Wages | Sundries | GST |
|---|---|---|---|---|---|---|---|---|
| Aug. 1 | Drawings | BS | 1 590 ✓ | | 1 590 | | | |
| 5 | Advertising | 509 | 1 760 ✓ | | | | 1 600 | 160 |
| 19 | Wages | BS | 1 800 ✓ | | | 1 800 | | |
| 26 | Registration | Bpay 406 | 1 650 ✓ | | | | 1 500 | 150 |
| 27 | Detergents | 510 | 330 | 300 | | | | 30 |
| 28 | Cleaning supplies | 511 | 1 870 | 1 700 | | | | 170 |

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**Study tip**

Using the cheque number as a guide, is essential in this process.

Of the three items that were reported on the Bank Reconciliation Statement as at 31 Jul 2025, the $1 430 deposit not yet credited and unpresented cheque #503 (for $1 100) have now appeared on the Bank Statement. However, the other cheque which was unpresented at 31 July 2025 – Chq. #507 for $880 – has still not appeared. This cheque will be again be reported as unpresented, this time on the Bank Reconciliation Statement as at 31 August 2025 (i.e. the next month):

**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 |
|---|---|---|---|---|
| **2025** | | **$** | **$** | **$** |
| August 1 | Balance bought forward | | | 1 007 CR |
| 1 | CSH/CHQs | | 1 430 ✓ | 2 437 CR |
| 3 | W/draw online Owner | 1 590 ✓ | | 847 CR |
| 4 | 503 | 1 100 ✓ | | 253 CR |
| 6 | Deposit POS | | 1 460 ✓ | 1 207 CR |
| 6 | CSH/CHQs | | 300 ✓ | 1 507 CR |
| 9 | Service fee | 17 | | 1 490 CR |
| 11 | Deposit Owner CapCont | | 3 000 ✓ | 4 490 CR |
| 19 | W/draw online Wages | 1 800 ✓ | | 2 690 CR |
| 25 | CSH/CHQs | | 550 ✓ | 3 240 CR |
| 26 | 509 | 1 760 ✓ | | 1 480 CR |
| 27 | W/draw Bpay 406 | 1 650 ✓ | | 170 DR |
| 28 | Transaction fee | 30 | | 200 DR |
| 29 | Dishonoured cheque | 550 | | 750 DR |
| 31 | Direct Deposit – AMP | | 660 | 90 DR |
| | TOTALS THIS PAGE | $8 497 | $6 740 | |
| | **Final Balance** | **DEBIT** | | **$ 90** |

**Figure 8.9** Bank Reconciliation Statement – consecutive periods

**WILLOW'S WINDOW WASH**

**Bank Reconciliation Statement as at 31 August 2025**

| | | |
|---|---|---|
| **Bank balance as per Bank Statement** | | $90 DR |
| **Add Unpresented cheques** | | |
| #507 | 880 | |
| #510 | 330 | |
| #511 | 1 870 | 3 080 |
| | | 3 170 |
| **Less Deposits not yet credited** | | 1 980 |
| **Bank balance as per business records** | | **$(1 190)** |

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If a cheque remained unpresented for a long period of time, the business would normally contact the entity to whom they wrote the cheque to make sure that everything was all right and that the cheque was not misplaced or lost.

### Review questions 8.7

1. **Explain** the role of the previous month's Bank Reconciliation Statement in the bank reconciliation process.
2. **Explain** how items that fail to appear on consecutive Bank Statements should be accounted for in a bank reconciliation.

## Where have we been?

- Internal control mechanisms protect assets from theft, damage and misuse; cash control mechanisms relate specifically to cash.
- 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.
- The Bank Statement and cash journals will not always show the same information because there may be some transactions the bank does not know about, and some transactions the business does not know about.
- The four steps in the bank reconciliation are: compare cash receipts; compare cash payments; update the firm's cash journals; prepare a Bank Reconciliation Statement.
- Items circled on the Bank Statement will be added to the cash journals; items circled in the cash journals will be reported in a Bank Reconciliation Statement.
- A dishonoured cheque must be recorded as a negative cash receipt.
- Deposits not yet credited and unpresented cheques must be reported on the Bank Reconciliation Statement until they appear on the Bank Statement.

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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 8.1

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### Bank reconciliation

As at 1 August 2025, Pippa's Dog Wash had $1 235 cash in its bank account. The firm's cash journals and Bank Statement for August 2025 are provided.

**Cash Receipts Journal**

| Date | Details | Rec. No. | Bank | Washing | Clipping & Cuts | Sundries | GST |
|---|---|---|---|---|---|---|---|
| Aug. 3 | B. Bulldog | 55 | **110** | 100 | | | 10 |
| 6 | K. Kelpy | 56 | **220** | | 200 | | 20 |
| 9 | P. Poodle | 57 | **242** | 220 | | | 22 |
| 18 | C. Collie | 58 | **330** | | 300 | | 30 |
| | B. Basset | 59 | **275** | 250 | | | 25 |
| 27 | Capital contribution | 60 | **1 000** | | | 1 000 | |
| 31 | L. Labrador | 61 | **385** | 350 | | | 35 |

**Cash Payments Journal**

| Date | Details | Doc. | Bank | Cleaning supplies | Drawings | Sundries | GST |
|---|---|---|---|---|---|---|---|
| Aug. 3 | Cleaning supplies | EFT 073 | **220** | 200 | | | 20 |
| 4 | Wages | 313 | **800** | | | 800 | |
| 12 | Drawings | 314 | **500** | | 500 | | |
| 17 | Registration | Bpay 104 | **440** | | | 400 | 40 |
| 19 | Advertising | 315 | **396** | | | 360 | 36 |
| 28 | Cleaning supplies | EFT 142 | **165** | 150 | | | 15 |
| 29 | Drawings | 316 | **500** | | 500 | | |
| 30 | Insurance | 317 | **462** | | | 420 | 42 |

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## Bendigo Bank

Upper Beaconsfield Branch

| A/c holder | Pippa's Dog Wash | | | a/c: 028474584 |
|---|---|---|---|---|
| | 12 Berwick Rd, Pakenham, VICTORIA 3199 | | | |
| **Date** | **Particulars** | **Debit** | **Credit** | **Balance** |
| **2025** | | **$** | **$** | **$** |
| August 1 | Balance b/fwd | | | 1 235 CR |
| 4 | Cash/Cheques | | 110 | 1 345 CR |
| 5 | EFTPOS W/draw 073 | 220 | | 1 125 CR |
| | Interest | | 20 | 1 145 CR |
| 7 | Cash/Cheques | | 220 | 1 365 CR |
| 9 | 313 | 800 | | 565 CR |
| 10 | Cash/Cheques | | 242 | 807 CR |
| 17 | Bpay W/draw 104 | 440 | | 367 CR |
| 19 | Cash/Cheques | | 605 | 972 CR |
| 20 | 314 | 500 | | 472 CR |
| 28 | 315 | 396 | | 76 CR |
| 29 | Cash/Cheques | | 1 000 | 1 076 CR |
| | EFTPOS W/draw 142 | 165 | | 911 CR |
| 30 | Transaction fee | 15 | | 896 CR |
| | **Closing balance** | | | **896 CR** |

*Required*

★ **a** **Update** the cash journals of Pippa's Dog Wash. **Total** the cash journals.

★ **b** **Calculate** the bank balance in the records of Pippa's Dog Wash as at 31 August 2025.

**c** **Explain** the purpose of preparing a Bank Reconciliation Statement.

★ **d** **Prepare** a Bank Reconciliation Statement for Pippa's Dog Wash as at 31 August 2025.

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## Exercise 8.2

W B page 129

### Bank reconciliation: dishonoured cheque

Smooth Lawn Services is owned and operated by Terry Hopgood who has provided the following information related to the firm's cash transactions for February 2025:

**SMOOTH LAWN SERVICES**

**Receipts and Payments (totals only) for February 2025**

| | |
|---|---|
| Cash receipts | 4400 |
| Less Cash payments | 3350 |
| Surplus (Deficit) | 1050 |
| Add Balance as at 1 February 2025 | 200 |
| Balance as at 28 February 2025 | $1250 |

**Cash Receipts Journal**

| Date | Details | Rec.No. | Bank | Mowing fees | Sundries | GST |
|---|---|---|---|---|---|---|
| Mar. 1 | G. Cole | 55 | **990** | 900 | | 90 |
| 6 | A. Biddiscombe | EFT 093 | **275** | 250 | | 25 |
| | M. Walker | EFT 094 | **187** | 170 | | 17 |
| 13 | A. Micari | EFT 095 | **550** | 500 | | 50 |
| 18 | D. Cope | 56 | **308** | 280 | | 28 |
| 25 | Capital contribution | BS | **2000** | | 2000 | |
| 31 | C. Brooke | 57 | **165** | 150 | | 15 |

**Cash Payments Journal**

| Date | Details | Doc. | Bank | Wages | Drawings | Sundries | GST |
|---|---|---|---|---|---|---|---|
| Mar. 1 | Advertising | 340 | **165** | | | 150 | 15 |
| 2 | Wages | BS | **300** | 300 | | | |
| 4 | Drawings | BS | **375** | | 375 | | |
| 12 | Wages | 341 | **120** | 120 | | | |
| 16 | Tools | EFTPOS 269 | **275** | | | 250 | 25 |
| 18 | Drawings | BS | **360** | | 360 | | |
| 21 | Wages | BS | **180** | 180 | | | |
| 27 | Rent | 347 | **220** | | | 200 | 20 |

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**Bank of Ballarat**
Yallambie Branch

A/c holder Smooth Lawn Services a/c: 867 5309
Yallambie VICTORIA 3058

| Date | Particulars | Debit | Credit | Balance |
|---|---|---|---|---|
| **2025** | | **$** | **$** | **$** |
| March 1 | Balance b/fwd | | | 1 250 CR |
| | Cash/Cheques | | 990 | 2 240 CR |
| 2 | W/draw online wages | 300 | | 1 940 CR |
| 4 | W/draw online drawings | 375 | | 1 565 CR |
| 6 | Deposit POS | | 462 | 2 027 CR |
| 13 | Deposit POS | | 550 | 2 577 CR |
| 17 | EFTPOS W/draw Bunn 269 | 275 | | 2 302 CR |
| 18 | Cash/Cheques | | 308 | 2 610 CR |
| 18 | W/Draw online | 360 | | 2 250 CR |
| 20 | Interest | | 25 | 2 275 CR |
| 20 | 340 | 165 | | 2 110 CR |
| 21 | W/draw online wages | 180 | | 1 930 CR |
| 25 | Deposit online owner CapCont | | 2 000 | 3 930 CR |
| 28 | Dishonoured cheque | 550 | | 3 380 CR |
| 31 | Bank charges | 10 | | 3 370 CR |

*Required*

**a** Using an example from the information provided, **explain** the term 'direct credit'.

⋆ **b** **Update** and **total** the cash journals of Smooth Lawn Services.

⋆ **c** **Calculate** the bank balance in the records of Smooth Lawn Services as at 31 March 2025.

⋆ **d** **Prepare** a Bank Reconciliation Statement for Smooth Lawn Services as at 31 March 2025.

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## Exercise 8.3

WB page 131

### Bank reconciliation: dishonoured cheque

Nick Anderson operates a watch and jewellery repair shop in Avondale Heights called Nick of Time. Extracts from the cash journals of the business for September 2025 showed the following:

**Cash Receipts Journal (Extract)**

| Date | Details | Rec. No. | Bank | Repair fees | Sundries | GST |
|---|---|---|---|---|---|---|
| Sept. 2025 | Totals to date | | **3300** | 2200 | 800 | 300 |

**Cash Payments Journal (Extract)**

| Date | Details | Doc. | Bank | Wages | Drawings | Sundries | GST |
|---|---|---|---|---|---|---|---|
| Sept. 2025 | Totals to date | | **3950** | 970 | 2300 | 530 | 150 |

**Additional information:**

- Nick's cash records revealed that his bank balance as at 1 September 2025 was $200.
- Nick's most recent Bank Statement was issued on 30 September 2025 and it revealed that his bank balance was $50 CR.
- After comparing the Cash Receipts Journal and the Cash Payments Journal with the Bank Statement, it was found that the following items appeared in only one set of records:
  - The bank has charged $20 for transaction fees.
  - A deposit of $110 in the cash receipts journal placed into the deposit drop box of the bank late in the day on 30 September 2025 does not appear on the Bank Statement.
  - The bank has directly credited the bank account of Nick of Time with $120, representing interest received on a term deposit.
  - Cheques written in September 2025 that did not appear on the Bank Statement:

| | | |
|---|---|---|
| Cheque | #146 | $25 |
| | #149 | $130 |
| | #153 | $600 |

  - C. Campbell paid $220 (including $20 GST) to Nick for Repair fees but the cheque has been dishonoured.
  - Interest on overdraft charged by the bank for the month totals $25.

*Required*

⋆ **a** **Complete** the cash journals for September 2025.

⋆ **b** **Calculate** the bank balance in the books of Nick of Time as at 30 September 2025.

⋆ **c** **Prepare** a Bank Reconciliation Statement for Nick of Time as at 30 September 2025.

**d** Other than preparing a Bank Reconciliation Statement, **identify** two cash control procedures that Nick should adopt.

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## Exercise 8.4

WB page 133

### Bank reconciliation: overdraft, dishonoured cheque

On 1 November 2025, the records of Pulsating Pecs Gym showed a positive bank balance of $2 000. The firm's cash journals for November 2025 (prior to receiving the Bank Statement) were totalled as follows:

- Cash Receipts Journal $27 400
- Cash Payments Journal $29 500

The Bank Statement for November 2025 showed that at 30 November 2025 the gym had a balance of $4 435 DR, and the statement revealed the following:

- Cheque #8751 for $2 300 and cheque #8763 for $615 had not been presented.
- A cheque from A. Weid for $484 (including $44 GST) had been debited on the Bank Statement, because it had been dishonoured.
- Interest of $245 had been credited in the Bank Statement.
- $6 970 banked on 29 November 2025 did not appear on the Bank Statement.
- Cheque #8778 for $78 had been wrongly entered in the Cash Payments Journal as $87.
- Bank fees and charges amounting to $50 were debited in the Bank Statement.

*Required*

⋆ **a** **Calculate** the bank balance according to the cash records of Pulsating Pecs Gym as at 30 November 2025.

⋆ **b** **Prepare** a Bank Reconciliation Statement for Pulsating Pecs Gym as at 30 November 2025.

**c** **Explain** how the dishonoured cheque should be recorded in the cash journals of Pulsating Pecs Gym.

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## Exercise 8.5

WB page 134

### Bank reconciliation: consecutive periods

Bob Scott owns and manages B & M Cleaning, a firm that cleans private homes and small offices, and has provided the following information related to the firm's cash transactions for June 2025.

**B & M CLEANING**

**Bank Reconciliation Statement as at 31 May 2025**

| | | |
|---|---|---|
| **Bank balance as per Bank Statement** | | $ 3200 CR |
| **Add Deposits not yet credited** | | 420 |
| | | 3620 |
| **Less Unpresented cheques** | | |
| #205 | 130 | |
| #209 | 100 | 230 |
| **Bank balance as per business records** | | **$ 3390** |

**Cash Receipts Journal**

| Date | Details | Rec. No. | Bank | House cleaning | Office cleaning | Sundries | GST |
|---|---|---|---|---|---|---|---|
| June 5 | A. Castle | 36 | **220** | 200 | | | 20 |
| 8 | E.J. Accountants | 37 | **330** | | 300 | | 30 |
| 14 | L. Christmas | 38 | **242** | 220 | | | 22 |
| 20 | J. Roberts | 39 | **220** | 200 | | | 20 |
| | R. Wyte & Assoc. | 40 | **440** | | 400 | | 40 |
| 27 | Capital contribution | 41 | **5000** | | | 5000 | |
| 30 | L. Martin | 42 | **308** | 280 | | | 28 |

**Cash Payments Journal**

| Date | Details | Doc. | Bank | Cleaning supplies | Drawings | Sundries | GST |
|---|---|---|---|---|---|---|---|
| June 1 | Cleaning supplies | 213 | **132** | 120 | | | 12 |
| 4 | Wages | 214 | **1500** | | | 1500 | |
| 12 | Drawings | 215 | **350** | | 350 | | |
| 15 | Equipment | 216 | **1320** | | | 1200 | 120 |
| 19 | Advertising | 217 | **220** | | | 200 | 20 |
| 22 | Cleaning supplies | 218 | **198** | 180 | | | 18 |
| 26 | Drawings | 219 | **350** | | 350 | | |
| 29 | Insurance | 220 | **385** | | | 350 | 35 |

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| Bank of Karingal<br>Ashleigh Avenue Branch | | | | |
|---|---|---|---|---|
| A/c holder | B & M Cleaning<br>12 Boona Dve, Frankston, 3199 | | | a/c: 861 3650114 |
| **Date** | **Particulars** | **Debit** | **Credit** | **Balance** |
| **2025** | | **$** | **$** | **$** |
| June 1 | Balance b/fwd | | | 3200 CR |
| 1 | 213 | 132 | | 3068 CR |
| 2 | Deposit POS | | 420 | 3488 CR |
| 5 | 214 | 1500 | | 1988 CR |
| 6 | Deposit POS | | 220 | 2208 CR |
| 9 | 209 | 100 | | 2108 CR |
| 10 | Deposit POS | | 330 | 2438 CR |
| 15 | Deposit POS | | 242 | 2680 CR |
| 15 | 215 | 350 | | 2330 CR |
| 16 | 216 | 1320 | | 1010 CR |
| 18 | Loan repayment | 1000 | | 10 CR |
| 22 | Deposit POS | | 660 | 670 CR |
| 25 | 218 | 198 | | 472 CR |
| 28 | 219 | 350 | | 122 DR |
| 29 | Cash/Cheques | | 5000 | 5122 CR |
| 30 | Interest | | 20 | 5142 CR |
| | **Closing balance** | | | **5142 CR** |

*Required*

**a** **Explain** how a petty cash system could improve the cash management procedures of B & M Cleaning.

⋆ **b** **Complete** the cash journals of B & M Cleaning.

⋆ **c** **Calculate** the bank balance in the records of B & M Cleaning as at 30 June 2025.

⋆ **d** **Prepare** a Bank Reconciliation Statement for B & M Cleaning as at 30 June 2025.

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## Exercise 8.6

WB page 136

### Bank reconciliation: consecutive periods

The following information is provided by the owner of Blooming Florist, a business that hires fake flowers for the beautification of reception areas to major companies.

**BLOOMING FLORIST**

**Bank Reconciliation Statement as at 31 October 2025**

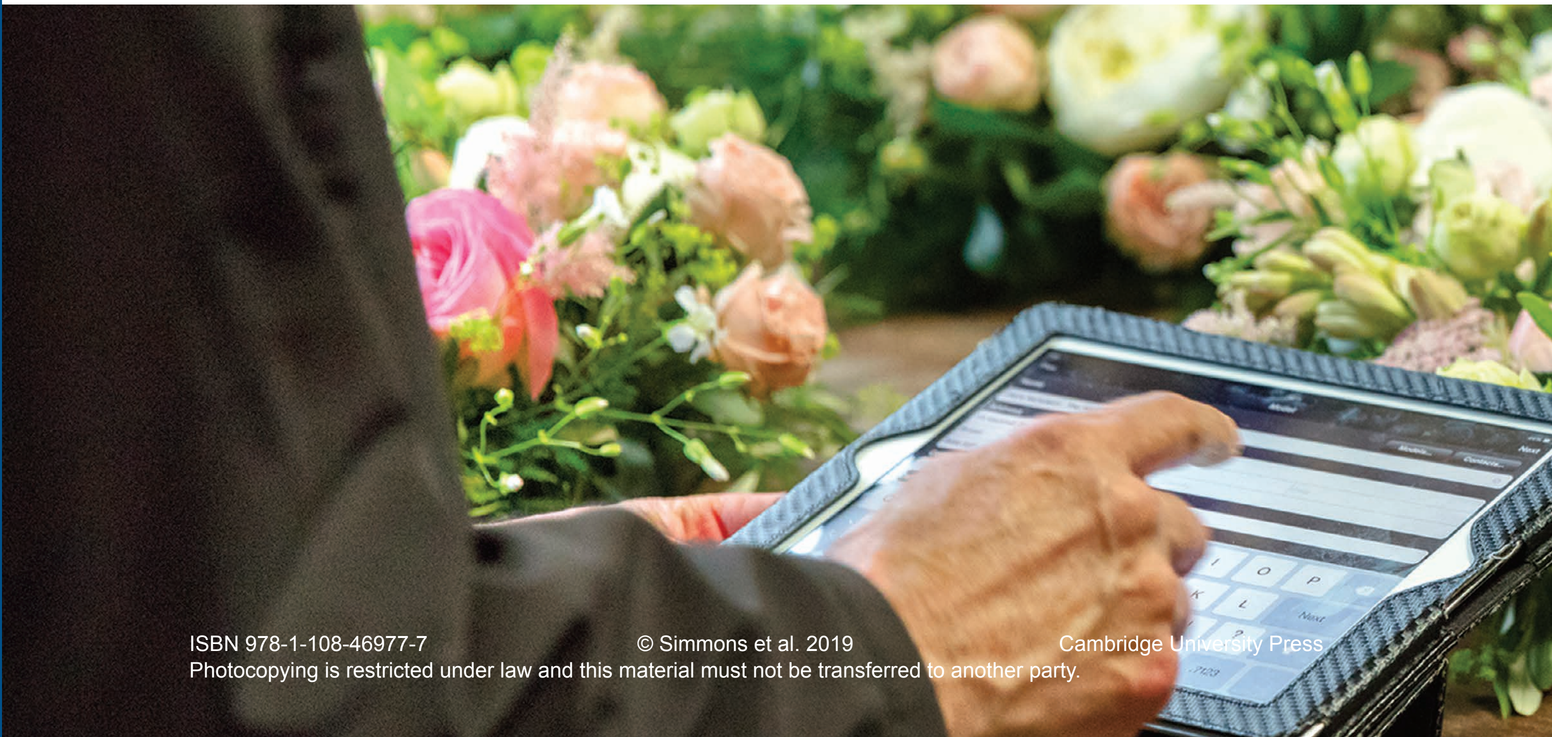
| | | |
|---|---|---|
| **Bank balance as per Bank Statement** | | $ 9380 CR |
| **Add Deposits not yet credited** | | 2720 |
| | | 12 100 |
| **Less Unpresented cheques** | | |
| #10731 | 13 610 | |
| #10737 | 90 | |
| #10743 | 1400 | 15 100 |
| **Bank balance as per business records** | | **$ (3000)** |

**Cash Receipts Journal**

| Date | Details | Rec. No. | Bank | Hire fees | Sundries | GST |
|---|---|---|---|---|---|---|
| Nov. 1 | Cash fees | 888–922 | **3300** | 3000 | | 300 |
| 8 | Cash fees | 923–990 | **4840** | 4400 | | 440 |
| 12 | Cash fees | 991–1032 | **4070** | 3700 | | 370 |
| 22 | Cash fees | 1033–078 | **2310** | 2100 | | 210 |

**Cash Payments Journal**

| Date | Details | Doc. | Bank | Transport | Drawings | Wages | Sundries | GST |
|---|---|---|---|---|---|---|---|---|
| Nov. 4 | Wages | 10744 | **720** | | | 720 | | |
| 5 | Registration | 10745 | **3960** | 3600 | | | | 360 |
| 12 | Office furniture | 10746 | **1650** | | | | 1500 | 150 |
| 18 | Petrol | 10747 | **180** | 180 | | | | |
| 22 | Drawings | 10748 | **1350** | | 1350 | | | |
| 28 | Prepaid insurance | 10749 | **2640** | 2400 | | | | 240 |



## SOUTH BANK

BANK STATEMENT

**Blooming Florists**
PO BOX 6943
Paganin 5678

Branch No. 473 0264
Chq Ac No. 753 0285
**Page No. 18**

| Date | Particulars | Debit | Credit | Balance |
|---|---|---|---|---|
| **Nov. 2025** | | **$** | **$** | **$** |
| 1 | Balance brought forward | | | 9 380 CR |
| | Cash/Cheques | | 3 300 | 12 680 CR |
| 4 | 10731 | 13 610 | | 930 DR |
| 8 | 10744 | 720 | | 1 650 DR |
| 9 | Cash/Cheques | | 840 | 810 DR |
| | Deposit POS | | 4 000 | 3 190 CR |
| 13 | Cash/Cheques | | 270 | 3 460 CR |
| | Deposit POS | | 3 800 | 7 260 CR |
| 18 | 10746 | 1 650 | | 5 610 CR |
| 21 | 10743 | 1 400 | | 4 210 CR |
| 23 | Cash/Cheques | | 2 310 | 6 520 CR |
| 25 | 10748 | 1 350 | | 5 170 CR |
| 29 | 10745 | 3 960 | | 1 210 CR |
| 30 | Service fee | 40 | | 1 170 CR |
| | Deposit Arthur Andersen | | 1 100 | 2 270 CR |

Note: Arthur Andersen paid for hire fees via direct credit.

*Required*

- ⋆ **a** **Complete** the cash journals of Blooming Florist as at 30 November 2025.
- ⋆ **b** **Calculate** the bank balance according to the cash records of Blooming Florist as at 30 November 2025.
- ⋆ **c** **Prepare** a Bank Reconciliation Statement for Blooming Florist at 30 November 2025.
- **d** **Explain** one reason why the owner should investigate the $2 720 deposit not yet credited.

## Exercise 8.7

WB page 138

### Bank reconciliation: consecutive periods, dishonoured cheque

Major Mechanicals is an automotive repair business owned and operated by Gillian Major. Gillian has provided the following information related to the firm's cash transactions for December 2025.

**MAJOR MECHANICALS**

**Bank Reconciliation Statement as at 30 November 2025**

| | | |
|---|---|---|
| **Bank balance as per Bank Statement** | | $ 400 DR |
| **Add Unpresented cheques** | | |
| #128 | 200 | |
| #131 | 150 | 350 |
| | | 750 |
| **Less Deposits not yet credited** | | 200 |
| **Bank balance as per business records** | | **$ (550)** |

**Cash Receipts Journal**

| Date | Details | Rec. No | Bank | Fees | Sundries | GST |
|---|---|---|---|---|---|---|
| Dec. 5 | B. Howell | 12 | **495** | 450 | | 45 |
| | Capital – Jacobs | 13 | **500** | | 500 | |
| 9 | J. Murachana | 14 | **110** | 100 | | 10 |
| 14 | A. Felix | 15 | **550** | 500 | | 50 |
| 19 | M. Jonas | 16 | **825** | 750 | | 75 |
| 23 | B. Howell | 17 | **330** | 300 | | 30 |
| 30 | F. Richards | 18 | **880** | 800 | | 80 |

**Cash Payments Journal**

| Date | Details | Doc. | Bank | Wages | Drawings | Sundries | GST |
|---|---|---|---|---|---|---|---|
| Dec. 1 | Wages | 133 | **250** | 250 | | | |
| 4 | Electricity | 134 | **330** | | | 300 | 30 |
| 12 | Tools | 135 | **440** | | | 400 | 40 |
| 15 | Wages | 136 | **240** | 240 | | | |
| 18 | Rent | 137 | **660** | | | 600 | 60 |
| 21 | Drawings | 138 | **170** | | 170 | | |
| 27 | Advertising | 139 | **385** | | | 350 | 35 |

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| Bank of Suburbia<br>Collingwood Branch | | | | |
|---|---|---|---|---|
| A/c holder | Major Mechanicals<br>95 Smith St<br>Collingwood,Victoria | | a/c: 345 9876001 | |
| **Date** | **Particulars** | **Debit** | **Credit** | **Balance** |
| **2025** | | **$** | **$** | **$** |
| Dec. 1 | Balance b/fwd | | | 400 DR |
| | Deposit POS | | 200 | 200 DR |
| 3 | 133 | 250 | | 450 DR |
| | 128 | 200 | | 650 DR |
| 5 | Deposit POS | | 995 | 345 CR |
| 9 | 134 | 330 | | 15 CR |
| | Cash/Cheques | | 110 | 125 CR |
| 14 | Deposit POS | | 550 | 675 CR |
| 15 | 136 | 240 | | 435 CR |
| 18 | 135 | 440 | | 5 DR |
| 19 | Deposit POS | | 825 | 820 CR |
| 20 | Loan repayment | 700 | | 120 CR |
| 21 | 138 | 170 | | 50 DR |
| 23 | Cash/Cheques | | 330 | 280 CR |
| 27 | Dishonoured cheque | 330 | | 50 DR |
| 30 | Interest | | 75 | 25 CR |
| | **Closing balance** | | | **25 CR** |

*Required*

a **State** the purpose of preparing a Bank Reconciliation Statement.

⋆ b **Complete** the cash journals of Major Mechanicals for December 2025.

c Referring to one Qualitative characteristic, **explain** why the firm's records must be updated before the preparation of the Cash Flow Statement.

⋆ d **Calculate** the bank balance in the cash records of Major Mechanicals as at 31 December 2025.

⋆ e **Prepare** a Bank Reconciliation Statement for Major Mechanicals as at 31 December 2025.

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## Exercise 8.8

W B **page 140**

## Bank reconciliation: consecutive periods, error

Fatima Hadj is one of three partners who operate a law firm called Hadj, Boulad and Brown. As the most financially literate of the three, Fatima performs most bookkeeping functions. She records the firm's cash transactions in a Cash Receipts Journal and a Cash Payments Journal, and she is responsible for collecting and banking all cash received. Cash fees are banked at the end of each week, and Bank Reconciliation Statements are prepared monthly. Fatima has supplied the following information from the firm's Accounting records for March 2025.

**HADJ, BOULAD AND BROWN**

**Bank Reconciliation Statement as at 28 February 2025**

| | | |
|---|---|---|
| **Bank balance as per Bank Statement** | | $ 150 DR |
| **Add Unpresented cheques** | | |
| #153 | 130 | |
| #155 | 90 | 220 |
| | | 370 |
| **Less Deposits not yet credited** | | 500 |
| **Bank balance as per business records** | | **$ 130** |

At the end of March 2025, the cash journals showed the following totals:

- Cash Receipts Journal $4 180
- Cash Payments Journal $3 940

On 31 March 2025, the Bank Statement of Hadj, Boulad and Brown showed a closing balance of $490 CR. After comparing the cash journals with the Bank Statement, the following discrepancies were found:

- The $500 deposit not yet credited as at 28 February 2025 appeared on the Bank Statement, as did Cheque #155. Cheque #153 did not appear on the Bank Statement.
- $30 interest appeared in the credit column of the Bank Statement, but not in the cash journals.
- A deposit of $300 (recorded in the Cash Receipts Journal on 31 March 2025) did not appear on the Bank Statement.
- Cheque #158 was recorded in the Cash Payments Journal as $170 but appeared on the Bank Statement as $120. Fatima has checked and the Bank Statement figure is correct. Two cheques written in March did not appear on the Bank Statement:

| | | |
|---|---|---|
| Cheque | #161 | $70 |
| | #162 | $140 |

### *Required*

**a** **Identify** one positive aspect and one negative aspect of the cash control procedures implemented by Hadj, Boulad and Brown.

**b** **Explain** why the Bank Reconciliation Statement has added the unpresented cheques to the bank balance as per Bank Statement.

**c** **Suggest** one reason why the Bank Statement does not show the deposit of $300 made on 31 March 2025.

⋆ **d** **Calculate** the bank balance in the records of Hadj, Boulad and Brown as at 31 March 2025.

⋆ **e** **Prepare** a Bank Reconciliation Statement for Hadj, Boulad and Brown as at 31 March 2025.

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## Exercise 8.9

### Bank reconciliation: consecutive periods, dishonoured cheque, overdraft

WB page 141

Con Stephanopoulos is a freelance architect operating under the business name of Con-Structions. The Bank Reconciliation Statement for Con-Structions as at 31 March 2025 showed the following.

**CON-STRUCTIONS**

**Bank Reconciliation Statement as at 31 March 2025**

| | | |
|---|---|---|
| **Bank balance as per Bank Statement** | | $ 2010 CR |
| **Add Deposits not yet credited** | | 500 |
| | | 2510 |
| **Less Unpresented cheques** | | |
| #152 | 190 | |
| #155 | 250 | |
| #159 | 150 | 590 |
| **Bank balance as per business records** | | **$ 1920** |

The cash journals of Con-Structions showed the following for April 2025:

- Cash receipts (total) $2925
- Cash payments (total) $3500

On 4 May 2025, Con received a Bank Statement for April 2025, which showed a closing balance of $500 DR. Upon checking the Bank Statement against his cash journals for April, Con discovered the following differences:

- The $500 deposit which was uncredited as at 31 March 2025 appeared on the Bank Statement.
- Of the cheques unpresented as at 31 March 2025, the following now appeared on the Bank Statement:

| | | |
|---|---|---|
| Cheque | #155 | $250 |
| | #159 | $150 |

- A direct debit of $350 referred to a loan instalment.
- Two cheques that were listed in the Cash Payments Journal did not appear on the Bank Statement:

| | | |
|---|---|---|
| Cheque | #164 | $490 |
| | #183 | $125 |

- A cheque Con received from a customer (worth $250 plus $25 GST) had been returned.
- A $2010 deposit made on 29 April 2025 was not shown on the Bank Statement.
- Bank charges amounted to $15.

### *Required*

**a** **Explain** why cheque #159 is listed as 'unpresented'.

**b** **Outline** two methods of cash control other than the preparation of a Bank Reconciliation Statement.

⋆ **c** **Calculate** the bank balance in the records of Con-Structions as at 30 April 2025.

**d** **Explain** what action Con should take with regard to the 'returned' cheque.

⋆ **e** **Prepare** a Bank Reconciliation Statement for Con-Structions as at 30 April 2025.

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## Exercise 8.10

WB page 143

## Bank reconciliation

Karl Fixit operates as a mechanic at a local service station and has supplied the following information from the firm's Accounting records for May 2025:

**FIXIT REPAIRS**

**Bank Reconciliation Statement as at 31 May 2025**

| | | |
|---|---|---|
| **Bank balance as per Bank Statement** | | $ 270 CR |
| **Add Deposits not yet credited** | | 800 |
| | | 1 070 |
| **Less Unpresented cheques** | | |
| #107 | 290 | |
| #111 | 750 | |
| #115 | 360 | 1 400 |
| **Bank balance as per business records** | | $ (330) |

Extracts from the cash journals for June 2025 showed the following:

**Cash Receipts Journal (Extract)**

| Date | Details | Rec. No. | Bank | Repair fees | Sundries | GST |
|---|---|---|---|---|---|---|
| June 2025 | Totals to date | | **4 120** | 3 400 | 350 | 370 |

**Cash Payments Journal (Extract)**

| Date | Details | Doc. | Bank | Parts | Wages | Sundries | GST |
|---|---|---|---|---|---|---|---|
| June 2025 | Totals to date | | **3 815** | 1 030 | 2 150 | 515 | 120 |

Fixit Repairs' most recent Bank Statement was issued on 30 June 2025 and it revealed a bank balance of $405 DR.

After comparing the Cash Receipts Journal and the Cash Payments Journal with the Bank Statement, it was found that the following items appeared in only one set of records:

- The $800 deposit not yet credited as at 31 May 2025 appeared on the Bank Statement, as did cheques #107 and #115.
- A deposit of $825 deposited at the bank late in the day on 30 June 2025 does not appear on the Bank Statement.
- The bank has directly debited the bank account with $550 representing a payment on a loan.
- Cheques written in June 2025 that did not appear on the Bank Statement:

| | | |
|---|---|---|
| Cheque | #137 | $325 |
| | #143 | $240 |

- A customer paid $385 for Repair fees but the cheque has been dishonoured.
- A deposit was recorded in the Cash Receipts Journal as $440 but appeared on the Bank Statement as $550. Karl has determined that the Bank Statement is correct.
- Interest on overdraft for the month totalled $45.

### *Required*

⋆ **a** **Complete** the cash journals for June 2025.

⋆ **b** **Calculate** the bank balance according to the books of Fixit Repairs as at 30 June 2025.

⋆ **c** **Prepare** a Bank Reconciliation Statement for Fixit Repairs as at 30 June 2025.

**d** **Define** the term 'dishonoured cheque'. **State** one reason why it appears on the debit side of the Bank Statement.

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## Exercise 8.11

WB page 145

### Bank reconciliation

Alex Sensor runs his own carpentry business and has presented the following information regarding the firm's cash transactions for October 2025:

**SENSOR CARPENTRY**

**Bank Reconciliation Statement as at 30 September 2025**

| | | |
|---|---|---|
| **Bank balance as per Bank Statement** | | $ 605 DR |
| **Add Deposits not yet credited** | | 1 005 |
| | | 400 |
| **Less Unpresented cheques** | | |
| #116 | 125 | |
| #123 | 50 | |
| #124 | 105 | 280 |
| **Bank balance as per business records** | | **$ 120** |

**Cash Receipts Journal**

| Date | Details | Rec. No. | Bank | Repair fees | Sundries | GST |
|---|---|---|---|---|---|---|
| Oct. 2 | Cash fees | 81 | **330** | 300 | | 30 |
| 5 | Capital contribution | 82 | **500** | | 500 | |
| 10 | Cash fees | 83 | **165** | 150 | | 15 |
| 11 | Commission | 84 | **50** | | 50 | |
| 16 | Cash fees | 85 | **330** | 300 | | 30 |
| | Cash fees | 86 | **220** | 200 | | 20 |
| 21 | Cash fees | 87 | **440** | 400 | | 40 |
| 24 | Cash fees | 88 | **110** | 100 | | 10 |
| 28 | Cash fees | 89 | **187** | 170 | | 17 |
| 30 | Cash fees | 90 | **154** | 140 | | 14 |

**Cash Payments Journal**

| Date | Details | Doc. | Bank | Supplies | Rent | Wages | Sundries | GST |
|---|---|---|---|---|---|---|---|---|
| Oct. 2 | Cash purchases | 127 | **99** | 90 | | | | 9 |
| 4 | Rent | 128 | **143** | | 130 | | | 13 |
| 8 | Drawings | 129 | **500** | | | | 500 | |
| 11 | Cash purchases | 130 | **550** | 500 | | | | 50 |
| 17 | Wages | 131 | **340** | | | 340 | | |
| 20 | Cash purchases | 132 | **528** | 480 | | | | 48 |
| 21 | Insurance | 133 | **385** | | | | 350 | 35 |
| 26 | Cash purchases | 134 | **77** | 70 | | | | 7 |
| 29 | Rent | 135 | **121** | | 110 | | | 11 |
| 30 | Drawings | 136 | **110** | | | | 110 | |

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## The Bank of Victoria

Victoria Park Branch

NAME Sensor Carpentry
29 Termite Road, Collingwood 3066

AC No. 112525

| Date | Particulars | Debit | Credit | Balance |
|---|---|---|---|---|
| 2025 | | $ | $ | $ |
| 30 SEPT. | Balance forward | | | 605 DR |
| 1 OCT. | Deposit POS | | 1 005 | 400 CR |
| 3 OCT. | CSH | | 330 | 730 CR |
| 4 OCT. | 116 | 125 | | 605 CR |
| 4 OCT. | DEP – Interest | | 135 | 740 CR |
| 6 OCT. | CHQ | | 500 | 1 240 CR |
| 7 OCT. | 123 | 50 | | 1 190 CR |
| 9 OCT. | 128 | 143 | | 1 047 CR |
| 10 OCT. | CSH | | 165 | 1 212 CR |
| 11 OCT. | CSH | | 50 | 1 262 CR |
| 13 OCT. | 129 | 500 | | 762 CR |
| 13 OCT. | Service fee | 6 | | 756 CR |
| 16 OCT. | Deposit POS | | 550 | 1 306 CR |
| 18 OCT. | 131 | 430 | | 876 CR |
| 18 OCT. | VT Finance | 75 | | 801 CR |
| 20 OCT. | 130 | 550 | | 251 CR |
| 21 OCT. | Deposit POS | | 440 | 691 CR |
| 24 OCT. | CHQ | | 110 | 801 CR |
| 26 OCT. | Dis. Chq. | 110 | | 691 CR |
| 26 OCT. | 132 | 528 | | 163 CR |
| 27 OCT. | 134 | 77 | | 86 CR |
| 29 OCT. | CSH | | 187 | 273 CR |
| 30 OCT | 133 | 385 | | 112 DR |

### *Required*

**a** **Explain** one error in the way the Bank Reconciliation Statement is presented as at 30 September 2025.

* **b** **Complete** the cash journals for October 2025.

* **c** **Calculate** the bank balance according to the records of Sensor Carpentry as at 31 October 2025.

* **d** **Prepare** a Bank Reconciliation Statement for Sensor Carpentry as at 31 October 2025.

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## Exercise 8.12

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### Bank reconciliation

John Launat operates as a courier driver in the northern suburbs for Nearly There Deliveries. He pays for the use of a local garage to park his van and employs an assistant. Receipts are issued for all jobs, but John sometimes uses cash from the register to pay for urgent expenses. His assistant is responsible for emptying the register and taking the daily takings to the bank. This is done at 4 p.m. every day. John has supplied the following information from the firm's Accounting records:

**NEARLY THERE DELIVERIES**

**Bank Reconciliation Statement as at 31 May 2025**

| | | |
|---|---|---|
| **Bank balance as per Bank Statement** | | $ 250 CR |
| **Add Deposits not yet credited** | | 950 |
| | | 1 200 |
| **Less Unpresented cheques** | | |
| #232 | 460 | |
| #248 | 740 | |
| #254 | 355 | 1 555 |
| **Bank balance as per business records** | | **$ (355)** |

Extracts from the cash journals for June 2025 showed the following:

**Cash Receipts Journal (Extract)**

| Date | Details | Rec. No. | Bank | Courier fees | Sundries | GST |
|---|---|---|---|---|---|---|
| June 2025 | Totals to date | | 325 | 2 700 | 355 | 270 |

**Cash Payments Journal (Extract)**

| Date | Details | Doc. | Bank | Petrol | Wages | Sundries | GST |
|---|---|---|---|---|---|---|---|
| June 2025 | Totals to date | | 3 560 | 1 200 | 1 880 | 360 | 120 |

The most recent Bank Statement for Nearly There Deliveries was issued on 30 June 2025. It showed a bank balance of $425 DR.

After comparing the Cash Receipts Journal and the Cash Payments Journal with the Bank Statement, it was found that the following items appeared in only one set of records:

- The $950 deposit not yet credited as at 31 May 2025 appeared on the Bank Statement, as did cheques #248 and #254.
- Interest on an overdraft charged by the bank for the month totalled $65.
- Cheques written in June 2025 that did not appear on the Bank Statement:

| | | |
|---|---|---|
| Cheque | #263 | $290 |
| | #270 | $565 |

- A payment for wages was recorded in the Cash Payments Journal as $130 but appeared on the Bank Statement as $110. John determined that the Bank Statement figure was correct.
- A deposit of $610 in the Cash Receipts Journal deposited at the bank late in the day on 30 June 2025 did not appear on the Bank Statement.
- During June, a customer paid $495 (including $45 GST) for courier fees but the cheque has been dishonoured.

### *Required*

**a** Other than bank reconciliation, **identify** one positive aspect and one negative aspect of the cash control procedures that John has implemented.

**b** **Explain** the difference between a 'deficit' and an 'overdraft'.

⋆ **c** **Complete** the cash journals for June 2025.

⋆ **d** **Calculate** the bank balance according to the records of Nearly There Deliveries as at 30 June 2025.

⋆ **e** **Prepare** a Bank Reconciliation Statement for Nearly There Deliveries as at 30 June 2025.

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Chapter 9

# Credit transactions

## Where are we headed?

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 transaction
- sales invoice
- purchase invoice
- Account Receivable
- credit purchase
- Purchases Journal
- credit fee
- Sales Journal
- Statement of Account.


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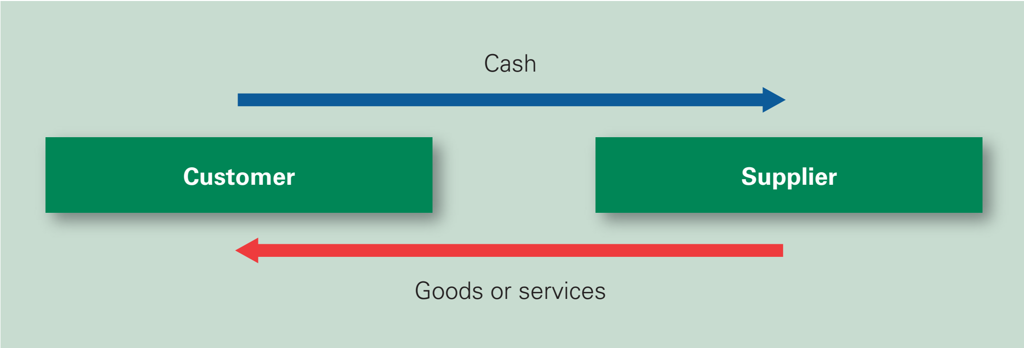
## 9.1 Credit transactions

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




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.

**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

**Example**

On 3 April 2025, 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 2025. 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 2025, 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' (as are cheques) because the customer does not owe the seller anything. (The credit relationship in this case is between the customer and the credit card provider.)

### Source document: Invoice

As has been noted previously, source documents are vital in ensuring the *Verifability* of Accounting reports; by authenticating each transaction, source documents ensure that the reports provide a *Faithful representation* and are free from bias.

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Whereas cash transactions are verified by a form of cash receipt or cheque butt (for receipts and payments respectively), credit transactions are verified by an invoice such as the one shown in Figure 9.2:

**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:** 3/4/2025
**Invoice:** 29

**TAX INVOICE**

**Original**
**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 2025, 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 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.

**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)

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.

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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 Receivable**
a customer who owes a debt to the business for goods or services sold to them on credit

### Accounts Payable

Conversely, a credit purchase will mean that the business will owe some 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 the 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

**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

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 reporting period.

Figure 9.3 shows the Purchases Journal for Funky Hair for April 2025:

**Figure 9.3** Purchases Journal

| Date[1] | Account Payable[2] | Inv. No.[3] | Inventory of materials[4] | GST[5] | Total 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** | **$** | **2 530** | **253** | **2 783** |

### 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 – which for this journal is a 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 has been purchased (its 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 reporting period. In this case, Funky Hair has purchased **$2530** worth of materials during April 2025. 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.**

**Study tip**

The amount of the GST on each purchase will always be identified, either as 'plus GST' or 'including GST'.

## 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 2025 would be:

| | Increase/Decrease/No effect | Amount $ |
|---|---|---|
| **Assets** | **Increase** (Inventory ) | 2 530 |
| **Liabilities** | **Increase** (increase **Accounts Payable $2 783**, decrease GST $253) | **2 530** |
| **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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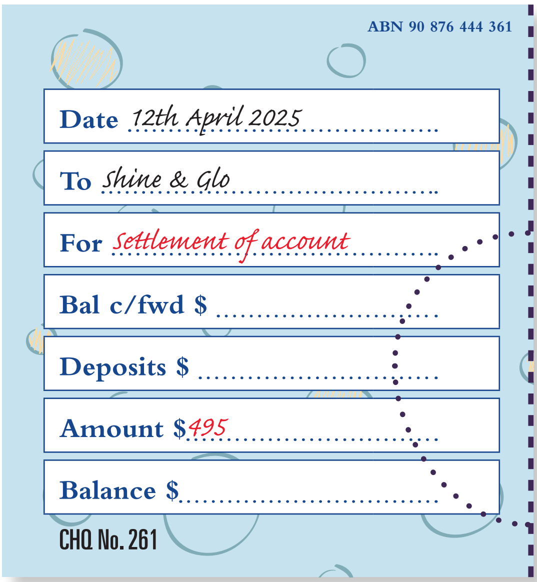
## 9.3 Payments to Accounts Payable

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 cheque butt, EFT receipt or other source document and recorded in the Cash Payments Journal. Figure 9.4 shows the cheque butt to provide evidence of a payment to an Account Payable:

**Figure 9.4** Payment to an Account Payable: cheque butt


ABN 90 876 444 361

Date 12th April 2025

To Shine & Glo

For Settlement of account

Bal c/fwd $

Deposits $

Amount $495

Balance $

CHQ No. 261

On a cheque butt, settlement of account indicates that the cash has been paid to Accounts 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 | Doc. | Bank | Accounts Payable | Drawings | Wages | Sundries | GST |
|---|---|---|---|---|---|---|---|---|
| April 2 | Gel 'n' Slick | 347 | **220** | 220 | | | | |
| 6 | Wages | 348 | **1 500** | | | 1 500 | | |
| 7 | Drawings | ATM 105 | **1 000** | | 1 000 | | | |
| 12 | Shine & Glo | 349 | **495** | 495 | | | | |
| 15 | Electricity | Bpay 635 | **275** | | | | 250 | 25 |
| 16 | Spray 'n' Hold | 350 | **385** | 385 | | | | |
| 20 | Wages | 351 | **1 500** | | | 1 500 | | |
| 21 | Drawings | ATM 603 | **600** | | 600 | | | |
| 23 | Shine & Glo | 351 | **990** | 990 | | | | |
| 28 | Rent | EFT 392 | **1 320** | | | | 1 200 | 120 |
| | **TOTALS** | **$** | **8 285** | **2 090** | **1 600** | **3 000** | **1 450** | **145** |

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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 2025 is thus **$2 090**.

### Effect on the Accounting equation

The overall effect of payments to accounts payable on the accounting equation of Funky Hair for April 2025 would be:

| | Increase/Decrease/No effect | Amount $ |
|---|---|---|
| **Assets** | Decrease (Bank) | 2 090 |
| **Liabilities** | Decrease (Accounts Payable) | 2 090 |
| **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, 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 2025, its Accounts Payable balance as at 30 April 2025 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 2025.

### Review questions 9.3

1. **State** two source documents 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

**credit fee**
a transaction that involves the provision of a service to a customer who is not required to pay until a later date

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.

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 15 October 2025, Funky Hair performed 6 wash, 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

15 October 2025
Invoice 514
Terms: n/30

| Service | Qty | Unit price | Total |
|---|---|---|---|
| **Wash, cut and blow wave** | **6** | **120** | 720 |
| **GST (10%)** | | | 72 |
| | | **Total** | **$792** |

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. Figure 9.8 shows the Sales Journal for Funky Hair for October 2025:

**Sales Journal**
an Accounting record that summarises all transactions involving the sale/performing of services on credit during a reporting period

**Figure 9.8** Sales Journal

| Date[1] | Account Receivable[2] | Inv. No.[3] | Fees[4] | GST[5] | Total Accounts Receivable[6] |
|---|---|---|---|---|---|
| April 6 | W. Nuptials | 514 | 720 | 72 | **792** |
| 9 | Perfect Weddings | 515 | 1 800 | 180 | **1 980** |
| 16 | Models Inc | 516 | 1 050 | 105 | **1 155** |
| 20 | Perfect Weddings | 517 | 1 200 | 120 | **1 320** |
| 23 | Models Inc | 518 | 860 | 86 | **946** |
| | **TOTALS** | **$** | **5 630** | **563** | **6 193** |

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**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 2025. 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.**

**Study tip**

The amount of the GST on each sale will always be identified either as 'plus GST' or 'including GST'.

## 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 2025 would be:

| | Increase/Decrease/No effect | Amount $ |
|---|---|---|
| **Assets** | Increase (increase **Accounts Receivable $6 193**) | 6 193 |
| **Liabilities** | Increase (GST Clearing) | 563 |
| **Owner's equity** | Increase (Fees $5 630 = Revenue) | 5 630 |

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### Review questions 9.4

1. **Explain** why Credit fees is 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.

## 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 a receipt from an Account Receivable:

**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 2025 |
| **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 | Rec. No. | Bank | Accounts Receivable | Hairdressing fees | Sundries | GST |
|---|---|---|---|---|---|---|---|
| April 2 | Cash fees | 312 | **132** | | 120 | | 12 |
| 5 | Models Inc | 313 | **1 650** | 1 650 | | | |
| 8 | Cash fees | 314 | **462** | | 420 | | 42 |
| 13 | Perfect Weddings | 315 | **2 000** | 2 000 | | | |
| 18 | W. Nuptials | 316 | **792** | 792 | | | |
| 22 | Cash fees | 317 | **319** | | 290 | | 29 |
| 26 | Capital contribution | 318 | **2 000** | | | 2 000 | |
| 28 | Perfect Weddings | 319 | **1 300** | 1 300 | | | |
| | **TOTALS** | **$** | **8 655** | **5 742** | **830** | **2 000** | **83** |

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Receipts from Accounts Receivable will be frequent, and so they are recorded in their own classification column just like cash sales and GST. The total cash received from Accounts Receivable by Funky Hair in April 2025 is thus **$5 742.**

### 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 2025 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 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 reporting period. Assuming an opening Accounts Receivable balance of $2 200 as at 1 April 2025, the Accounts Receivable balance of Funky Hair as at 30 April 2025 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 | 5 630 | From the Sales Journal |
| | 7 830 | |
| – Receipts from Accounts Receivable | 5 742 | From the Cash Receipts Journal |
| Accounts Receivable balance at end | $2 088 | Goes into the *next* Balance Sheet as a current asset |

This new balance of the total owed by Accounts Receivable ($2 088) can now be reported as a current asset in the Balance Sheet for Funky Hair as at 30 April 2025.

### 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 is not a source document that must be recorded. Figure 9.12 shows the Statement of Account from an Account Payable – Shine & Glo – for April 2025:

**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 2025

| Date | Details | Sales | Payments | Balance |
|---|---|---|---|---|
| April 1 | Balance carried forward | | | 220 |
| 3 | Inv. 29 | 495 | | 715 |
| 12 | Payment received: (Chq. 349) | | 495 | 220 |
| 15 | Inv. 35 | 770 | | 990 |
| 23 | Payment received: (Chq. 351) | | 990 | – |
| 29 | Inv. 39 | 660 | | 660 |
| | Balance owing: 30 April 2025 | | | **$660** |

This Statement of Account summarises the various credit purchases made by Funky Hair during April 2025, 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.

## 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

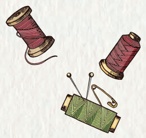
*Please note: asterisks indicate that an answer for that question is available in the Selected Answers section at the end of this book.*

### Exercise 9.1

WB page 151

### Source documents

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 2025 | 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 special 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.

### Exercise 9.2

WB page 152

### Purchases Journal

Sparky Electricians has provided the following list of transactions for July 2025:

| | | |
|---|---|---|
| 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 2025 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.

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## Exercise 9.3

WB page 153

### Purchases Journal and Cash Payments Journal

Heel 'n' Toe purchases all its supplies on credit. As at 31 August 2025, its Account Payable records showed the following balances:

| | |
|---|---|
| Sole Man | 770 |
| Lillies Laces | 120 |
| Leather Emporium | 1980 |
| **Total Accounts Payable** | **$2870** |

During September 2025, the following transactions occurred:

| | | |
|---|---|---|
| Sept. | 1 | Paid Lillies Laces $120 (Chq. 165) |
| | 3 | Purchased leather on credit from Leather Emporium for $360 plus $36 GST (Inv. L56) |
| | 7 | Paid wages – $950 (WDWL online 9560) |
| | 8 | Purchased stock from Sole Man for $825 including $75 GST (Inv. 201) |
| | 11 | Paid $2200 (GST included) for new office equipment (Chq. 166) |
| | 14 | Owner withdrew $500 cash (ATM 653) |
| | 16 | Purchased supplies from Lillies Laces for $240 plus GST (Inv. LL314) |
| | 19 | Paid Sole Man $770 (Chq. 167) |
| | 21 | Paid wages – $950 (WDWL online 9875) |
| | 24 | Credit purchase of soles from Sole Man for $400 plus $40 GST (Inv. 246) |
| | 27 | Cash drawings – $500 (ATM 741) |
| | 30 | Paid Leather Emporium $1000 (Chq. 168) |

*Required*

*a **Record** the transactions for September 2025 in the journals of Heel 'n' Toe.

b **Explain** the effect of the transaction on 30 September 2025 on the Balance Sheet of Heel 'n' Toe.

*c **Calculate** the total owed to Accounts Payable as at 30 September 2025.

d **Explain** why there is no GST to account for when cash is paid to an Account Payable.


## Exercise 9.4

WB page 155

### Journals and Accounts Payable

'Mow and Mulch' repairs mowers and other gardening equipment. All materials are purchased on credit, and as at 1 April 2025, its Account Payable records showed the following balances:

| | |
|---|---|
| Parts and Pieces | 14000 |
| ReeObi | 9900 |
| Victor Mowers | 10500 |
| **Total Accounts Payable** | **$34400** |

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During April 2025, the following transactions occurred:

| | | |
|---|---|---|
| April | 2 | Paid ReeObi $6 000 (Chq. 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 (Chq. 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 (Chq. 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 (Chq. 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 (Chq. 219) |

*Required*

*a **Record** the transactions for April 2025 in the journals of Mow and Mulch.

*b **Calculate** the balance of Accounts Payable as at 30 April 2025.

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.

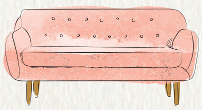
## Exercise 9.5

WB page 157

## Source documents

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:** 149
**Terms:** Net 30 days
TAX INVOICE Duplicate
5 October 2025

**Charge to:** Ouch Dental
Molar St, Essendon Victoria 3040

| Item | Description | Qty | Unit Cost | $ |
|---|---|---|---|---|
| Repair | Chesterfield – 3 seater | 3 | 1 500 | 4 500 |
| | GST | | | 450 |
| | **Total** | | $ | **4 950** |

*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.

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## Exercise 9.6

WB page 158

### Sales Journal

Cut and Groom provides gardening services and has provided the following list of its transactions for February 2025:

| | | |
|---|---|---|
| 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 which will be used on the next sales invoice issued by Cut and Groom.

***b** **Record** the transactions for February 2025 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 2025.

**d** **Explain** the effect of GST on credit sales on the GST payable to the ATO.

## Exercise 9.7

WB page 159

### Sales Journal and Cash Receipts Journal

Unbreakable Gear hires plates, glass and cutlery for events and functions. As at 1 May 2025, its Accounts Receivable records showed the following balances:

| | |
|---|---|
| Fab Events | 3 550 |
| Party Dayz | 4 450 |
| **Total Accounts Receivable** | **$8 000** |

During May 2025, the following transactions occurred:

| | | |
|---|---|---|
| May | 1 | Received $1 850 cash from Fab Events (Rec. 56) |
| | 3 | Hired gear on credit to Fab Events for $1 420 plus $142 GST (Inv. 271) |
| | 4 | Hire fees – $280 plus GST (Rec. 57) |
| | 6 | Received loan from Fincorp – $8 000 to purchase new office equipment (BS) |
| | 9 | Provided party gear to Party Dayz on credit for $1 595 inclusive of GST (Inv. 272) |
| | 10 | Fab Events paid $1 800 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 months 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 $3 200 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 2025 is **not** classified as revenue.

**b** **Explain** why there is no GST to account for as a result of the transaction on 10 May 2025.

***c** **Record** the transactions for May 2025 in the journals of Unbreakable Gear.

***d** **Calculate** the balance owed by Accounts Receivable as at 31 May 2025.

**e** **Explain** whether all Accounts Receivable have met the credit terms during May 2025.

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## Exercise 9.8

W B page 161

### Credit transactions

Adeline Skywalker operates Musical Beat that provides music tuition services and hires instruments. At 30 June 2025, 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 2025:

| | | |
|---|---|---|
| July | 1 | Paid monthly rent of $1 200 plus $120 GST (Chq. 205) |
| | 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 on account (Chq. 206) |
| | 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 (Chq. 207) |
| | 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 on account (Chq. 208) |
| | 30 | Provided tuition to Beaconsfield Primary for $561 including $51 GST (Inv. 113) |
| | 31 | Received $8 interest on bank account (BS) |

*Required*

* **a** **Record** the transactions for July 2025 in the journals of Musical Beat.

* **b** Using the appropriate formula, **calculate** the balances of Accounts Receivable and Accounts Payable as at 31 July 2025.

**c** Referring to your answers to part 'b', **explain** how Musical Beat could verify these balances.

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## Exercise 9.9

## Statement of Account

WB page 163

The owner of No Drips Painting has received the following source document in the mail:

PAINT WORLD
ABN: 68 803 200 163
Penny Lane
St Kilda Victoria 3182

5 Nov 2025
**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.

**c** **Explain** how No Drips Painting would be reported in the Balance Sheet of Paint World.

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Chapter 10

# Reporting for a service business

## Where are we headed?

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 reduction in liabilities that leads to an increase in owner's equity (except for a Capital contribution)

**Revenue** is an increase in assets or reduction 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.

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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.

## 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 accrued wages or wages owing.
- **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.

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.

**Study tip**

Compare the definitions of 'revenue' and 'expenses'– opposites definitely apply here.

## 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*

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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 arbitrary (or 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).

### 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 is 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.

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## 10.2 The Income Statement

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.

**Income Statement**
an Accounting report that details the revenue earned and expenses incurred during the reporting period

**Example**

Nomi's Naturopathy has provided the following information relating to its trading activities for May 2025:

**NOMI'S NATUROPATHY**

**Balance Sheet as at 30 April 2025**

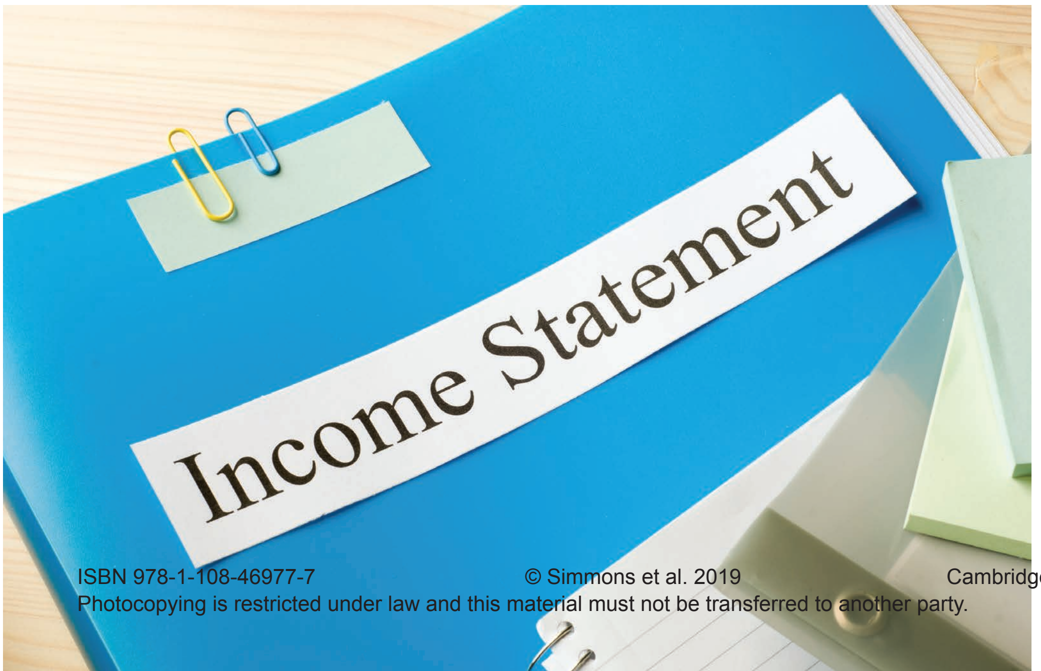
| | $ | $ | | $ | $ |
|---|---|---|---|---|---|
| **Current Assets** | | | **Current Liabilities** | | |
| Bank | 4 000 | | GST Payable | 400 | |
| Accounts Receivable | 2 200 | | Accounts Payable | 1 100 | |
| Inventory of materials | 500 | 6 700 | Mortgage | 6 000 | 7 500 |
| | | | **Non-Current Liabilities** | | |
| **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 | Account Receivable | Inv. No. | Fees | GST | Account Receivable |
|---|---|---|---|---|---|
| April | **TOTALS** | **$** | 3 800 | 380 | 4 180 |

**Purchases Journal**

| Date | Account Payable | Inv. No. | Materials | GST | Account Payable |
|---|---|---|---|---|---|
| April | **TOTALS** | **$** | 1 500 | 150 | 1 650 |

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**Example (continued)**

**NOMI'S NATUROPATHY**
**Cash Flow Statement for May 2025**

| | $ | $ |
|---|---|---|
| **CASH FLOWS FROM OPERATING ACTIVITIES** | | |
| Cash fees | 6 000 | |
| Receipts from Accounts Receivable | 3 300 | |
| GST received | 600 | |
| Interest on Bank Account | 20 | 9 920 |
| GST paid | (440) | |
| Payments to Accounts Payable | (880) | |
| Wages | (1 800) | |
| Electricity | (400) | |
| Interest on mortgage | (200) | |
| GST settlement | (400) | |
| Materials | (1 400) | (5 520) |
| **Net Cash Flows from Operations** | | **4 400** |
| **CASH FLOWS FROM INVESTING ACTIVITIES** | | |
| Office furniture | | (3 000) |
| **Net Cash Flows from Investing activities** | | **(3 000)** |
| **CASH FLOWS FROM FINANCING ACTIVITIES** | | |
| Capital contribution | 1 000 | |
| Loan – INS Finance | 2 000 | 3 000 |
| Drawings | (2 000) | |
| Mortgage repayment | (500) | (2500) |
| **Net Cash Flows from Financing activities** | | **500** |
| **Net Increase (Decrease) in cash position** | | **1 900** |
| **Add Bank Balance at start (1 May 2025)** | | **4 000** |
| **Bank Balance at end (31 May 2025)** | | **5 900** |

**Additional information:**

- Inventory of materials was $300 as at 31 May 2025.
- The Loan – INS Finance is an interest-only loan payable 1 May 2027.

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## 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.

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.
- 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 either; 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, 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 below).
- 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 furniture is a *future* economic benefit rather than an *outflow* of an economic benefit.

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- 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.

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

However, when preparing the Income Statement, the business needs to calculate how much of its materials were actually consumed or 'used up' within the *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 the Cost of materials used for Nomi's Naturopathy would be calculated for May 2025:

**Figure 10.1** Calculating Cost of materials used

| | | |
|---|---|---|
| Inventory of materials at start | 500 | From the *previous* Balance Sheet (as at 30 April 2025) |
| + Credit purchases | 1500 | From the Purchases Journal |
| + Credit purchases | 1400 | From the Cash Payments Journal |
| **Cost of materials available for use** | **3400** | |
| Inventory of materials at end | 300 | From physical count (as at 31 May 2025) |
| 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 2025, 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 2025 as a current asset: Inventory of materials.)

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The Income Statement for Nomi's Naturopathy for May 2025 is shown in Figure 10.2:

**Figure 10.2** Income Statement

**NOMI'S NATUROPATHY**

**Income Statement for May 2025**

| | $ | $ |
|---|---|---|
| **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 2025.) 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 2025.

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 Material on hand at the end of the *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 attendant 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 in cash position (net decrease)* 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, Cash purchases of materials and Payments to Accounts Payable was *greater* than the 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 the 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 cash deficit.
2 Citing three examples, **explain** how a business can incur a Net Loss and yet generate a cash surplus.
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 2025 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 2025**

| | $ | $ | | $ | $ |
|---|---|---|---|---|---|
| **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 | |
| | | | | 36520 | |
| | | | *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 2025.

**2** Accounts Receivable

This is calculated by:

| | |
|---|---|
| Accounts Receivable at start | $2200 |
| Plus Credit fees plus 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 2025.

**5** Other assets

There were no transactions affecting Equipment or Premises, so these items remain unchanged.

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**6** GST Clearing $160

| | | |
|---|---|---|
| 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 Receivable

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 Receivable 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 2025.

**9** Mortgage $6 000/$59 500

$500 was reported as a Financing cash outflow in the Cash Flow Statement for May 2025. 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 twelve months from the date of the statement (12 months × $500 per month = $6 000).

**10** Capital $31 100

This is the Capital of $30 100 from the previous Balance Sheet (as at 30 April 2025), plus the Capital contribution reported as a Financing cash inflow in the Cash Flow Statement for May 2025.

**11** Plus Net Profit $4 320

This is the Net Profit determined in the Income Statement for May 2025.

**12** Less Drawings $2 000

This was reported as a Financing cash outflow in the Cash Flow Statement for May 2025.

**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

Should the business incur a Net Loss, the Owner's equity section of the Balance Sheet would appear as is shown in Figure 10.4:

**Figure 10.4** Reporting a Net Loss in the Balance Sheet

| | | |
|---|---|---|
| **Owner's equity** | | |
| Capital – Nomi | 31 320 | |
| *Less* Net Loss | 600 | |
| | 30 720 | |
| *Less* Drawings | 1 800 | 28 920 |

### 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.

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## 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 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.

Ethical considerations

- **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.

### 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.

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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.

Ethical considerations

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).

**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 engage in creating 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

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**Example**

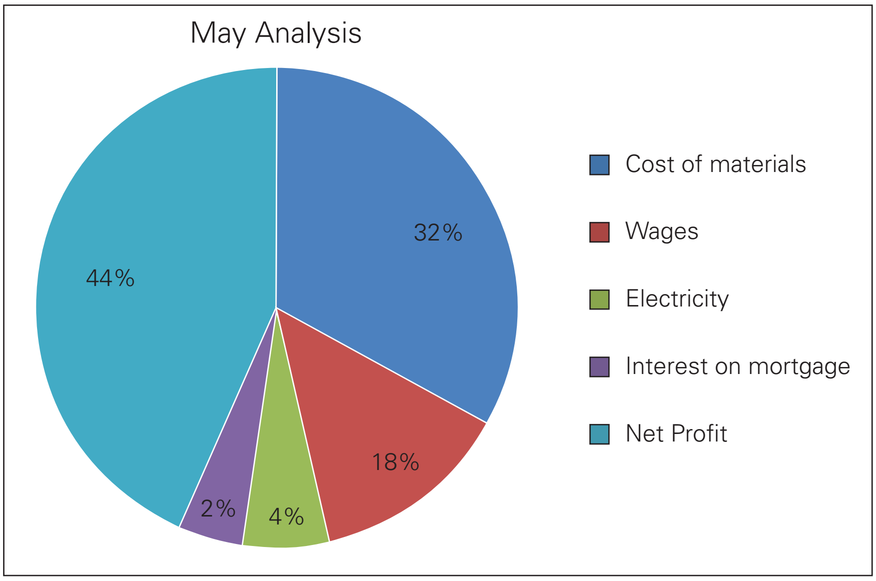
**Pie chart: Spreadsheet**

| | A | B | C | Formula in cell |
|---|---|---|---|---|
| 1 | **Item** | **$** | **%** | |
| 2 | Cash fees | 6 000 | 61.1 | =B2/$B$5 |
| 3 | Credit fees | 3800 | 38.6 | =B3/$B$5 |
| 4 | Interest on Bank Account | 20 | 0.2 | =B4/$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 |

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 B4) for the Total Revenue. (Remember a common short cut to create an absolute reference cell is to press the F4 key.) 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.

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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).

**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

## Line graphs

When an owner or manager wishes to view data longitudinally, that is looking at changes in a particular item over *time*, line graphs can be useful way of presenting information.

**Example**

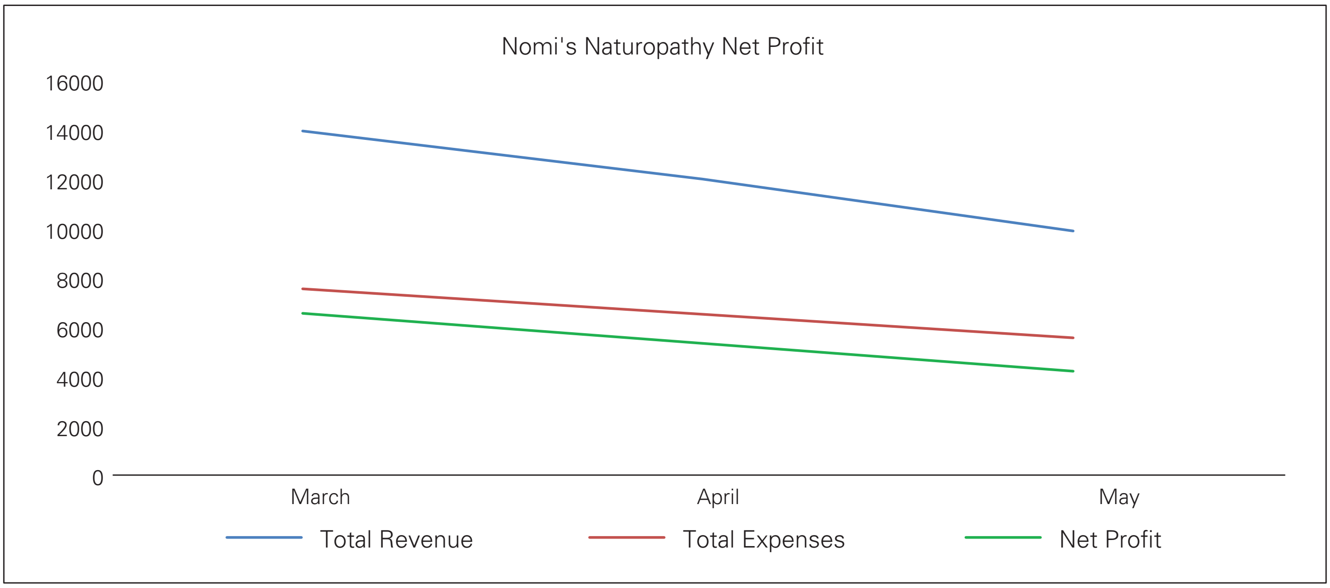
Nomi's Naturopathy has presented the following data relating to its activities for the last three months:

| | March | April | May |
|---|---|---|---|
| Total Revenue | 13 950 | 12 040 | 9 820 |
| Total Expense | 7 425 | 6 600 | 5 500 |
| Net Profit | 6 525 | 5 440 | 4 320 |

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 last 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.

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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 Noni 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 Noni should be considerably worried and determine why this is occurring quickly, e.g. it may be due to a new competitor in the area.

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** | 13 950 | 7 425 | 6 525 |
| **3** | **April** | 12 040 | 6 600 | 5 440 |
| **4** | **May** | 9 820 | 5 500 | 4 320 |

### 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 reduce 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

WB page 165

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

WB page 167

**Income Statement**

Christi's Car Clean Emporium has provided the following cash flows for January 2025:

| | $ |
|---|---|
| **Cash receipts** | |
| Cash fees | 7 430 |
| Receipts from Accounts Receivable | 1 000 |
| GST received | 743 |
| Capital contribution | 10 000 |
| **Cash payments** | |
| Wages | 2 250 |
| Cleaning supplies | 3 000 |
| Drawings | 700 |
| GST paid | 1 430 |
| Equipment | 9 000 |
| Advertising | 300 |
| Rent | 2 000 |
| Loan repayment | 5 000 |

**Additional information:**

- Credit fees were $1 800 plus GST.
- Bank Balance at 1 January 2025 was $6 500.
- Inventory of cleaning supplies as at 1 January 2025 was $450.
- Inventory of cleaning supplies as at 31 January 2025 was $600.
- Owner's equity as at 1 January 2025 was $23 000.

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*Required*

- ⋆ **a** **Prepare** a Cash Flow Statement for Christi's Car Clean Emporium for January 2025.
- ⋆ **b** **Calculate** the Cost of cleaning supplies used for January 2025.
- ⋆ **c** **Prepare** an Income Statement for Christi's Car Clean Emporium for January 2025.
- **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 cash deficit in January 2025 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 2025.
- **g** **Calculate** the Net Profit Margin for Christi's Car Clean Emporium.

## Exercise 10.3

WB page 170

## Income Statement

Batman and Bowler is a specialist cricket coaching clinic, and as at 1 October 2025, the Balance Sheet showed Bank of $500 and Owner's equity of $39 400. The owner has provided the firm's Cash Flows for October 2025:

| | $ |
|---|---|
| **Cash receipts** | |
| Cash fees | 4 000 |
| Receipts from Accounts Receivable | 2 000 |
| GST received | 400 |
| Interest on investments | 150 |
| GST refund | 2 300 |
| Loan – ANZ | 2 000 |
| **Cash payments** | |
| Wages | 4 200 |
| Drawings | 1 000 |
| GST paid | 345 |
| Electricity | 400 |
| Insurance | 250 |
| Rent | 2 000 |
| Accounting fees | 800 |
| Interest on loan | 100 |

**Additional information:**

- Credit fees were $3 300 inclusive of GST.

*Required*

- ⋆ **a** **Prepare** a Cash Flow Statement for Batman and Bowler for October 2025.
- ⋆ **b** **Prepare** an Income Statement for Batman and Bowler for October 2025.
- **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 cash surplus for October 2025.
- **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 2025.

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## Exercise 10.4

WB page 173

### Income Statement and Balance Sheet

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 2025, 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 2025 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 2025.
- 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.

*Required*

⋆ **a** **Prepare** a Cash Flow Statement for Blue Pools for March 2025.

⋆ **b** **Prepare** an Income Statement for Blue Pools for March 2025.

**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 2025.

⋆ **e** **Prepare** an appropriately classified Balance Sheet for Blue Pools as at 31 March 2025.

**f** **Provide** two recommendations to Jackson for improving his revenue earnings.

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## Exercise 10.5

WB page 177

### Accounting reports

On 1 January 2025 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 2025, 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** | **117500** | **Total Equities** | **117500** |

The cash journals for Sew Well for June 2025 showed the following:

**Cash Receipts Journal (extract)**

| Date | Details | Rec. No. | Bank | Cash fees | Accounts Receivable | Sundries | GST |
|---|---|---|---|---|---|---|---|
| June 2025 | Capital contribution | | | | | 4000 | |
| | **TOTALS** | **$** | **21590** | **13900** | **2 300** | **4000** | **1390** |

**Cash Payments Journal (extract)**

| Date | Details | Doc. | Bank | Wages | Materials | Accounts Payable | Drawings | Sundries | GST |
|---|---|---|---|---|---|---|---|---|---|
| June 2025 | Van expenses | | | | | | | 800 | |
| | Loan repayment | | | | | | | 400 | |
| | GST settlement | | | | | | | 1000 | |
| | Sewing machines | | | | | | | 4500 | |
| | Interest on loan | | | | | | | 150 | |
| | **TOTALS** | **$** | **27220** | **10200** | **3400** | **3100** | **2800** | **6850** | **870** |

| Date | Accounts Receivable | Inv. No. | Fees | GST | Total Accounts Receivable |
|---|---|---|---|---|---|
| | **Total** | **$** | 4500 | 450 | 4950 |

| Date | Accounts Payable | Inv. No. | Inventory of materials | GST | Total Accounts Payable |
|---|---|---|---|---|---|
| | **Total** | **$** | 1900 | 190 | 2090 |

**Additional information:**

- Inventory of materials as at 30 June 2025 was $3000.
- The Loan – Aussie HL is repayable at $4800 p.a.

*Required*

⋆ **a** **Prepare** a Cash Flow Statement for Sew Well for June 2025.

⋆ **b** **Calculate** the Cost of materials used for Sew Well for June 2025.

⋆ **c** **Prepare** an Income Statement for Sew Well for June 2025.

**d** **Explain** two reasons why Sew Well was able to earn a profit despite suffering a cash deficit for June 2025.

⋆ **e** **Prepare** an appropriately classified Balance Sheet for Sew Well as at 30 June 2025.

**f** **Explain** why the Balance Sheet is titled 'as at', yet the Income Statement is titled for the period.

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## Exercise 10.6

WB page 181

### Accounting reports

Mark Lindsberg runs a drycleaning 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 2025, 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 2025 was $35 300. In August 2025 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 2025.

The cash journals of Clean as a Whistle for September 2025 showed the following:

**Cash Receipts Journal (extract)**

| Date | Details | Rec. No. | Bank | Cleaning fees | Consultancy fees | Sundries | GST |
|---|---|---|---|---|---|---|---|
| Sept. 2025 | Loan – ANZ | | | | | 4 000 | |
| | **TOTALS** | **$** | **18 300** | **9 500** | **3 500** | **4 000** | **1 300** |

**Cash Payments Journal (extract)**

| Date | Details | Doc. | Bank | Supplies | Drawings | Wages | Sundries | GST |
|---|---|---|---|---|---|---|---|---|
| Sept. 2025 | 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 2025 in readiness for the purchase of a new computer in mid-October 2025 and is repaid in quarterly instalments of $2 100.
- All supplies were consumed during the reporting period.

*Required*

* **b** **Prepare** a Cash Flow Statement for Clean as a Whistle for September 2025.

* **c** **Prepare** an Income Statement for Clean as a Whistle for September 2025.

**d** **Explain** a reason why Clean as a Whistle suffered a Net Loss despite generating a cash surplus for September 2025.

* **e** **Prepare** an appropriately classified Balance Sheet for Clean as a Whistle as at 30 September 2025.

**f** **State** two ethical considerations Mark needs to keep in mind in regards to his line of work.

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## Exercise 10.7

WB page 185

### Income Statement and Balance Sheet

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 2025, the assets and liabilities 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 2025, Big Star Decorating earned a profit of $5 400, and Alex withdrew $3 500.

*Required*

**a** **Calculate** Alex's capital as at 1 December 2025.

**b** **Calculate** the Working Capital Ratio of Big Star Decorating as at 1 January 2025.

**c** Referring to the Working Capital Ratio, **comment** on the liquidity of Big Star Decorating as at 1 January 2025.

The cash flows for Big Star Decorating for January 2025 showed the following:

| | $ |
|---|---|
| **Cash receipts** | |
| Cash fees | 8 000 |
| GST received | 800 |
| **Cash payments** | |
| Wages | 500 |
| Paint | 4 000 |
| Drawings | 3 000 |
| GST paid | 490 |
| Insurance | 200 |
| Loan principal | 1 000 |
| Interest on loan | 100 |
| GST settlement | 2 000 |
| Van expenses | 700 |

Alex is concerned that because the business has suffered a cash deficit, it must not be making a profit.

*Required*

* **d** **Prepare** a Cash Flow Statement for Big Star Decorating for January 2025.

* **e** **Prepare** an Income Statement for Big Star Decorating for January 2025.

**f** **Explain** two reasons, apart from Drawings, why Big Star Decorating was able to earn a profit despite suffering a cash deficit for January 2025.

* **g** **Prepare** an appropriately classified Balance Sheet for Big Star Decorating as at 31 January 2025.

**h** Alex discovers that her employee is disposing of unused paint down the drains of client's homes. He stated it was cheaper to dispose of this way. **Advise** Alex on a course of action to follow. **Justify** your response.

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## Exercise 10.8

WB page 189

### Income Statement and Balance Sheet

At the start of 2025, 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 $45 000 p.a. but was eager to take up the challenge of owning and operating his own small business. As at 30 June 2025, the unclassified Balance Sheet of Faster than the Rest showed the following:

| **Assets** | **$** | **Equities** | **$** |
|---|---|---|---|
| Accounts Receivable | 6 000 | Bank | 500 |
| Inventory of fuel | 800 | Accounts Payable | 1 000 |
| GST receivable | 1 000 | Loan – nab | 24 000 |
| Office equipment | 11 500 | Capital – Owen | 29 000 |
| Courier vans | 35 200 | | |
| **Total Assets** | **54 500** | **Total Equities** | **54 500** |

**Additional information:**

- The Loan – nab was taken out on a fixed-term at the start of January 2025. The principal is repaid on the first of every month in equal instalments of $500.
- At 1 June 2025, Michael's equity in Faster than the Rest amounted to $31 000. During June 2025, the firm earned a profit of $1 500.

*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 2025.

**c** **Calculate** Michael's Drawings for June 2025.

**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 2025 showed the following:

**FASTER THAN THE REST**
**Cash Flow Statement for July 2025**

| | **$** | **$** |
|---|---|---|
| **CASH FLOWS FROM OPERATING ACTIVITIES** | | |
| Cash fees | 12 000 | |
| GST received | 1 200 | |
| Accounts Receivable | 5 400 | |
| GST refund | 1 000 | 19 600 |
| Payments to Accounts Payable | (900) | |
| GST paid | (590) | |
| Wages – driver | (6 700) | |
| Van expenses | (4 000) | |
| Insurance | (1 200) | |
| Interest on loan | (300) | (13 690) |
| **Net Cash Flows from Operations** | | **5 910** |
| **CASH FLOWS FROM INVESTING ACTIVITIES** | | |
| Office equipment | | (700) |
| **Net Cash Flows from Investing activities** | | **(700)** |
| **CASH FLOWS FROM FINANCING ACTIVITIES** | | |
| Capital contribution | 4 000 | 4 000 |
| Drawings | (1 900) | |
| Loan principal | (500) | (2 400) |
| **Net Cash Flows from Financing activities** | | **1 600** |
| **Net increase (decrease) in cash position** | | **6 810** |
| **Add Bank Balance at start (1 July 2025)** | | **(1 500)** |
| **Bank Balance at end (31 July 2025)** | | **6 310** |

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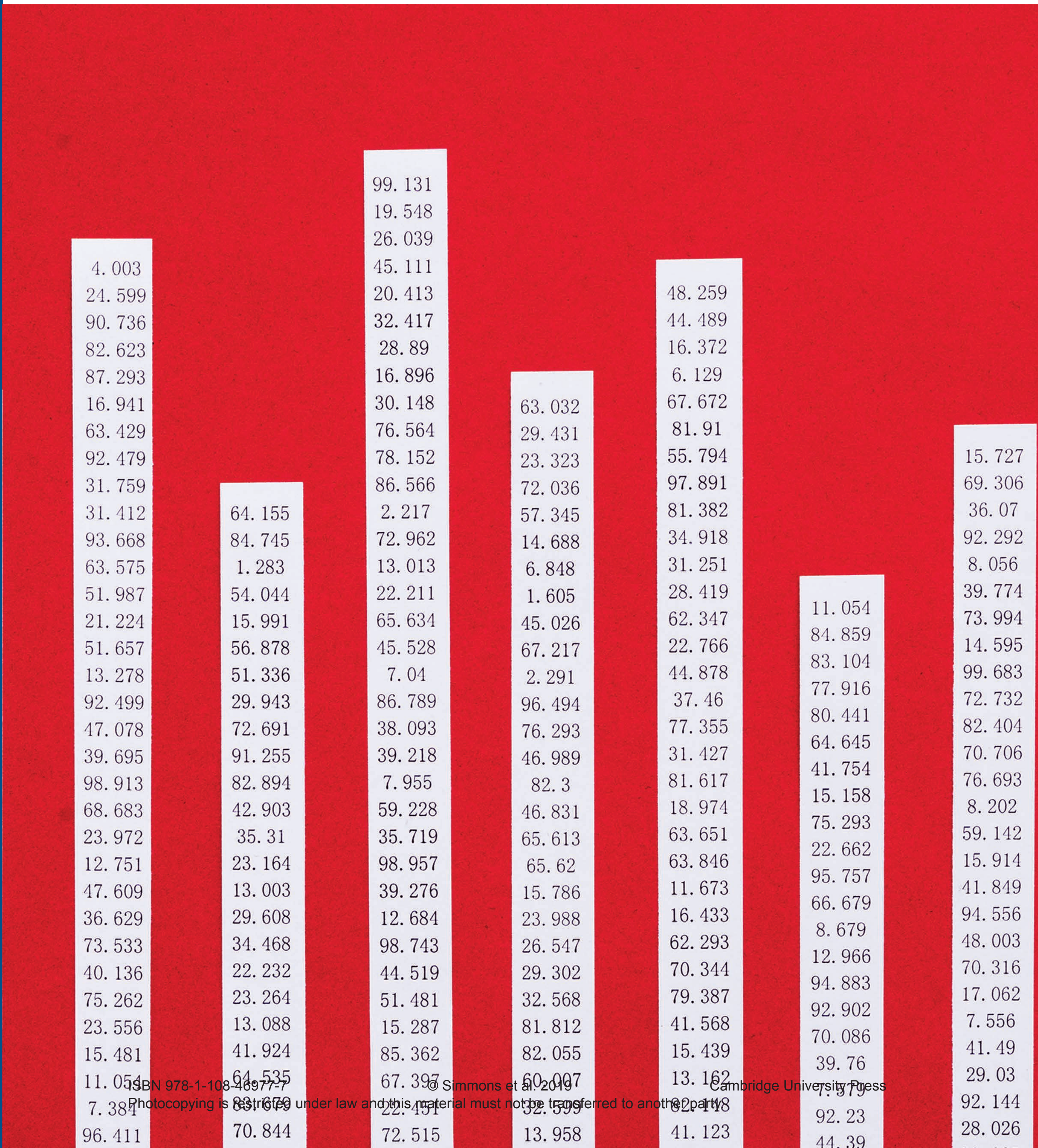
Michael is confident because the bank balance has increased, the firm must be trading profitably.

*Required*

- ⋆ **e** **Prepare** an Income Statement for Faster Than the Rest for July 2025.
- **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 cash surplus despite incurring a loss.
- ⋆ **h** **Prepare** an appropriately classified Balance Sheet for Faster Than the Rest as at 31 July 2025.

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# Accounting and decision-making for a trading business

# Unit 2

In Unit 2 of the VCE Accounting course, we will cover the following chapters:



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Chapter 11

# Trading firms and inventory

## Where are we headed?

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 (IC)
- First In, First Out (FIFO)
- physical count
- inventory loss
- inventory gain.


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## 11.1 Trading firms and inventory

**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**.

**trading firms**
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

### 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 text will use 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.

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Such an important asset as inventory needs to be protected and as previously raised in Chapter 8 there are 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 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 is another form of deterrent.
- **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 consideration

## 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:

- 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 its performance, composition, components, packaging, flammability and labelling; mandatory standards exist to ensure information and safety features exist for consumers.

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?

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- 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. Methods such as Last In, First Out (LIFO) have been banned as these methods can have the effect, in times of rising prices, of understating profit and inventory at the end of a reporting period as these methods allocate the more expensive inventory earlier. This can have the effect of:

- distorting profit or loss figures and reducing tax payable
- providing misleading financial information 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.

### 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.

Ethical consideration

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## 11.2 Accounting for inventory

Source documents → Records → Reports → Advice

**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

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.)

### 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, which 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. (Chq. 312).

#### 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 | |

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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: 15/07/2025**
**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 | |

## 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 *in* to 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.

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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 $500.

### Effect on the Accounting Equation

The overall effect of the cash sale on the Accounting equation for Jessie's T-shirts would be:

**Study tip**

At the time of a sale, an asset (Inventory) becomes an expense (Cost of Sales).

| | 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.

**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: 18/07/2025**

**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.

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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 impacted in the Balance Sheet.

### 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.

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## 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, model or the item was damaged in transit.

**Example (continued)**

The following credit note was received by Jessie's T-shirts:

**Boonds**
Shaw Road, Collingwood
VIC, 3066
ABN: 32 624 098 001

**Credit Note:** B94
**Date:** 30/7/2025

**Customer:** Jessie's T-shirts
Mussel Crescent,
Sth Melb., VIC, 3205

| Code | Description | Quantity | Unit Price | Total |
|---|---|---|---|---|
| BTBk306XL | Faulty Goods (loose stitching) | 2 | $5.50 | $11.00 |
| | | | GST | $1.10 |
| | | | TOTAL | $12.10 |

#### Effect on the Accounting Equation

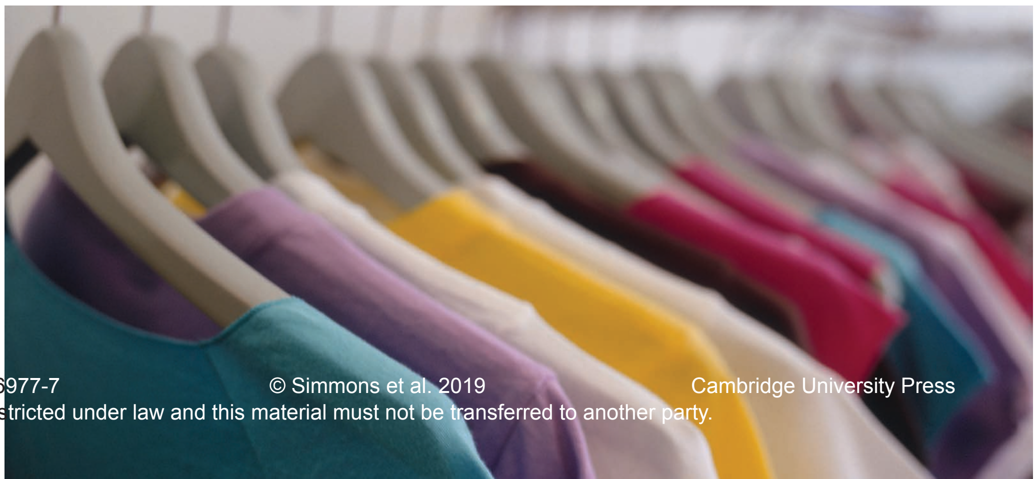
Jessie's T-shirts has returned 2 T-shirts to its supplier, Boonds, due to them being faulty. Note the value of the inventory used in a Purchase return is its cost price. The supplier (Boonds) accepting the return would indicate the cost of the inventory they are providing credit for and would issue the original version of the credit note to the customer (Jessie's T-shirts), while retaining a copy for its own records.

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).



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**Example (continued)**

The following credit note was received by Jessie's T-shirts:

**Jessie's T-shirts**
Mussel Crescent
Sth Melb., VIC, 3205
ABN: 43 908 600 259

**Credit Note:** J601
**Date:** 30/7/2025

**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 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).

## 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
   - Sale return.
4 **State** which value of inventory is used in a credit note to verify a:
   - Purchase return of inventory
   - Sale return of inventory.

   **Justify** your response.
5 **State** the effect on each element of the Accounting equation of a:
   - Purchase return of inventory
   - Sale return of inventory.

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## 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-shirts withdrawn as advertising for personal use:

**Jessie's T-shirts**

**MEMO:** 1
**Date:** 26/8/2025

**From:** Jessie

**To:** Accounting Department
Withdrew one T-shirt for personal use cost $5.50.

**Signature:** J. Shortsleave

### Effect on the Accounting Equation

The overall effect of the 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 |

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## 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:** 27/8/2025

**From:** Jessie

**To:** Accounting Department
Donated 5 T-shirts (BTBk306XL) to school fete cost $22.50.

**Signature:** J. Shortsleave

### Effect on the Accounting Equation

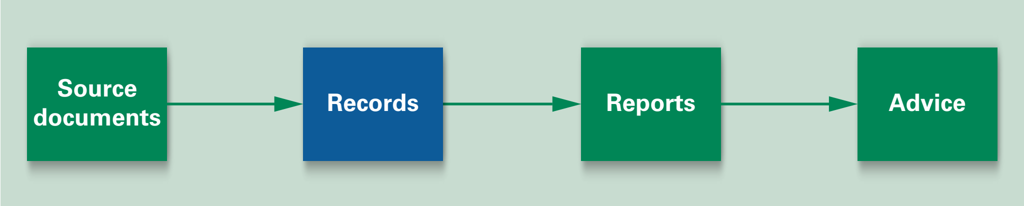
The overall effect of advertising using inventory on the Accounting equation for Jessie's T-shirts would be:

| | 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 marketing purposes.

## 11.5 Inventory cards




**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.

Under the perpetual inventory system, all movements of inventory in and out of the business are recorded on 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 bar codes 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:

**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 | Details | 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 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.

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### *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.

### *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 |
| | 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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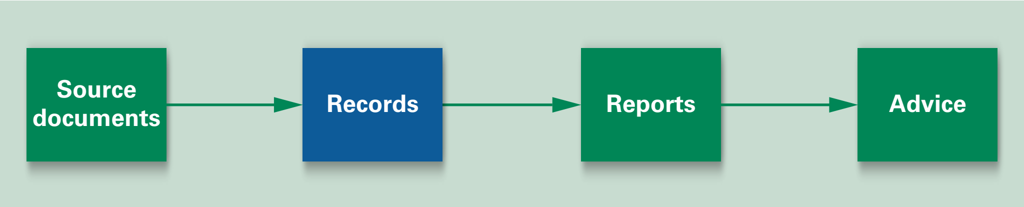
## 11.6 Recording transactions in inventory cards




**Study tip**

The cost price of inventory does not include GST: no GST is ever recorded in the inventory card.

### Where cost prices are constant

*Purchases*

Aug. 5 Purchased 15 Black XL T-shirts from Boonds @ $4.50 plus 45c GST each (Chq. 463)

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.

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### *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 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:

**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 | | | | | |
| | | **IN** | | | **OUT** | | | **BALANCE** | | |
| **Date** | **Details** | **Qty** | **Cost** | **Total** | **Qty** | **Cost** | **Total** | **Qty** | **Cost** | **Total** |
| Aug. 1 | Balance | | | | | | | 10 | 4.50 | 45.00 |
| 5 | Chq. 463 | 15 | 4.50 | 67.50 | | | | 25 | 4.50 | 112.50 |
| 12 | Rec. 32 | | | | 8 | 4.50 | 36.00 | 17 | 4.50 | 76.50 |

**Study tip**

The only value ever recorded in an inventory card is cost price.

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?

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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 impact the value of the inventory recorded in the Balance Sheet at the end of the reporting period.

**Identified Cost (IC)**
the actual cost price of the inventory that is purchased and sold is identified and recorded

**Identified Cost (IC)**, 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 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

| | | IN | | | OUT | | | BALANCE | | |
|---|---|---|---|---|---|---|---|---|---|---|
| **Date** | **Details** | **Qty** | **Cost** | **Total** | **Qty** | **Cost** | **Total** | **Qty** | **Cost** | **Total** |
| Aug. 1 | Balance | | | | | | | 10 | 4.50 | 45.00 |
| 5 | Chq. 463 | 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 |

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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 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.

### Advertising

Aug. 27 Jessie's T-shirts gave 5 T-shirts to support the local school fete raffle (Memo 2). The 5 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

| | | IN | | | OUT | | | BALANCE | | |
|---|---|---|---|---|---|---|---|---|---|---|
| **Date** | **Details** | **Qty** | **Cost** | **Total** | **Qty** | **Cost** | **Total** | **Qty** | **Cost** | **Total** |
| Aug. 1 | Balance | | | | | | | 10 | 4.50 | 45.00 |
| 5 | Chq. 463 | 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 |

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### *Credit sale*

Aug. 28 The business sold 7 T-shirts at a cost of $16.50 including GST (Inv. 185) to Bert's Shirts. (Identified Cost indicated the following inventory was sold: 1 at $4.50, 2 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 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 | Details | IN | | | OUT | | | BALANCE | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | Qty | Cost | Total | Qty | Cost | Total | Qty | Cost | Total |
| Aug. 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 loss or inventory gain.

**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 or during the physical count.

**inventory loss**
an expense that occurs when the physical count shows less inventory than is shown on the inventory cards

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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.

**Example**

Aug. 31 Physical count revealed 4 black XL T-shirts on hand (Memo 15). (Identified Cost indicated that there were 3 black XL T-shirts valued at $5.50 and 1 at $5.00).

According to the inventory card, there should be 6 black XL T-shirts on the shelves, but the physical count reveals that there are only 4. Therefore, 2 T-shirts have been lost and the inventory card needs to be updated to reflect the actual number of T-shirts on hand.

**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.

**Figure 11.7** Recording an inventory loss 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

| | | IN | | | OUT | | | BALANCE | | |
|---|---|---|---|---|---|---|---|---|---|---|
| **Date** | **Details** | **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 |

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

**inventory gain**
a revenue that occurs when the physical count shows more inventory on hand than is shown in the inventory card

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 or during the physical count.

**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 1 T-shirt more than the balance showed in the inventory card, indicating an inventory gain.

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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).

**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

| | | IN | | | OUT | | | BALANCE | | |
|---|---|---|---|---|---|---|---|---|---|---|
| **Date** | **Details** | **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 at 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 3 T-shirts (to make up the 20 sold) assumed to be from the $5 batch.

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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

| | | IN | | | OUT | | | BALANCE | | |
|---|---|---|---|---|---|---|---|---|---|---|
| Date | Details | Qty | Cost | Total | Qty | Cost | Total | Qty | Cost | Total |
| Aug. 1 | Balance | | | | | | | 10 | 4.50 | 45.00 |
| 5 | Chq. 463 | 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.

### *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 5 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.

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Figure 11.10 shows how these transactions would be recorded in the inventory card using 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 | Details | IN | | | OUT | | | BALANCE | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | Qty | Cost | Total | Qty | Cost | Total | Qty | Cost | Total |
| Aug. 1 | Balance | | | | | | | 10 | 4.50 | 45.00 |
| 5 | Chq. 463 | 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 |

### *Credit sale*

Aug. 28 The business sold 7 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 10 units we will use up the 3 units of $5 and the 7 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.

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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 | **Location:** Row 16, Bay C3
**Inventory code:** BTBk306XL | **Supplier:** Boonds
**Inventory method:** FIFO

| | | IN | | | OUT | | | BALANCE | | |
|---|---|---|---|---|---|---|---|---|---|---|
| **Date** | **Details** | **Qty** | **Cost** | **Total** | **Qty** | **Cost** | **Total** | **Qty** | **Cost** | **Total** |
| Aug. 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 |

### 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 as compared to 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 4 black XL T-shirts on hand (Memo 15); the inventory card for black XL T-shirts showed a balance of 6 T-shirts

According to the inventory card, there should be 6 black XL T-shirts on the shelves, but the physical count reveals that there are only 4. Therefore, 2 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

| | | IN | | | OUT | | | BALANCE | | |
|---|---|---|---|---|---|---|---|---|---|---|
| **Date** | **Details** | **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.

### 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 1 T-shirt more than the balance showed in the inventory card, indicating an inventory gain.

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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

| | | IN | | | OUT | | | BALANCE | | |
|---|---|---|---|---|---|---|---|---|---|---|
| **Date** | **Details** | **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 2025), 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

| | | IN | | | OUT | | | BALANCE | | |
|---|---|---|---|---|---|---|---|---|---|---|
| Date | Details | Qty | Cost | Total | Qty | Cost | Total | Qty | Cost | Total |
| Aug. 1 | Balance | | | | | | | 10 | 4.50 | 45.00 |
| 5 | Chq. 463 | 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 **Location:** Row 16, Bay C3
**Inventory code:** BTBk306XL **Supplier:** Boonds
**Inventory method:** FIFO

| Date | Details | IN | | | OUT | | | BALANCE | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | Qty | Cost | Total | Qty | Cost | Total | Qty | Cost | Total |
| Aug. 1 | Balance | | | | | | | 10 | 4.50 | 45.00 |
| 5 | Chq. 463 | 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 | Advertising | Value of inventory at end |
|---|---|---|---|
| Identified Cost | $172.00 | $22.50 | $21.50 |
| First In, First Out | $164.50 | $25.00 | $22.00 |

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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 Profit and Inventory in the Balance Sheet. The opposite holds true if there was a consistent decline in inventory prices: Cost of Sales would be higher as the more expensive inventory is 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.


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## 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).

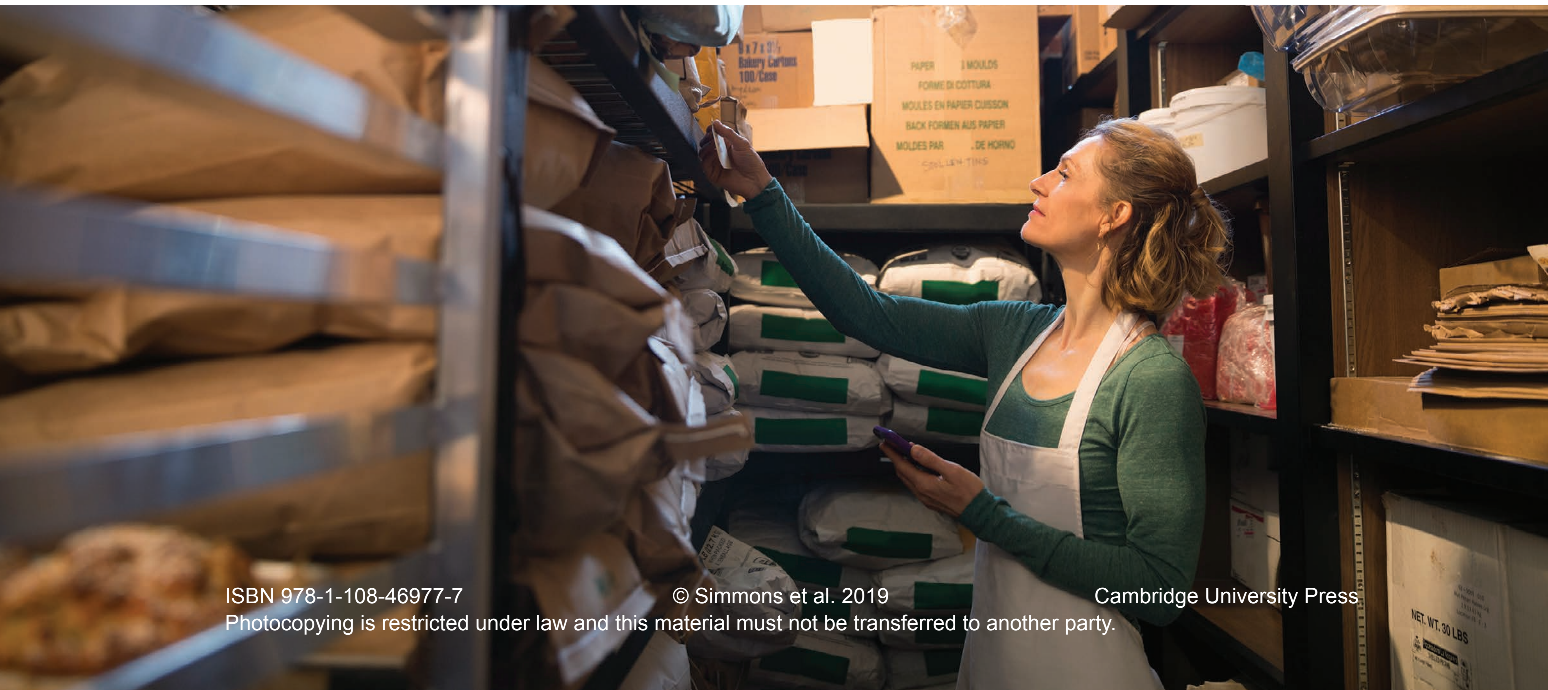
### Inventory cards and ICT

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 bar codes 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.

## Exercises

### Exercise 11.1

WB page 194

### Identifying inventory

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

WB page 195

### Inventory transactions

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.

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## Exercise 11.3

WB page 196

### Inventory cards

Jackson Jewellers sells a variety of watches, including the Gismo 120, which it purchases from Ryan International. As at 30 September 2025, Jackson Jewellers had five Gismo 120 watches on hand valued at $210 each. The following are transactions relating to Gismo 120 watches that occurred during October 2025:

| | | |
|---|---|---|
| Oct. | 1 | Purchased 4 watches at $210 plus $21 GST each (Chq. 427) |
| | 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 (Chq. 435) |

*Required*

**a** **Suggest** one reason why Chq. 432 does not appear in this list of transactions.

**b** **Record** the transactions for October 2025 in the inventory card for Gismo 120 watches.

**c** **Explain** why the GST on purchases of inventory is not recorded in the inventory card.

**d** **Explain** how the sale of inventory creates an expense.

**e** 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. **Discuss** whether Jackson Jewellery should purchase from this new supplier.

## Exercise 11.4

WB page 198

### Inventory cards and Identified Cost

Len Sherbert owns and operates The Perfume Shop and has provided the following information relating to inventory item 1112 Funk, 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 (Chq. 880) |
| | 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 one 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 (Chq. 894) |
| | 30 | Sold 15 bottles at $220 inclusive of GST each (Rec. 37) |

*Required*

**a** **Record** the transactions for April 2025 in the inventory card for Funk perfume.

**b** Referring to your answer to part ‘a’, **explain** the operation of the Identified Cost assumption.

**c** **Calculate** the Cost of Sales for Funk perfume for April 2025.

**d** **Calculate** the Gross Profit on Funk perfume for April 2025.

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## Exercise 11.5

WB page 200

### Inventory loss and gain

Chiltern Chainsaws sells timber cutting equipment, and after recording all transactions for August 2025, its inventory cards showed 12 brushcutter chainsaws on hand worth $400 each. A physical physical count on 31 August 2025 showed 10 chainsaws on hand (Memo 13).

*Required*

**a** Referring to one Qualitative characteristic, **explain** the role of a physical 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 brushcutter chainsaws.

## Exercise 11.6

WB page 201

### Inventory loss and gain

Maxwell's Hardware sells a number of different tools, including the Silver hammer. After recording all transactions for November 2025, the inventory card showed 43 hammers on hand, but a physical physical count on 30 November 2025 counted 47 (Memo 91). The hammers have a cost price of $15.

*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

WB page 202

### Inventory cards, FIFO, Identified Cost and physical count

Loud As sells stereos and other hi-fi equipment, and as at 1 December 2025 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 (Chq.123) |
| | 14 | 2 stereos were sold to Blown nightclub for $2 200 including $200 GST each (Inv. 301) (Identified Cost 2 at $1 100) |
| | 17 | Sales return of 1 stereo from Blown nightclub due to malfunction. (Cr. Note 23) |
| | 19 | Purchase return of problematic stereo to supplier of $ 1 000 (Cr. Note x56) |
| | 21 | Bought 10 stereos from Rockweiler at a bargain price of $1 000 plus $100 GST each (Chq. 127) |
| | 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 11 at $1 000 and 1 at $1 100) |

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*Required*

**a** **Record** the transactions for December 2025 in the inventory card for Rockweiler stereos using Identified Cost.

**b** **Record** the transactions for December 2025 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** **Identify** three differences in figures that will occur in the financial reports due to the method used.

**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 answer to part 'a', **state** the effect on each element of the Accounting equation of the transaction on 31 December 2025.

**g** **Explain** why inventory loss is classified as an expense.

## Exercise 11.8

WB page 205

### Inventory cards and cash journals using FIFO

Cuong's Electrical World buys and sells electrical products such as DVD players, VCRs, and TVs. The owner maintains individual inventory cards for all inventory and uses the FIFO method of recording. As at 1 June 2025, there were four Samsong DVD players (code no. 250) on hand at a cost price of $100 each. The following transactions took place during June 2025:

| | | |
|---|---|---|
| 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 (Chq. 1255) |
| | 7 | Sold 6 DVD players for $297 (including $27 GST) each (Rec. 89) |
| | 9 | Paid wages $540 (Chq. 1256) |
| | 12 | Bought 5 DVD players at $120 plus $12 GST each (Chq. 1257) |
| | 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 (Chq. 1258) |
| | 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 2025 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 2025 in the cash journals of Cuong's Electrical World.

**d** **State** the effect on each element of the Accounting equation of the transaction on:

- 2 June 2025
- 7 June 2025
- 30 June 2025.

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## Exercise 11.9

WB page 208

### Recording for inventory using FIFO

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 2025, there were 15 desks on hand worth $50 each. The following transactions relating to desks occurred during September 2025:

| | | |
|---|---|---|
| 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 (Chq. 320) |
| | 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 2025.

**c** **Record** the transactions for September 2025 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 2025 was not recorded.

**f** **Calculate** Cost of Sales for desks for September 2025.

**g** **Calculate** Gross Profit on desks for September 2025.

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## Exercise 11.10

WB page 210

### Recording for inventory – FIFO vs Identified Cost

Gia Lucchetti is the owner and manager of Lucchetti Paints, a business that sells paint and painting equipment. Inventory is recorded using the perpetual system and inventory cards are maintained according to First In, First Out (FIFO). Ceiling paint is sold for $77 per can including $7 GST. On 1 August 2025, 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 2025:

| | | |
|---|---|---|
| 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 (Chq. 184) |
| | 5 | Paid wages $780 (Chq. 185) |
| | 8 | Purchased 4 cans of paint for $44 inclusive of GST each (Chq. 186) |
| | 9 | Gia withdrew $400 cash for personal use (Chq. 187) |
| | 12 | Received a loan from JH Finance for $5000 (Rec. 232) |
| | 16 | Paid $440 including $40 GST for advertising (Chq. 188) |
| | 19 | Gia took 2 cans of paint to use on her home renovations (Memo 20) (Identified Cost: 2 at $35) |
| | 22 | Paid wages $620 (Chq. 189) |
| | 25 | Purchased 10 cans of paint at $45 plus $4.50 GST each (Inv. 901) |
| | 27 | Purchase return of 2 cans of paint (purchased on 25 August 2025) due to leakage (Cr. Note 25). |
| | 28 | Sold 6 cans of paint (Inv. 309) (Identified Cost: 2 at $40 and the remainder at $45) |
| | 31 | A physical 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 2025 in the inventory card for ceiling paint under:
- Identified Cost
- FIFO.

**b** **State** two benefits Gia derives by recording transactions in inventory cards.

**c** **Record** the relevant transactions for August 2025 in the journals of Lucchetti Paints.

**d** Referring to one Accounting assumption, **explain** why the transaction on 19 August 2025 must be recorded in the inventory card.

**e** Assuming FIFO, **explain** the effect on owner's equity as at 31 August 2025 if the transaction on 19 August 2025 had **not** been recorded.

**f** **Calculate** Gross Profit on ceiling paint for August 2025 using Identified Cost and FIFO.

Chapter 12

# Reporting and managing inventory

## Where are we headed?

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 regards 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 2025. All inventory is sold at a 100% mark-up:

**Inventory Card**

**Inventory item**: Yukihimo P225/65R14
**Inventory code**: Y132 **Location**: Row 10, Bay D45
**Inventory method**: FIFO **Supplier**: Yukihimo

| | | IN | | | OUT | | | BALANCE | | |
|---|---|---|---|---|---|---|---|---|---|---|
| **Date** | **Details** | **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 | Chq. 267 | 15 | 45 | 675 | | | | 25 | 45 | 1 125 |
| 12 | Rec. 54 | | | | 11 | 45 | 495 | 14 | 45 | 630 |
| 17 | Inv. 832 | 18 | 5 | 90 | | | | 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 |

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 2025.

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 2025 and 31 July 2025 – are referenced by a memo, indicating that they are not sales. The transaction on 3 July 2025 could be drawings of inventory for personal use, or perhaps a donation as a form of advertising, while the transaction on 31 July 2025 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 2025 would thus be calculated as:

| | | | | |
|---|---|---|---|---|
| July | 12 | Rec. 54 | | $495 |
| | 23 | Inv. 72 | (630 + 300) | $930 |
| Cost of Sales for Yukihimo tyres for July 2025 | | | | $1 425 |

**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.

## 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.

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The Cost of Sales for July 2025 would thus be calculated as:

| | |
|---|---|
| Cost of Sales for Yukihimo tyres for July 2025 | $1 425 |
| Cost of Sales for Greatyear tyres for July 2025 | 1 200 |
| Cost of Sales for Bridgerock tyres for July 2025 | 1 780 |
| Cost of Sales for Michelton tyres for July 2025 | 940 |
| Cost of Sales for July 2025 | $5 345 |

This total – derived from all the inventory cards – will be reported as an expense in the Income Statement for July 2025, 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 just 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 cash flows under which inventory is 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 2025. It had a bank balance of $10 600 at the start of August.

**Sales Journal**

| Date | Accounts Receivable | Inv. No. | Sales | GST | Total Accounts Receivable |
|---|---|---|---|---|---|
| Aug. 2025 | | | | | |
| | **TOTALS** | **$** | **10 000** | **1 000** | **11 000** |

**Cash Receipts Journal**

| Date | Details | Rec. No. | Bank | Sales | Receipts from Accounts Receivable | Sundries | GST |
|---|---|---|---|---|---|---|---|
| Aug. 2025 | Loan – Bank of Guam | | | | | 5 000 | |
| | **TOTALS** | **$** | **62 420** | **46 200** | **6 600** | **5 000** | **4 620** |

**Cash Payments Journal**

| Date | Details | Doc. | Bank | Inventory | Drawings | Wages | Sundries | GST |
|---|---|---|---|---|---|---|---|---|
| Aug. | Freight In | | | | | | 1 200 | |
| 2025 | Advertising | | | | | | 2 000 | |
| | Loan – Principal | | | | | | 500 | |
| | Interest on loan | | | | | | 200 | |
| | Delivery to | | | | | | | |
| | customers | | | | | | 1 400 | |
| | **TOTALS** | **$** | **48 560** | **30 000** | **5 000** | **4 800** | **5 300** | **3 460** |

**Additional information:**

- The inventory cards for August 2025 revealed the following:

  Cost of Sales $30 800
  Inventory on hand $13 200

- Sales returns (selling price) $1 800
- A physical count on 31 August 2025 showed $12 400 worth of inventory on hand.

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The Cash Flow Statement for Tyre City for August 2025 is shown in Figure 12.1:

**Figure 12.1** Cash Flow Statement for a trading business

**TYRE CITY**

**Cash Flow Statement for August 2025**

| | $ | $ |
|---|---|---|
| **CASH FLOW FROM OPERATING ACTIVITIES** | | |
| Cash sales | 46 200 | |
| Cash received 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 Operations** | | **14 360** |
| **CASH FLOW FROM INVESTING ACTIVITIES** | | |
| **Net Cash Flows from Investing activities** | | |
| **CASH FLOW FROM FINANCING ACTIVITIES** | | |
| Loan | | 5 000 |
| Drawings | (5 000) | |
| Loan | (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 2025)** | | **10 600** |
| **Bank balance at end (31 August 2025)** | | **24 460** |

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The Income Statement for Tyre City for August 2025 is shown in Figure 12.2:

**Figure 12.2** Income Statement for a trading business

**TYRE CITY**

**Income Statement for August 2025**

| | $ | $ |
|---|---|---|
| **Revenue** | | |
| Cash sales | 46 200 | |
| Credit sales | 10 000 | 56 200 |
| Less Sales returns | | 1 800 |
| **Net Sales[1]** | | **54 400** |
| **Less Cost of Goods Sold[2]** | | |
| Cost of Sales | 30 800 | |
| Freight in | 1 200 | 32 000 |
| **Gross Profit[3]** | | **22 400** |
| Less Inventory loss | | 800 |
| **Adjusted Gross Profit[4]** | | **21 600** |
| **Less Other expenses** | | |
| Wages | 4 800 | |
| Advertising | 2 000 | |
| Interest on loan | 200 | |
| Delivery to customers | 1 400 | 8 400 |
| **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.

**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

## 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 our reputation and for future sales. It is a good indicator of the quality of our inventory.

## 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, 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

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.

**Adjusted Gross Profit**
Gross Profit less Inventory loss (or plus Inventory gain)

### 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 purchase of inventory is not reported as an expense. **Explain** where a cash purchase 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

$$\textbf{Net Profit Margin (NPM)} = \frac{\textbf{Net Profit}}{\textbf{Net Sales}} \times 100$$

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 2025 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

$$\textbf{NPM} = \frac{\text{Net Profit}}{\text{Net Sales}} \times 100$$

$$= \frac{\$13\,200}{\$54\,400} \times 100$$

$$= \textbf{24.26\%}$$

**Study tip**

When assessing performance, look *backwards* (to previous figures), *forwards* (to budget figures) and *sideways* (to competitors or industry averages).

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 periods ratios**
- **budgeted performance**
- **competitors' performance** (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)

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 (GPM)** a profitability indicator that measures the average mark-up by calculating the percentage of Net Sales revenue that is retained as Gross Profit

Gross Profit Margin is calculated as shown in Figure 12.5:

**Figure 12.5** Formula: Gross Profit Margin

$$\textbf{Gross Profit Margin (GPM)} = \frac{\textbf{Gross Profit}}{\textbf{Net Sales}} \times 100$$

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 2025 Tyre City had earned $54 400 in Net Sales, and $22 400 in Gross Profit.

The Gross Profit Margin of Pulse Music would be calculated as shown in Figure 12.6:

**Figure 12.6** Calculation: Gross Profit Margin

$$\begin{aligned} \textbf{GPM} &= \frac{\text{Gross Profit}}{\text{Net Sales}} \times 100 \\ &= \frac{\$22\,400}{\$54\,400} \times 100 \\ &= 41.18\% \end{aligned}$$

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 $1 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.

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## 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 2025:

**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 2025** | | | **$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 2025) |
| + 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 2025)** |

* 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 2025) 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 2025) 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

**Inventory Turnover**
an efficiency indicator that measures the average number of days it takes for a business to convert its inventory into sales

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.

**Figure 12.9** Formula: Inventory Turnover

$$\textbf{Inventory Turnover} = \frac{\textbf{Average inventory} \times \textbf{365}}{\textbf{Cost of Goods Sold}}$$

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

$$\textbf{Average inventory} = \frac{\textbf{Inventory at start + inventory at end}}{\textbf{2}}$$

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 2025, Stainless Cutlery had inventory on hand worth \$55 000. During 2025 its Cost of Sales was \$300 000, and on 31 December 2025 Inventory on hand was \$45 000.

The Inventory Turnover of Stainless Cutlery for 2025 would be calculated as is shown in Figure 12.12:

**Figure 12.11** Calculation: Average Inventory

$$\textbf{Average Inventory} = \frac{\$55\,000 + \$45\,000}{2}$$

$$= \$50\,000$$

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*Rounded to nearest day where:

**Figure 12.12** Calculation: Inventory Turnover

$$\textbf{Inventory Turnover} = \frac{\$50\,000 \times 365}{\$300\,000}$$
$$= 61 \text{ days*}$$

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 which 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.

### 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.

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## 12.8 Inventory management

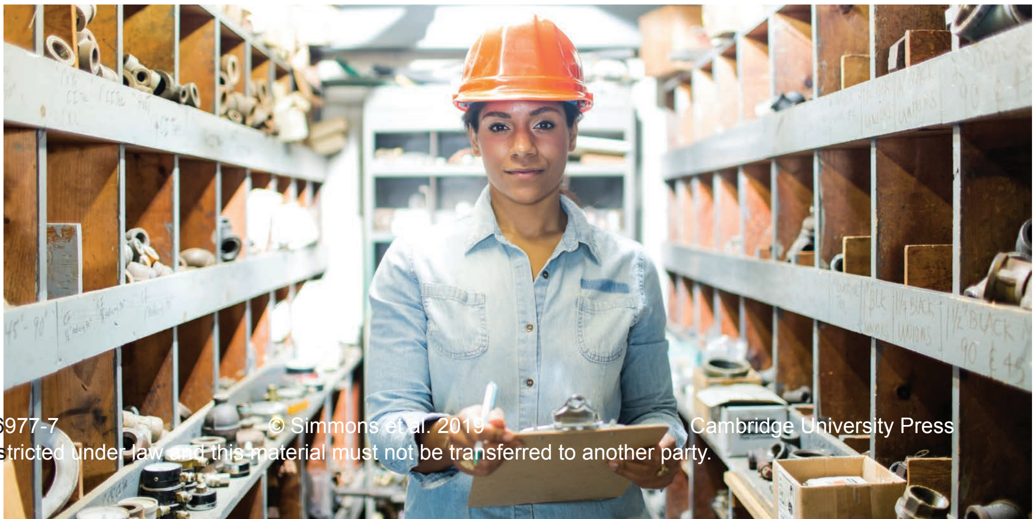
As we noted in Chapter 11, effective inventory management is essential to the survival of a trading business as inventory is the firm's main source of revenue and is likely to be one of its most significant assets.

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 stocked 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, 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.

## 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

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### Calculating Cost of Sales

Chris Chendo operates a music store called Sonics and has provided the following inventory card for Ibsen guitars for November 2025:

**Inventory Card**

**Inventory item**: Ibsen Guitars
**Inventory code**: IB335
**Inventory method**: FIFO
**Location**: Bay 21
**Supplier**: Ibsen Music

| | | IN | | | OUT | | | BALANCE | | |
|---|---|---|---|---|---|---|---|---|---|---|
| **Date** | **Details** | **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 2025 (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 2025.

**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 2025.

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## Exercise 12.2
WB page 216

### Calculating Cost of Sales

Julie Hibbert is the owner of House of Tennis and has provided the inventory card for Majesty tennis racquets for July 2025:

**Inventory Card**

**Inventory item**: Majesty tennis racquets
**Inventory code**: MT-122-C
**Inventory method**: Identified Cost
**Location**: Shelf near counter
**Supplier**: Dilnot Tennis

| | | IN | | | OUT | | | BALANCE | | |
|---|---|---|---|---|---|---|---|---|---|---|
| Date | Details | Qty | Cost | Total | Qty | Cost | Total | Qty | Cost | Total |
| July 1 | Balance | | | | | | | 4 | 45 | 180 |
| 6 | Chq. 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 transactions are made on cash terms, and all sales are marked up 100%.
- Memo 16 was the only memo issued during July 2025.

*Required*

**a** **State** the source document that would verify the transaction that occurred on 12 July 2025.
**b** **Describe** the transaction that occurred on 19 July 2025.
**c** **Explain** why the purchase of inventory is not classified as an expense.
**d** **Calculate** Cost of Sales for Majesty tennis racquets for July 2025.
**e** **Explain** the effect of an inventory gain on Cost of Sales.

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## Exercise 12.3

WB page 217

## Financial reports

Gemima Finkelstein owns WhereIsIt Maps and has provided the following information relating to the firm's trading activities for March 2025:

**Sales Journal**

| Date | Accounts Receivable | Inv. No. | Sales | GST | Total Accounts Receivable |
|---|---|---|---|---|---|
| March | | | | | |
| | **TOTALS** | **$** | **5 000** | **500** | **5 500** |

**Cash Receipts Journal**

| Date | Details | Rec. No. | 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 | Doc. | 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** |

**Additional information:**

- Gemima's capital as at 1 March 2025 was $34 000.
- WhereIsIt Maps bank balance as at 1 March was $1 800.
- The inventory cards for March 2025 showed Cost of Sales of $15 800, and Inventory on hand of $7 400.
- A physical count on 31 March 2025 showed Inventory on hand of $7 100.
- Industry Average for Gross Profit Margin 25% and Net Profit Margin of 5%.

*Required*

* **a** **Prepare** a Cash Flow Statement and an Income Statement for WhereIsIt Maps for March 2025.

**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 2025.

**d** **Calculate** the Gross Profit Margin and Net Profit Margin for WhereIsIt Maps. **Comment** on the results.

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## Exercise 12.4

WB page 220

### Income Statement

Dion Virente is the owner of The Photography Place and has provided the following information relating to the firm's trading activities for October 2025:

**THE PHOTOGRAPHY PLACE**
**Cash Flow Statement for October 2025**

| | $ | $ |
|---|---|---|
| **CASH FLOWS FROM OPERATING ACTIVITIES** | | |
| Cash sales | 20 000 | |
| Cash received from Accounts Receivable | 15 000 | |
| GST received | 3 500 | 38 500 |
| 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 Operations** | | **7 430** |
| **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** | | **6 430** |
| **Bank balance at start (1 October 2025)** | | **1 200** |
| **Bank balance at end (31 October 2025)** | | **7 630** |

**Additional information:**

- Credit sales were $23 000 for October.
- Sales returns for October were $1 200.
- Dion's capital as at 1 October 2025 was $45 000.
- The inventory cards for October 2025 showed Cost of Sales of $23 000 and Drawings of inventory of $600.
- A physical count on 31 October 2025 revealed an Inventory gain of $300.

*Required*

* **a** **Prepare** an Income Statement for The Photography Place for October 2025.

**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 2025.

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## Exercise 12.5

WB page 222

### Financial reports

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 2025 showed the following information:

**Cash Receipts Journal**

| Date | Details | Rec. No | Bank | Sales | Sundries | GST |
|---|---|---|---|---|---|---|
| 2025 | Capital contribution | | | | 6 000 | |
| | **TOTALS** | **$** | **160 000** | **140 000** | **6 000** | **14 000** |

**Cash Payments Journal**

| Date | Details | Doc. | Bank | Inventory | Drawings | Wages | Sundries | GST |
|---|---|---|---|---|---|---|---|---|
| 2025 | 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 2025 showed Cost of Sales of $96 000, Drawings of inventory of $1 500 and Inventory on hand as at 31 December 2025 of $20 000.
- A count on 31 December 2025 revealed Inventory on hand of $18 500 (Memo 63).
- As at 1 January 2025 Capital was $75 000 and Bank $18 500.
- Industry Average for Gross Profit Margin 40% and Net Profit Margin of 12%.

*Required*

* **a** **Prepare** a Cash Flow Statement and an Income Statement for Baxter's Books for 2025.

**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 2025.

**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. **Comment** on Baxter's Books performance and **justify** by giving two recommendations.

## Exercise 12.6

WB page 225

### Inventory Turnover

As at 1 January 2025, Wally's Timber Yard held Inventory on hand worth $25 000. During 2025, the business generated sales of $180 000, incurring Cost of Sales of $91 250 in the process. As at 31 December 2025, Inventory on hand had increased to $35 000. In 2024, Inventory Turnover was 100 days.

*Required*

**a** **Calculate** the Inventory Turnover of Wally's Timber Yard for 2025.

**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.

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## Exercise 12.7

WB page 226

### Inventory Turnover

Gia's Dancewear has provided the following information relating to the firm's activities for December 2025:

| | |
|---|---|
| Sales revenue | $26 000 |
| Net Profit | $2 000 |
| Average Inventory on hand | $3 600 |
| Cost of Sales | $18 000 |
| Average Total Assets | $50 000 |

Inventory Turnover: industry average 80 days

*Required*

**a** **Calculate** the Inventory Turnover of Gia's Dancewear for December 2025.
**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.

## Exercise 12.8

WB page 227

### Reporting and managing inventory

Benita Superior owns and manages a sporting goods store in Northcote called Superior Sports Store. Benita has provided the following information for 2025:

| | |
|---|---|
| Assistant's wages | $9 200 |
| Cost of Sales | $73 000 |
| GST settlement | $620 |
| Rent | $10 000 |
| Inventory on hand – 1 January 2025 | $12 500 |
| Cartage inwards | $2 300 |
| GST received | $10 500 |
| Heating and power | $1 200 |
| Credit sales | $110 000 |
| Sales returns | $5 000 |
| Inventory Turnover: industry average | 35 days |

**Additional information:**

- A physical count on 31 December 2025 revealed $5 500 Inventory on hand. The inventory cards at the same date showed Inventory on hand worth $6 000.
- In 2024, Superior Sports had an Inventory Turnover of 55 days.

*Required*

**a** Using the formula, **calculate** cash purchases of inventory for 2025.
**b** **Explain** why cash purchases of inventory are **not** reported in the Income Statement.
*** c** **Prepare** an Income Statement for Superior Sports for 2025.
**d** **Explain** why the Income Statement for a trading firm shows both Gross Profit and Net Profit.
**e** **Calculate** Inventory Turnover for Superior Sports for 2025.
**f** Referring to your answer to part 'e', **explain** whether Benita should be pleased with the Inventory Turnover for 2025.
**g** **State** two possible reasons for the change in Inventory Turnover from 2024 to 2025.
**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.

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## Exercise 12.9

WB page 230

### Reporting and managing inventory

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. Mario has provided the following information for the year ended 30 June 2025:

| | |
|---|---|
| Credit sales | $47 500 |
| Cost of Sales | $19 000 |
| Inventory on hand – 1 July 2015 | $7 400 |
| Inventory on hand – 30 June 2025 | $7 800 |

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 2024.

*Required*

**a** **Calculate** the Inventory Turnover for Antique Arts for the year ended 30 June 2025.

**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 2025.

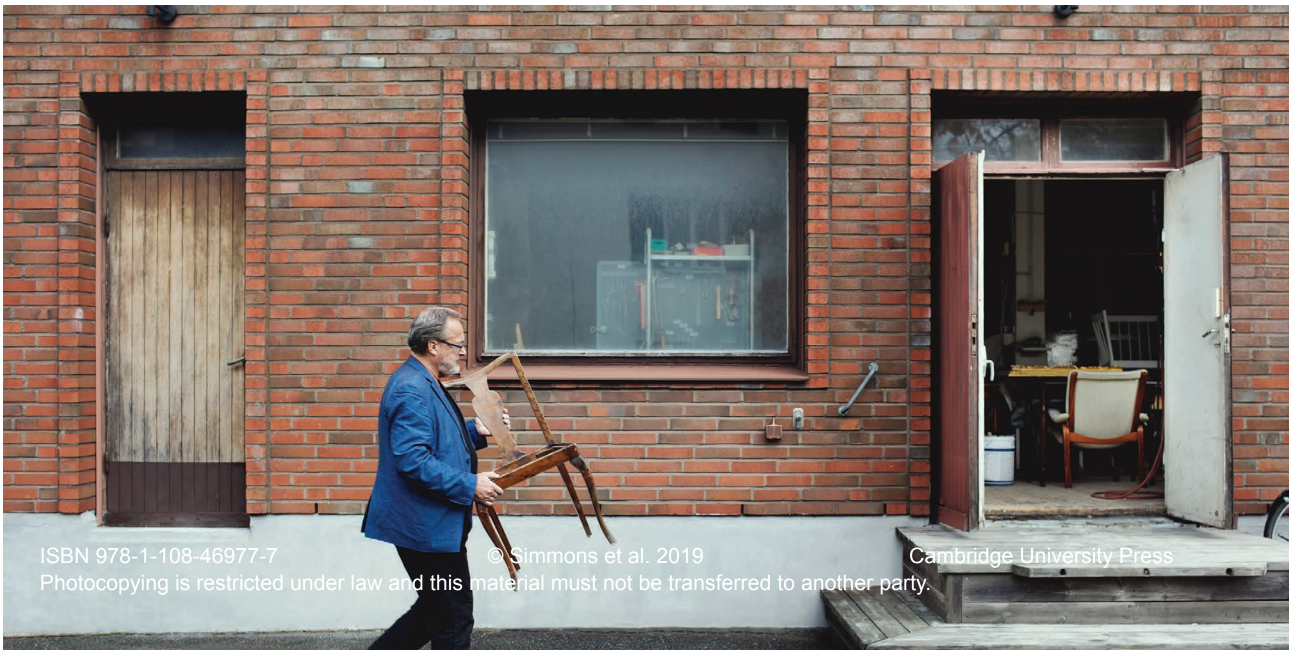
**c** **Calculate** the percentage mark-up Mario has applied to his inventory.

**d** **Explain** how decreasing the percentage mark-up may affect:

- Inventory Turnover
- Gross Profit.

Mario has provided the following information for August 2025:

| | |
|---|---|
| Inventory on hand – 1 August 2025 | $7 800 |
| Sales | $38 500 |
| Sales returns | $1 500 |
| Capital – 1 August 2025 | $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 |



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**Additional information:**

- At the start of August, 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 $1600 cash, and an antique lamp worth $400.
- On 31 August 2025, a physical count revealed $6500 Inventory on hand while the inventory cards showed Inventory on hand as $6100.

*Required*

**e** **Calculate** Cost of Sales for August 2025.

*** f** **Prepare** an Income Statement for Antique Arts for August 2025.

*** g** **Prepare** the owner's equity section of the Balance Sheet for Antique Arts as at 31 August 2025.

**h** **Explain** the effect on owner's equity as at 31 August 2025 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%

**Justify** your response.

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Chapter 13

# Accounts Payable for a trading business

## Where are we headed?

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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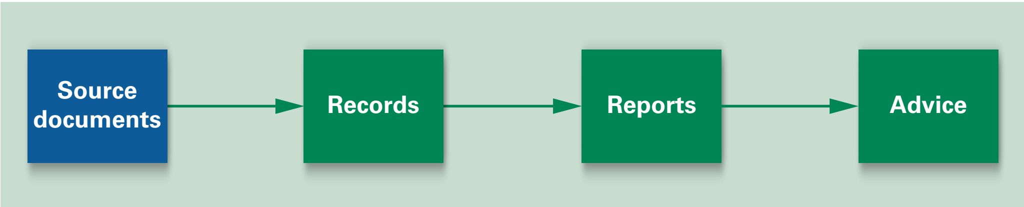
## 13.1 Trading firms and credit transactions

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 then
- the exchange of cash at a later date.

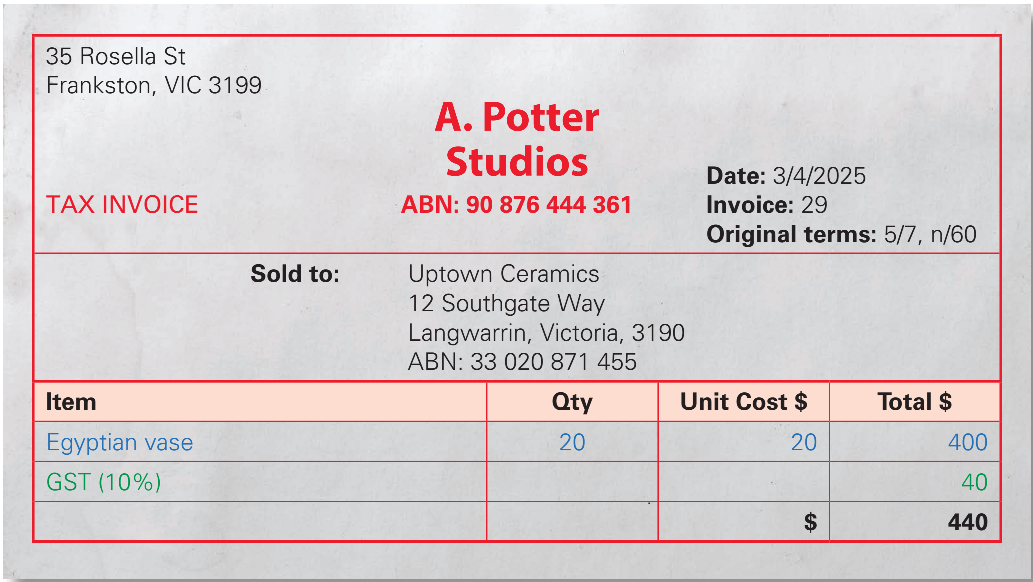
The Accounting system for a trading business must therefore be able to identify and record both of these transactions.

### 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**

TAX INVOICE

**ABN: 90 876 444 361**

**Date:** 3/4/2025
**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 Cost $ | Total $ |
|---|---|---|---|
| Egyptian vase | 20 | 20 | 400 |
| GST (10%) | | | 40 |
| | | $ | 440 |

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 thus provides 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 7 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**

Compared to 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**

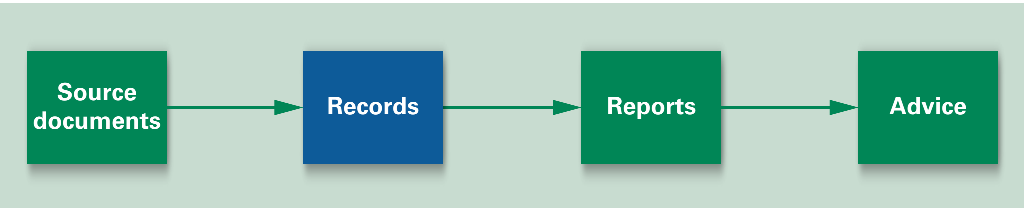
See Section 11.1 for a more detailed discussion of ethical considerations regarding purchasing inventory.

Chapter 11 outlined some of the ethical considerations involved in purchasing inventory, including whether the inventory is:

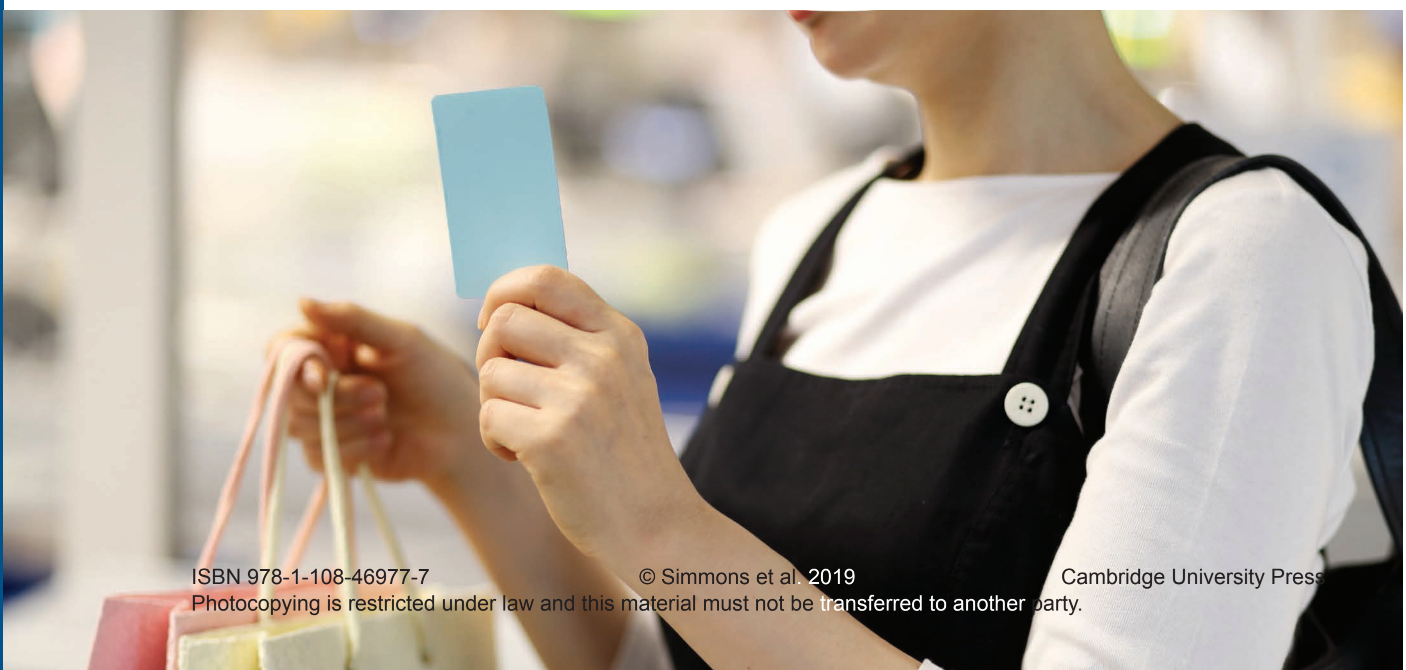
- safe, legal and 'socially responsible'
- produced in a socially and environmentally responsible manner
- able to do what has been advertised
- priced fairly.

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 2025 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 Rec. 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 (Chq. 261) |
| | 15 | Bought inventory from A. Potter Studios worth $600 plus GST (Inv. 35) |
| | 19 | Paid $200 to Account Payable* – Pots 'n' Pitchers (EFT Rec. 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 (Chq. 263) |
| | 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 2025:

**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 |

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**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).

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.

## 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 2025 would be:

| | Increase/Decrease/No effect | Amount $ |
|---|---|---|
| **Assets** | Increase (Inventory) | 2460 |
| **Liabilities** | Increase (increase Accounts Payable $2706, decrease GST $246) | 2460 |
| **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 $2460 worth of inventory during April 2025. 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 $2706.

**Ethical considerations**

### Review questions 13.2

1 **Explain** why a trading business should include ethical considerations when purchasing inventory.
2 **Explain** the role of the Purchases Journal for a trading business.
3 **Identify** the source document used to verify all transactions in the Purchases Journal.
4 **Explain** the effect of 'GST on credit purchases' on:
- the valuation of inventory
- GST payable.

5 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.
6 **State** the effect of a credit purchase of inventory on the Accounting equation.

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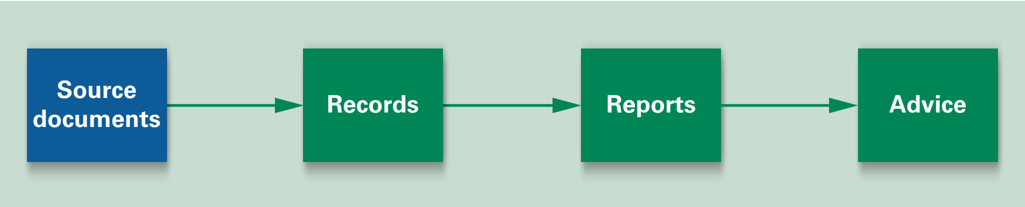
## 13.3 Payments to Accounts Payable

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 can be made by cheque or electronically via Electronic Funds Transfer. Figure 13.3 shows the cheque butt to provide evidence of a payment to Account Payable – A. Potter Studios:

**Figure 13.3** Payment to an Account Payable: cheque butt


On a cheque butt, 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.

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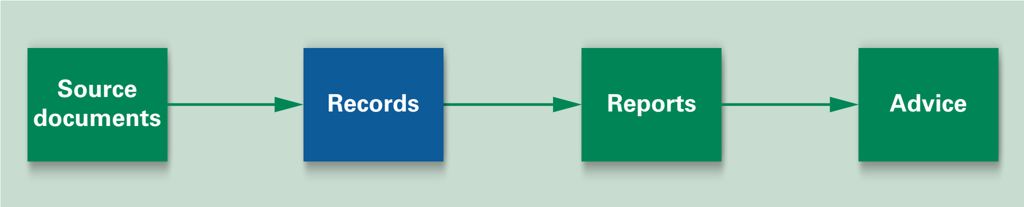
## Recording: Cash Payments Journal




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 2025 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 Rec. 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 (Chq. 261) |
| | 15 | Bought inventory from A. Potter Studios worth $600 plus GST (Inv. 35) |
| | 19 | Paid $200 to Account Payable – Pots 'n' Pitchers (EFT Rec. 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 (Chq. 263) |
| | 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 | Doc. | 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 | 261 | **440** | 440 | | | | |
| 15 | Electricity | 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 | 263 | **660** | 660 | | | | |
| 28 | Rent | 267 | **1 320** | | | | 1 200 | 120 |
| | **TOTALS** | **$** | **5 815** | **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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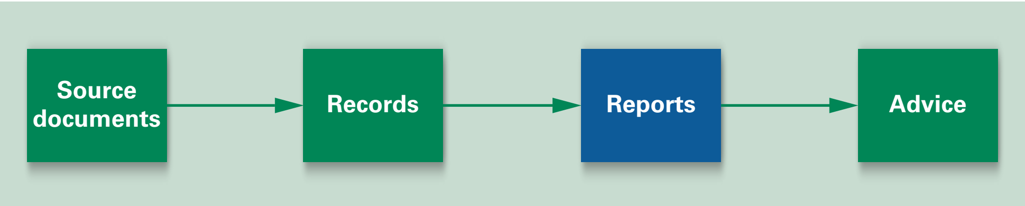
Payments to Accounts Payable will be frequent, and so are recorded in their own classification column, just like (in this example) Drawings, Wages and GST. Total cash paid to Accounts Payable by Uptown Ceramics in April 2025 is thus $1 520.

### Effect on the Accounting equation

The overall effect of payments to Accounts Payable on the Accounting equation of Uptown Ceramics as at 30 April 2025 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 2025, its Accounts Payable balance as at 30 April 2025 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 2025) |
| + 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 2025)** |

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 2025.

### Review questions 13.3

1 **Identify** the source documents 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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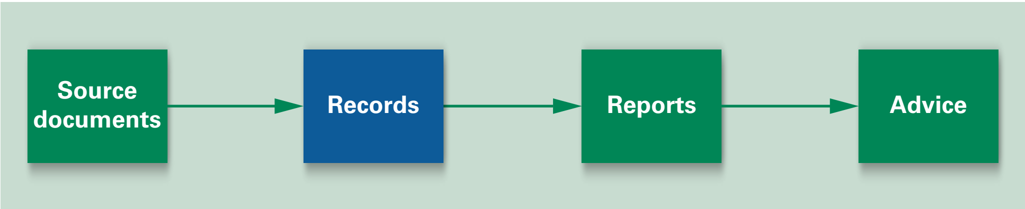
## 13.4 Subsidiary records: Accounts Payable

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 micro-management 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 2025 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 | Chq. 261 | (440) | – |
| 15 | Purchase (incl. GST) | Inv. 35 | 660 | 660 |
| 21 | Payment | Chq. 263 | (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 Rec. 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 Rec. 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 2025:

**Figure 13.7** Accounts Payable Schedule

**UPTOWN CERAMICS**
**Accounts Payable Schedule as at 30 April 2025**

| 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.

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**Ethical considerations**

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.

Applying *Relevance* means that only the total Accounts Payable balance of **$1 506** 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 which 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**

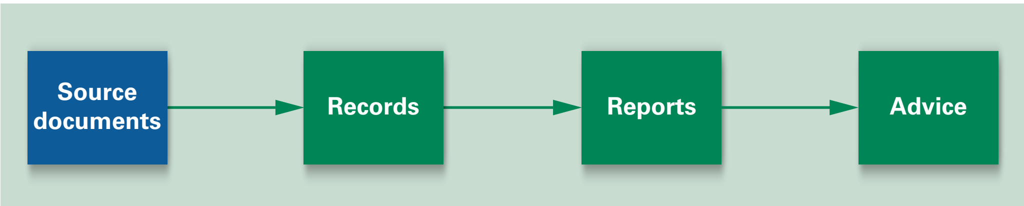
## 13.5 Purchase returns

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 2025, 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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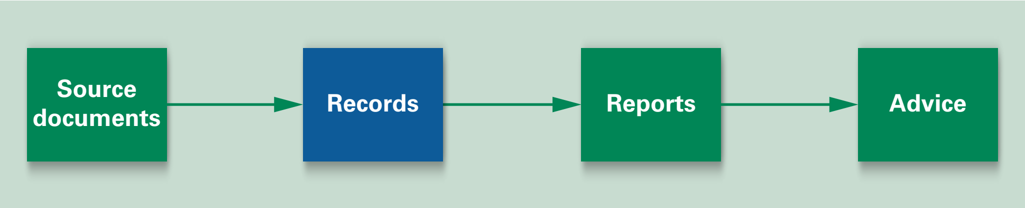
## Recording: Accounts Payable record




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 Rec. 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 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 2025 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 $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).

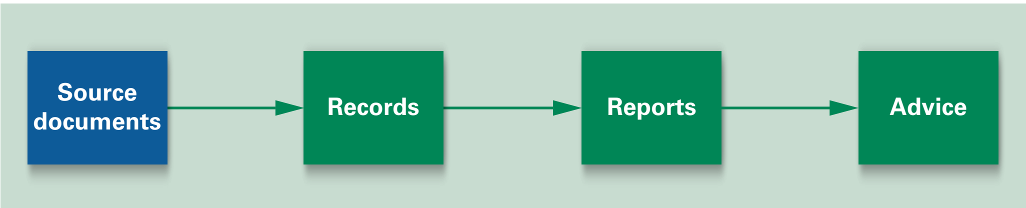
Let's return to the earlier example, concentrating on the transactions with A. Potter Studios but this time considering the settlement discount.

**Example**

During April 2025, 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 (Chq. 261) |
| | 15 | Bought inventory from A. Potter Studios worth $600 plus GST (Inv. 35) |
| | 21 | Paid Account Payable – A. Potter Studios for settlement of account (Chq. 263) |
| | 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 a cheque butt or 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 invoice price.

**Study tip**

In credit terms, the second and fourth numbers refer to the number of days.

### Calculating the discount

The payment made on 9 April 2025 falls just within the 7 day discount period from the purchase date of 2 April 2025 meaning Uptown Ceramics it is entitled to a discount of 5%.

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The discount revenue earned on 9 April 2025 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

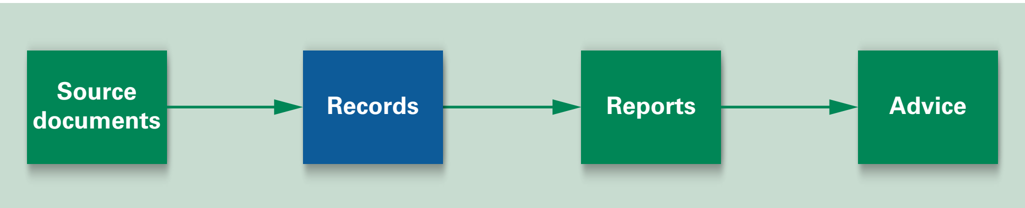
By paying early, Uptown Ceramics earns a discount of 5% on the full balance of $440 (including the GST) that it owes to A. Potter Studios. This discount of $22 means it is only required to pay $418, but the balance it owes to A. Potter Studios is reduced by the total amount of $440 ($418 plus $22).

The same process would be used to calculate the discount earned on 21 April 2025, 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**

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.

## Recording: Cash Payments Journal




Given the discount revenue earned, the amounts paid to A. Potter Studios on 9 and 21 April 2025 would reduce, and be recorded in the Cash Payments Journal as shown in Figure 13.10:

**Figure 13.10** Cash Payments Journal: Payments to Accounts Payable with discount

**Cash Payments Journal ***

| Date | Details | Doc. | 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 | 261 | **418** | 418 | | | | |
| 15 | Electricity | 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 | 263 | **627** | 627 | | | | |
| 28 | Rent | 267 | **1 320** | | | | 1 200 | 120 |
| | **TOTALS** | **$** | **5 760** | **1 465** | **1 200** | **1 500** | **1 450** | **145** |

* Other probable entries have been added to show a more complete Cash Payments Journal.

This would reduce the overall Cash payments to $5 760 and payments to Accounts Payable to $1 465, but by including the Discount revenue of $55, the balance owed to Accounts Payable would still reduce by the full **$1 520**.

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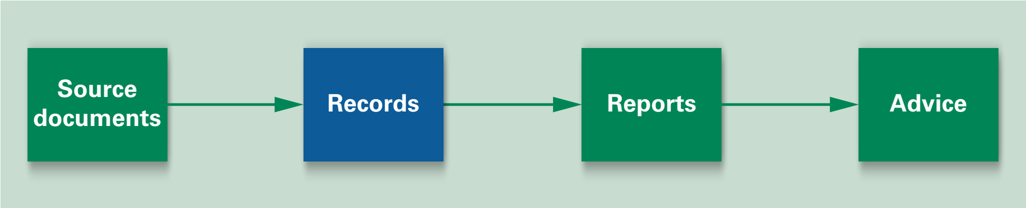
## Recording: Accounts Payable record




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 | Chq. 261 | (418) | |
| | Discount revenue | | (22) | – |
| 15 | Purchase (incl. GST) | Inv. 35 | 660 | 660 |
| 21 | Payment | Chq. 263 | (627) | |
| | Discount revenue | | (33) | – |
| 29 | Purchase (incl. GST) | Inv. 39 | 330 | 330 |

### Effect on the Accounting equation

Using the transaction on 9 April 2025 as an example, a payment to settle an Account Payable, where discount revenue is involved, will thus 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:

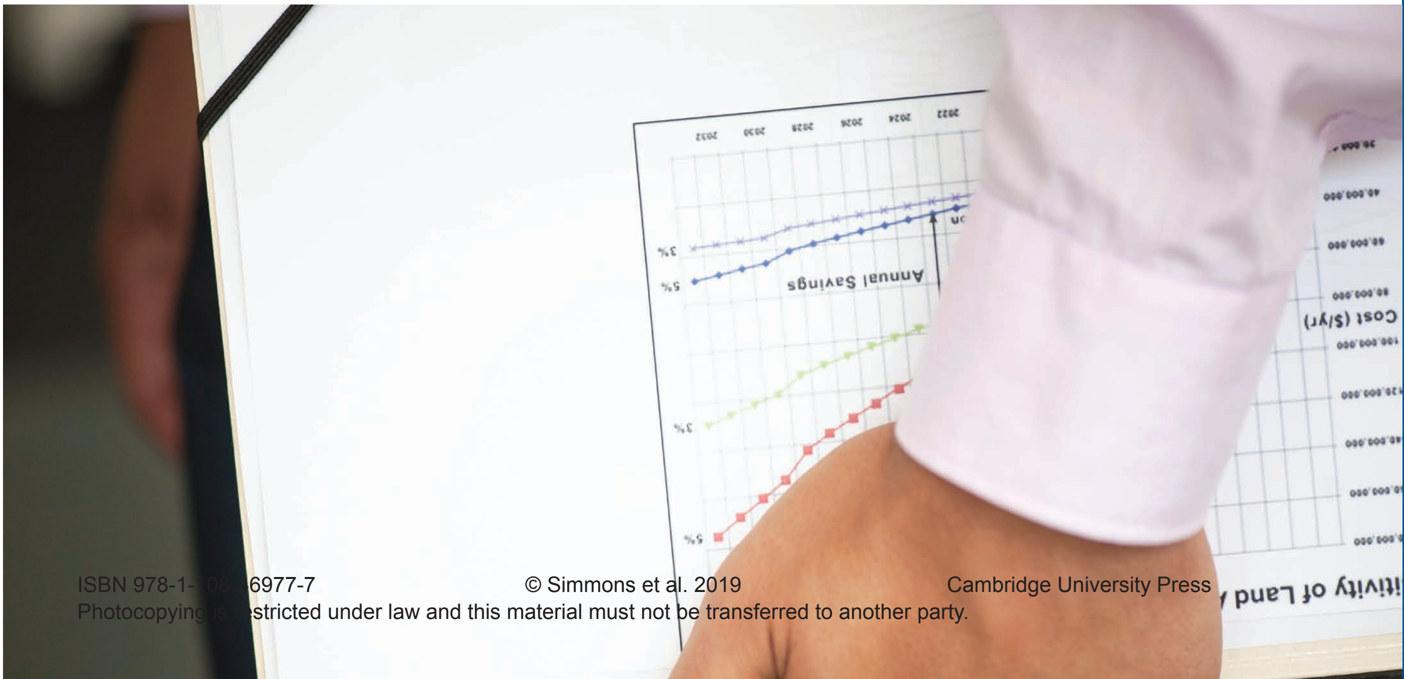
**Figure 13.12** Accounts Payable formula: amended

| | | |
|---|---|---|
| Accounts Payable balance at start | 320 | From the *previous* Balance Sheet (as at 1 April 2025) |
| + 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 2025)** |

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 2025:

**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 2025

| Date | Details | Sales | Payments | Balance |
|---|---|---|---|---|
| April 3 | **Sale: Inv. 29** | **440** | | 440 |
| 9 | Payment received: (Chq. 261)<br>Discount given | | 418<br>22 | – |
| 15 | **Sale: Inv. 35** | **660** | | 660 |
| 21 | Payment received: (Chq. 263)<br>Discount given | | 627<br>33 | – |
| 29 | **Sale: Inv. 39** | **330** | | 330 |
| | **Balance owing: 30 April 2025** | | | **$330** |

This Statement of Account summarises the various Credit purchases (including GST) made by Uptown Ceramics during April 2025, 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.

**Ethical considerations**

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).

**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.

**Ethical considerations**

## 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 a cheque butt or 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.

## 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

WB page 234

### Source documents

The following document was provided by the manager of Miller 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:** Miller Time (ABN: 40 321 440 646)
Toorak Rd, Toorak, 3142

| Date 2025 | 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 Miller Time.
**d** **Explain** why the GST on credit purchases does not affect the valuation of inventory.
**e** **Explain** the effect of this transaction on the Accounting equation of Miller Time.

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## Exercise 13.2

W B page 235

### Purchases Journal

Sparks Electrical Supplies has provided the following list of transactions for July 2025:

| | | |
|---|---|---|
| July | 2 | Credit purchase of inventory from ACDC Industries for $3 600 plus $360 GST (Inv. AI61) |
| | 7 | Bought inventory on credit from Scott Supplies for $4 400 including $400 GST (Inv. 633) |
| | 16 | Purchased inventory from Mickle and Sons for $3 300 inclusive of GST (Inv. M15) |
| | 23 | Purchased inventory from Scott Supplies for $2 860 including $260 GST (Inv. 642) |
| | 28 | Received delivery of inventory from ACDC Industries, at a cost of $2 700 plus $270 GST (Inv. AI73) |

*Required*

**a** **Explain** the role of the Purchases Journal.

*__b__ **Record** the transactions for July 2025 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

W B page 236

### Purchases Journal and Cash Payments Journal

Shoes by Imelda purchases all its inventory on credit. As at 31 August 2025, 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 2025** | **$2530** |

During September 2025, the following transactions occurred:

| | | |
|---|---|---|
| Sept. | 1 | Paid Fine Footwear $900 (Chq. 272) |
| | 3 | Purchased shoes on credit from Johnny Choose for $420 plus $42 GST (Inv. 34A) |
| | 7 | Paid wages – $720 (EFT Rec. 29) |
| | 8 | Purchased inventory from Style House for $825 including $75 GST (Inv. 1002) |
| | 11 | Paid $5 500 including GST for new office equipment (Chq. 273) |
| | 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 (Chq. 274) |
| | 21 | Paid wages – $780 (EFT Rec. 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 (Chq. 275) |

*Required*

⋆ **a** **Record** the transactions for September 2025 in the journals of Shoes by Imelda.

**b** **Explain** the effect of the transaction on 30 September 2025 on the Balance Sheet of Shoes by Imelda.

**c** **Calculate** the balance of Accounts Payable as at 30 September 2025.

**d** **Explain** why there is no GST to account for when cash is paid to an Account Payable.

## Exercise 13.4

W B page 238

### Journals and Accounts Payable

Macedon Mowers sells mowers and other gardening equipment. All inventory is purchased on credit, and as at 31 March 2025 its Account Payable records showed the following balances:

| | |
|---|---|
| Bushman Tools | $12 000 |
| Viking Equipment | 8 000 |
| Melagar Mowers | 13 900 |
| **Balance of Accounts Payable as at 31 March 2025** | **$33 900** |

During April 2025, the following transactions occurred:

| | | |
|---|---|---|
| April | 2 | Paid Viking Equipment $6 000 (Chq. 104) |
| | 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 Rec. 23) |
| | 10 | Paid Malegar Mowers $10 000 (Chq. 105) |
| | 12 | Bought chainsaws from Viking Equipment for $6 000 plus $600 GST (Inv. VT15) |
| | 13 | Paid electricity bill $190 plus $19 GST (Chq. 106) |
| | 18 | Purchased mowers from Malegar Mowers for $8 250 including $750 GST (Inv. 019) |
| | 19 | Paid Viking Equipment $4 000 (Chq. 107) |
| | 21 | Owner withdrew $500 cash (ATM Rec. 12) |
| | 22 | Paid $870 wages (EFT Rec. 24) |
| | 23 | Purchased inventory from Bushman Equipment for $8 800 including GST (Inv. 401C) |
| | 24 | Paid Malegar Mowers $3 500 (Chq. 108) |
| | 27 | Paid $143 for water bill including GST (Chq. 109) |
| | 29 | Bought chainsaws from Viking Tools for $5 000 plus $500 GST (Inv. VT26) |
| | 29 | Paid Bushman Tools $12 000 (Chq. 110) |

As at 1 April 2025, the inventory card for Mowers showed 5 mowers on hand worth $250 each.

*Required*

* **a** **Record** the transactions for April 2025 in the journals of Macedon Mowers.

**b** **Record** the transaction on 7 April 2025 in the inventory card for mowers.

**c** **Record** the transactions for April 2025 in the Accounts Payable records of Macedon Mowers.

**d** **Prepare** an Accounts Payable Schedule for Macedon Mowers as at 30 April 2025.

**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

WB page 240

### Credit note

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

**Credit Note 23**
**Tax invoice**

**For credit of:** Sarrish Cycles (ABN: 15 032 003 018)
Mt Alexander Road, Essendon 3040

| Date 2025 | 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 2025, Sarrish Cycles had 5 Cyclone 1000 bikes on hand which it had purchased for $300 plus GST each and 7 which it had purchased for $320 plus GST each and 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.

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## Exercise 13.6

WB page 241

### Purchase returns

Amoré Décor sells paintings, prints and other decorations. All inventory is purchased on credit from Daglish Designs and as at 31 October 2025 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 2025, 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 Rec. 45) |
| | 23 | Returned 2 of the items purchased on 15 November 2025 due to damage (Cr. Note 42) |

*Required*

**a** **Identify** the special journals in which the following documents would be recorded in the accounts of Amoré Décor:
- Invoice 76
- EFT receipt 45.

**b** **Explain** how Invoice 76 would be recorded in the special journals of Daglish Designs.

**c** **Record** the transactions for November 2025 in the inventory card for Chambers prints.

**d** **Record** the transactions for November 2025 in the Accounts Payable record for Daglish Designs.

**e** **Explain** the effect on the Accounting equation of the transaction on 23 November 2025.

**f** Referring to your answers to parts 'e' 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

WB page 243

### Discount revenue

Macarthur Park sells garden furniture and as at 1 January it owed $600 to Account Payable – Charlie Luu. Inventory is purchased on credit terms of 5/7, n/60 and during January 2025 the following transactions occurred:

| | | |
|---|---|---|
| Jan. | 4 | Paid Charlie Luu $600 (EFT Rec. 17) |
| | 17 | Purchased inventory for $4 000 plus GST on terms of 5/7, n/60 (Inv. 115) |
| | 21 | Paid Charlie Luu in full settlement of account (EFT Rec. 24) |
| | 28 | Purchased inventory 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 2025, **calculate**:
- the discount revenue earned
- the cash paid to Account Payable – Charlie Luu.

**c** **Explain** the effect of the transaction on 21 January 2025 on the Accounting equation of Macarthur Park.

**d** **Record** the transactions for January 2025 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

WB page 245

### Recording in journals and Accounts Payable

Diana Adams is the owner of Diana's Jewellery which had the following balances in its Balance Sheet as at 31 January 2025:

**Accounts Payable:**

| | |
|---|---|
| – Beads and Stones | $8800 |
| – Carter Diamonds | $7150 |

Diana has provided the following list of transactions for February 2025:

| | | |
|---|---|---|
| Feb. | 1 | Paid GST owing to ATO $1700 (Chq. 201) |
| | 3 | Paid Beads and Stones $8360 for balance from January, receiving 5% discount (EFT Rec. 26) |
| | 4 | Credit purchase from Precious Inc. for $5100 plus GST (Inv. 1702) |
| | 5 | Cash purchase of display cabinets for $16500 including GST (Chq. 201) |
| | 7 | Paid Carter Diamonds full amount owing (EFT Rec. 29) |
| | 9 | Purchased inventory from Beads and Stones for $4000 plus GST (Inv. 65) |
| | 10 | Paid for rent for February to July 2025: $2400 plus GST (Chq. 202) |
| | 12 | Returned inventory worth $4500 plus GST to Precious Inc. (Cr. Note 12) |
| | 14 | Paid wages $1200 (EFT Rec. 33) |
| | 15 | Paid Beads and Stones for Invoice 65, receiving 5% discount (EFT Rec. 36) |
| | 17 | Credit purchase from Carter Diamonds for $6600 including GST (Inv. c311) |
| | 20 | Paid electricity bill of $110 including GST (Chq. 203) |
| | 22 | Credit purchase from Beads and Stones for $7920 including GST (Inv. 78) |
| | 23 | Paid Carter Diamonds for Invoice c311, receiving 8% discount (EFT Rec. 38) |
| | 24 | Cash drawings $1000 (ATM Rec. 09) |
| | 27 | Paid wages $1250 (EFT Rec. 43) |
| | 28 | Purchased jewellery from Carter Diamonds for $4200 plus GST (Inv. c346) |

*Required*

**a** **Calculate** the discount revenue earned by Diana's Jewellery on:
- 3 February 2025
- 15 February 2025.

***b** Using the formula, **calculate** the balance of Accounts Payable as at 28 February 2025.

**c** **Record** the transactions for February 2025 in the Accounts Payable records of Diana's Jewellery.

***d** **Prepare** an Accounts Payable Schedule for Diana's Jewellery as at 28 February 2025.

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

W B page 247

## Accounts Payable

Peter Ohm owns and operates a small trading business called Shock Electrics. On 31 May 2025, 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 2025 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 | Doc. | Bank | Accounts Payable | Drawings | Wages | Sundries | GST |
|---|---|---|---|---|---|---|---|---|
| June 1 | Sparkwell | EFT 201 | 5 244 | 5 244 | | | | |
| 3 | Drawings | ATM 32 | 900 | | 900 | | | |
| 6 | General PC | Chq. 237 | 4 800 | 4 800 | | | | |
| 7 | Wages | EFT 202 | 2 000 | | | 2 000 | | |
| 10 | Advertising | Chq. 238 | 1 100 | | | | 1 000 | 100 |
| 14 | Sparkwell | EFT 203 | 6 072 | 6 072 | | | | |
| 21 | Wages | EFT 204 | 2 650 | | | 2 650 | | |
| 29 | Electron | Chq. 239 | 7 000 | 7 000 | | | | |
| | **TOTALS** | **$** | **29 766** | **23 116** | **900** | **4 650** | **1 000** | **100** |

**Additional information:**

- Sparkwell provided a discount of $456 on 1 June 2025 and $528 on 14 June 2025.
- On 16 June 2025, 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 2025.

**d** **State** the effect of the following transactions on the Accounting equation of Shock Electrics:

- 6 June 2025
- 16 June 2025.

***e** **Record** the transactions for June 2025 in the Accounts Payable records of Shock Electrics.

**f** **Prepare** an Accounts Payable Schedule for Shock Electrics as at 30 June 2025.

**g** Other than detecting errors, **explain** two benefits of recording transactions in subsidiary records.

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## Exercise 13.10

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### Statement of Account

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 2025**
**Account # 1002**

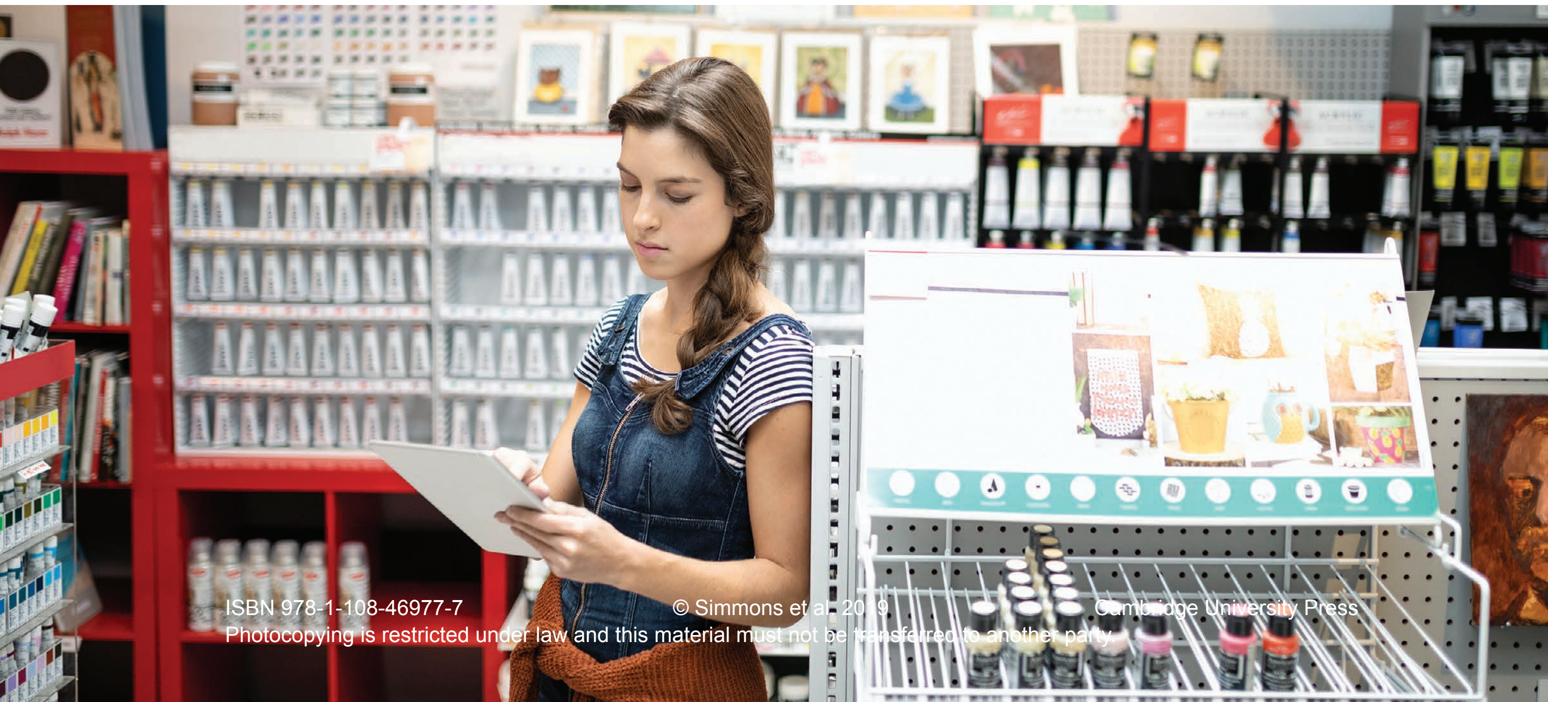
**STATEMENT OF ACCOUNT**

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 (Chq. 132)<br>Discount allowed | | 1 000<br>100 | 1 760 |
| 19 | Return – excess stock (Cr. Note 35) | | 440 | 1 320 |
| 24 | Sale (Inv. 1786) | 3 520 | | 4 840 |
| | **Balance – 31 March 2025** | | | **$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 7 days for Accounts Payable to pay early and receive a discount. **Justify** your answer.
- **c** **Explain** the effect of the transaction on 10 March 2025 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 2025.
- **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 2025.



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Chapter 14

# Accounts Receivable for a trading business

## Where are we headed?

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

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.

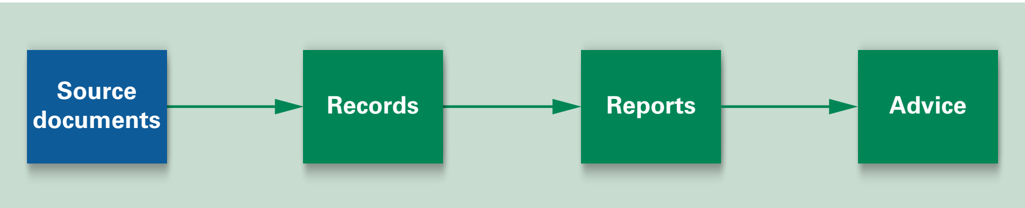
**credit sale**
the provision of inventory to a customer who is not required to pay until a later date

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**

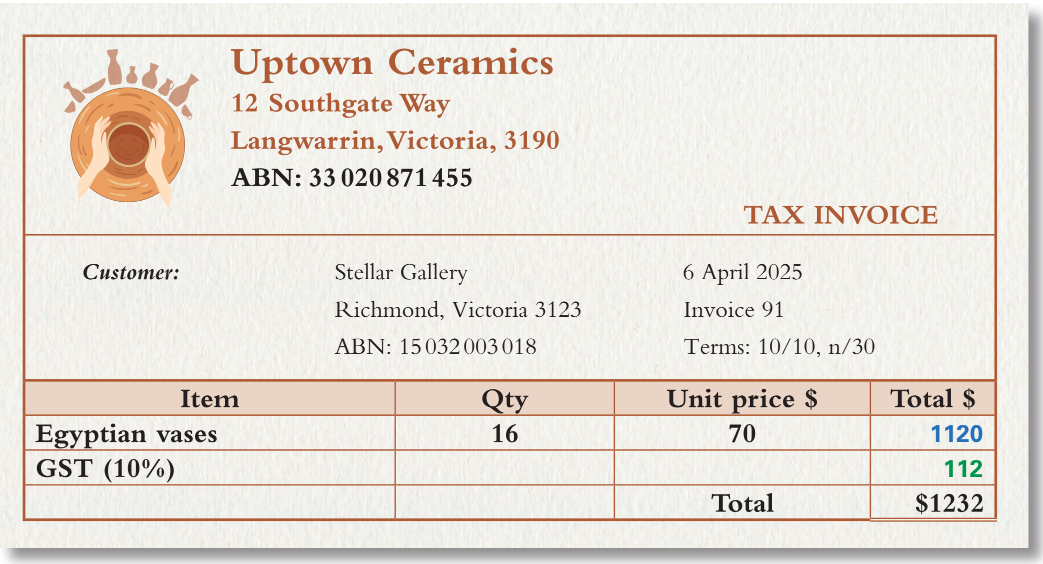
On 6 April 2025, Uptown Ceramics sold 16 Egyptian vases to Stellar Gallery for $1 120 plus $112 GST (Inv. 91).

### Source document: Sales invoice




The Sales invoice for this credit sale is shown in Figure 14.1:

**Figure 14.1** Sales invoice



Uptown Ceramics
12 Southgate Way
Langwarrin, Victoria, 3190
ABN: 33 020 871 455

TAX INVOICE

*Customer:* Stellar Gallery, Richmond, Victoria 3123, ABN: 15 032 003 018
6 April 2025
Invoice 91
Terms: 10/10, n/30

| Item | Qty | Unit price $ | Total $ |
|---|---|---|---|
| Egyptian vases | 16 | 70 | 1120 |
| GST (10%) | | | 112 |
| | | Total | $1232 |

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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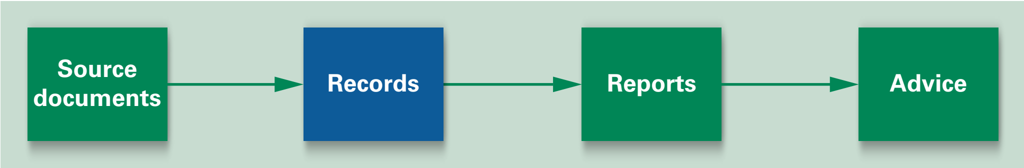
## Recording: Sales Journal




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 2025, 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) |

Figure 14.2 shows the Sales Journal for Uptown Ceramics for April 2025:

**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** | **$** | **3 910** | **391** | **4 301** |

**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.

### Effect on the Accounting equation

Assuming the inventory cards determined Cost of Sales to be $1 500, the overall effect of total credit sales on the Accounting equation of Uptown Ceramics as at 30 April 2025 would be:

| | Increase/Decrease/No effect | Amount $ |
|---|---|---|
| **Assets** | Increase (increase Accounts Receivable $4 301, decrease Inventory $1 500) | 2 801 |
| **Liabilities** | Increase (GST payable) | 391 |
| **Owner's equity** | Increase (Sales revenue $3 910 less Cost of sales $1 500) | 2 410 |

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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 2025. In the process it has 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.

## 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 have elected to only stock fair trade products, and given the possible health effects some businesses have made decisions to not sell products containing alcohol or tobacco.
- **environmental effects of the items it holds for sale**
  Items that are produced or packaged 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 using plastic bags and stopped selling products using palm oil because of their effect on the environment and changes in customers' behaviour in response.
- **advertising strategy it uses**
  Advertising strategies that are racist or sexist, or discriminatory and harm society in other ways can be harmful to both society and profits, and businesses must consider their obligation to promote respect and tolerance rather than mistrust and prejudice.
- **prices it charges.**
  Businesses are entitled to charge prices that generate profits, but in so doing must not exploit its customers, particularly those that are vulnerable. 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 considerations

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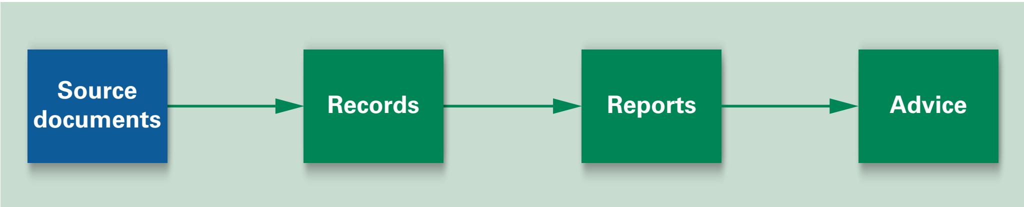
## 14.2 Receipts from Accounts Receivable

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 2025, Uptown Ceramics received $1 000 from Stellar Gallery (EFT Rec. 19).

### Source document



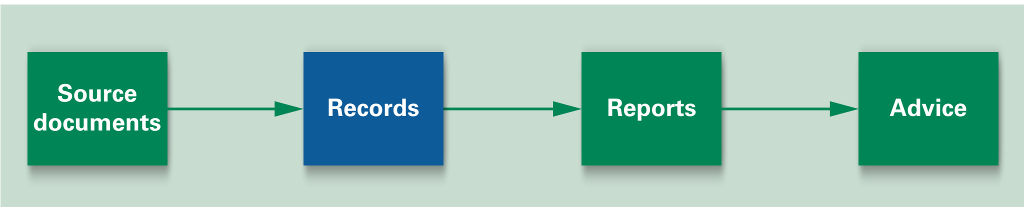

Receipts from Accounts Receivable can be taken in person at the store or electronically via Electronic Funds Transfer. Figure 14.3 shows the receipt to provide evidence of a payment from an Account Receivable.

**Figure 14.3** Receipt from an Account Receivable: EFT receipt

| Empire Bank<br>Uptown Ceramics (A/c: 892 552 001)<br>**Funds transfer** | |
|---|---|
| **Date of receipt** | 17/4/2025 |
| **From** | Stellar Gallery<br>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




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.

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**Example**

During April 2025 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 | Rec. No. | Bank | Accounts Receivable | Sales | Sundries | GST |
|---|---|---|---|---|---|---|---|
| April 2 | Cash sales | 123 | **132** | | 120 | | 12 |
| 5 | Decorators' World | EFT 18 | **440** | 440 | | | |
| 8 | Cash sales | 124 | **462** | | 420 | | 42 |
| 17 | Stellar Gallery | EFT 19 | **1 000** | 1 000 | | | |
| 18 | Home Junction | EFT 20 | **220** | 220 | | | |
| 22 | Cash sales | 125 | **319** | | 290 | | 29 |
| 26 | Capital contribution | 126 | **5 000** | | | 5 000 | |
| 28 | Stellar Gallery | 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 2025 is thus $2 160.

## 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.

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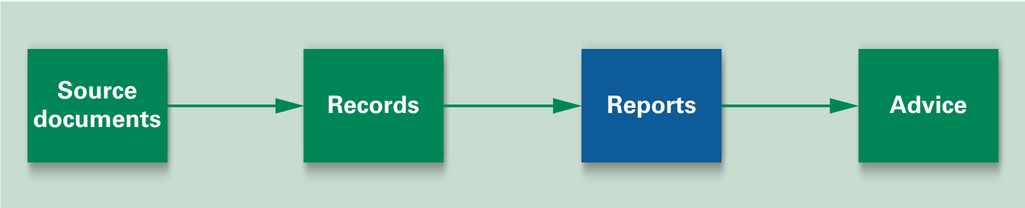
The overall effect of receipts from Accounts Receivable on the Accounting equation of Uptown Ceramics for April 2025 would be:

| | 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 | |

## 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 2025, the Accounts Receivable balance of Uptown Ceramics as at 30 April 2025 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 2025) |
| + 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 2025)** |

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 2025.

### 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.

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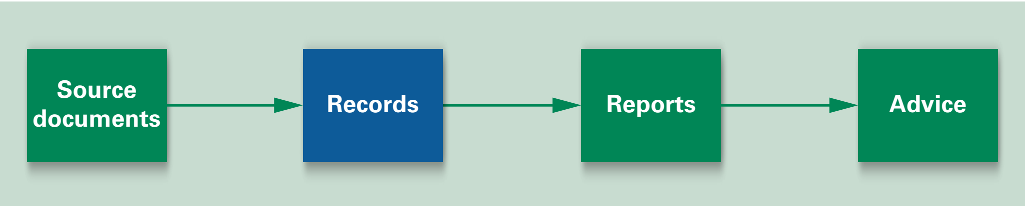
## 14.3 Subsidiary records: Accounts Receivable

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.

### 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 2025 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

**Figure 14.6** Accounts Receivable records

**Account Receivable – Stellar Gallery**

| Date | Details | Document | Amount $ | Balance $ |
|---|---|---|---|---|
| April 1 | Balance | | | 100 |
| 6 | Sales (including GST) | Inv. 91 | 1 232 | 1 332 |
| 17 | Receipt | EFT Rec. 19 | (1 000) | 332 |
| 23 | Sales (including 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 (including 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 (including 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 (including GST) | Inv. 94 | 880 | 880 |

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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, Discounts expense and Bad debts (each of which is covered later in this chapter).

## Accounts Receivable Schedule

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.

**Accounts Receivable Schedule**
a listing of the name and balance of each Accounts Receivable record

Figure 14.7 shows the Accounts Receivable Schedule for Uptown Ceramics as at 30 April 2025:

**Figure 14.7** Accounts Receivable Schedule

**UPTOWN CERAMICS**

**Accounts Receivable Schedule as at 30 April 2025**

| 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 Schedule and the formula applies to both Accounts Receivable and Accounts Payable – the total of the Schedule (**$2 901**) should match the figure calculated using the formula (**$2 901**), 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 which 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.


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## 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, but at their selling price in the Accounts Receivable records and reports.

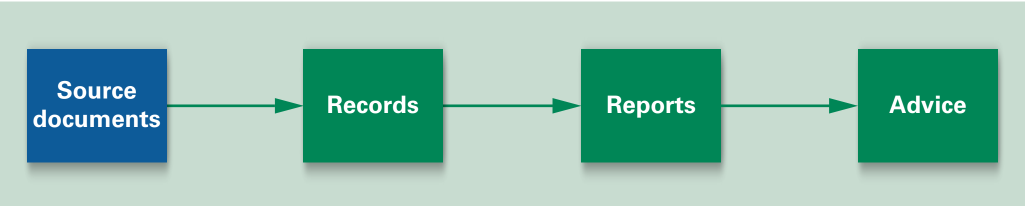
Valued at its cost price, a Sales return will be recorded in the IN column of the relevant inventory card, increasing the value of Inventory on hand and resulting in a decrease in Cost of Sales.

At the same time, Sales returns is a negative revenue which will decrease profit (this will be explained in detail in Chapter 15), 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**

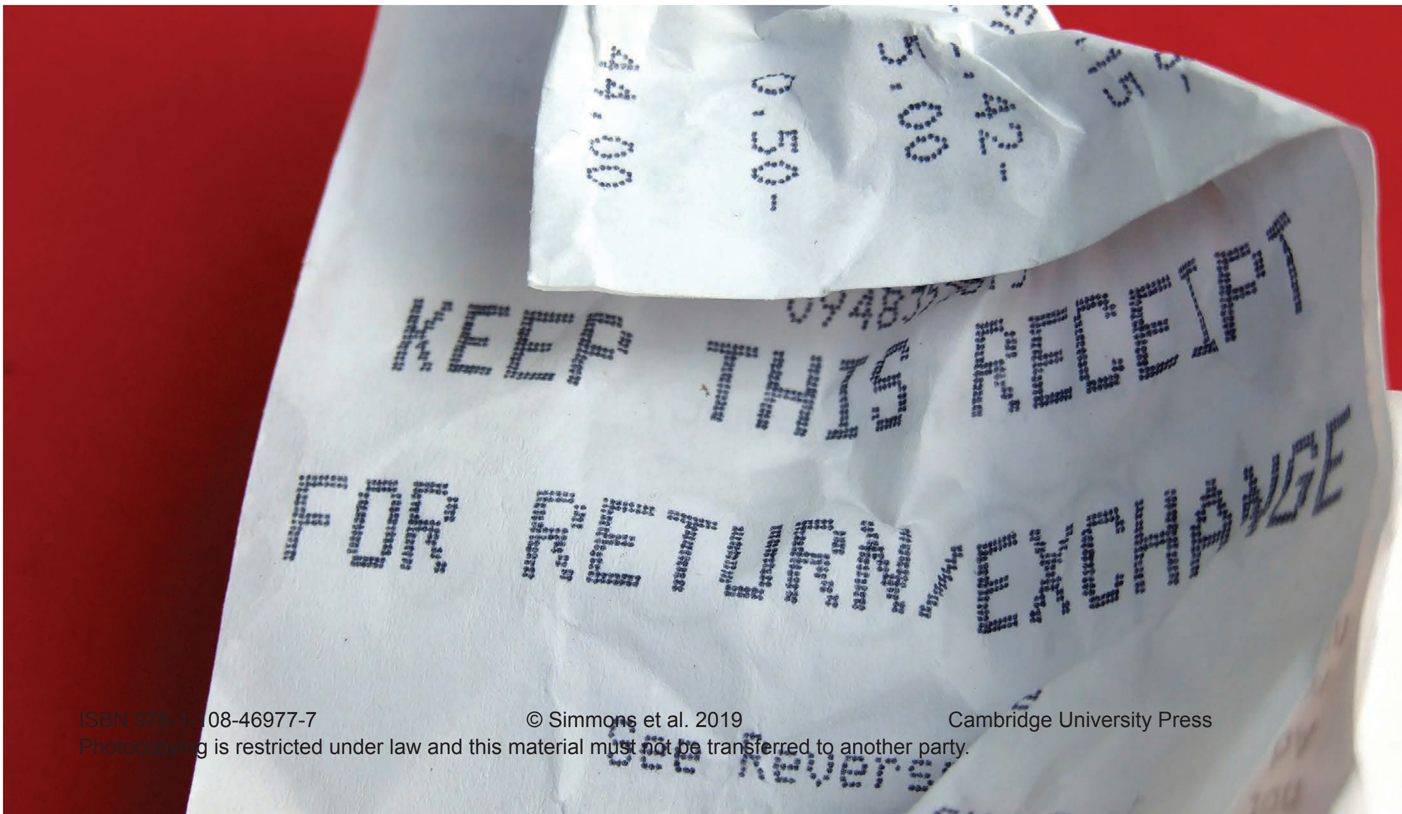
On 30 April 2025, A. Minty returned to Uptown Ceramics returned inventory worth $200 plus GST it had purchased on 16 April 2025 (Cr. Note 145).

### 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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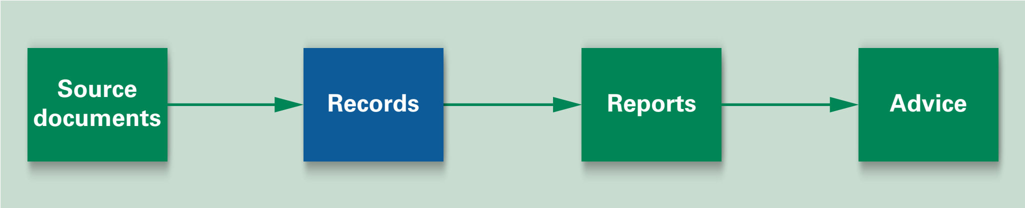
## Recording: Accounts Receivable record




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 (including GST) | Inv. 93 | **726** | 726 |
| 30 | Sales return (including 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 2025 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 which acts ethically and responsibly may generate a market advantage from its behaviour, while a business which 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. The discount itself is the amount that will not be received from the customer but will still be deducted from the amount owed by the customer. It reduces the amount received (from the Account Receivable) with the **discount expense** decreasing assets (Accounts Receivable) 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.

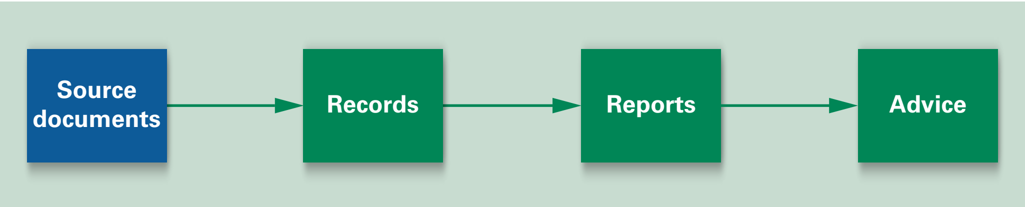
**discount expense**
an expense in the form of a decrease in assets (Accounts Receivable) and owner's equity, incurred when cash is received early from Accounts Receivable and a settlement discount is given by the business

**Example**

During April 2025, Uptown Ceramics had the following transactions:

| | | |
|---|---|---|
| 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 this receipt is an EFT receipt but could equally be an electronic or hand-written receipt generated at the business premises. Note that no amount is given, but this can be calculated by reference to the balance of the Accounts Receivable record.

### Calculating the discount

In Figure 14.1 the credit terms of the sale were noted at 10/10, n/30, meaning Uptown Ceramics allows 30 days to pay the net amount (balance owing) on the invoice, but provides a discount of 10% of the invoice price if customers pay within 10 days.

The receipt on 29 April 2025 falls just within this period from the purchase date of 20 April 2025 meaning Uptown Ceramics will allow Decorators' World a discount of 10%.

The discount expense incurred on 29 April 2025 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.

**Figure 14.9** Calculation: Discount expense

| | | |
|---|---|---|
| **Discount expense** | = | Discount rate × Amount owing |
| | = | 10% × $880 |
| | = | $88 |

By paying early, Decorators' World earns a discount of 10% on the full balance of $880 (including the GST) that it owes to Uptown Ceramics. This discount of $88 means that Uptown Ceramics will only receive $792, but the balance owed by Decorators' World is reduced by the total amount of $880 ($792 plus $88).

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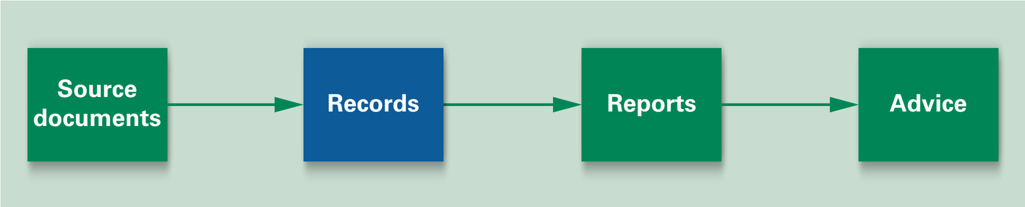
## Recording: Cash Receipts Journal




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:

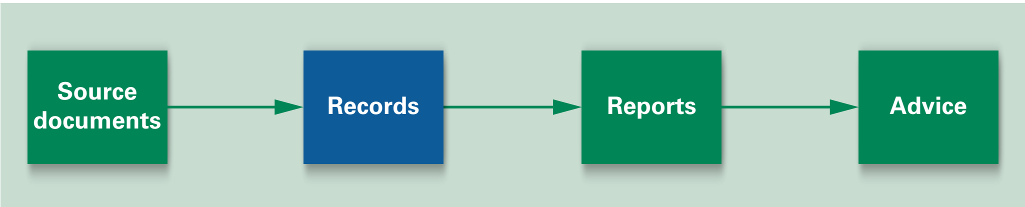
**Figure 14.10** Cash Receipts Journal: Receipts from Accounts Receivable with discount

**Cash Receipts Journal ***

| Date | Details | Rec. No. | Bank | Accounts Receivable | Sales | Sundries | GST |
|---|---|---|---|---|---|---|---|
| April 2 | Cash sales | 123 | **132** | | 120 | | 12 |
| 5 | Decorators' World | EFT 18 | **440** | 440 | | | |
| 8 | Cash sales | 124 | **462** | | 420 | | 42 |
| 17 | Stellar Gallery | EFT 19 | **1 000** | 1 000 | | | |
| 18 | Home Junction | EFT 20 | **220** | 220 | | | |
| 22 | Cash sales | 125 | **319** | | 290 | | 29 |
| 26 | Capital contribution | 126 | **5 000** | | | 5 000 | |
| 28 | Stellar Gallery | 127 | **500** | 500 | | | |
| 29 | Decorators' World | EFT 21 | **792** | 792 | | | |
| | **TOTALS** | **$** | **8 865** | **2 952** | **830** | **5 000** | **83** |

* Other probable entries have been added to show a more complete Cash Receipts Journal.

## 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. 19 | 440 | – |
| 20 | Sales (including GST) | Inv. 91 | **880** | 880 |
| 29 | Receipt | EFT Rec. 21 | 792 | |
| | Discount expense | | 88 | – |

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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 | nil |
| **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.*

### Costs

- *Less cash is received from Accounts Receivable.*
- *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 used to verify a receipt from an Account Receivable where a discount is involved.
4. **State** the effect of a receipt from an Account Receivable with discount expense on the Accounting equation.
5. **List** the benefits of offering discounts to Accounts Receivable.
6. **List** the costs of offering discounts to Accounts Receivable.


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**bad debt**
an expense incurred when a debt is written off because it is deemed to be irrecoverable

**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.

## 14.6 Bad debts

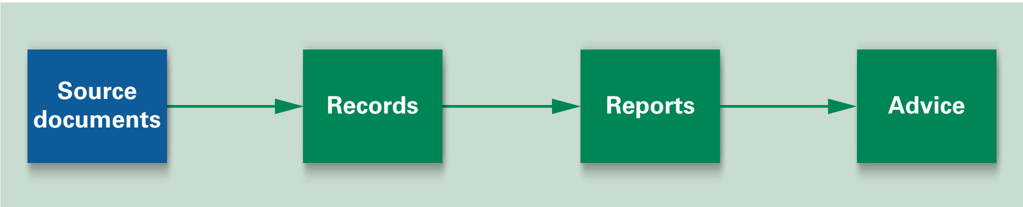
Unfortunately for small business owners, not all Accounts Receivable can be counted on to repay the amounts they owe, and occasionally a debt may need to be written off as uncollectable or 'bad'. These **bad debts** are expenses as they decrease assets (Accounts Receivable) and also decrease owner's equity, and they are usually recognised as being incurred when the debt is deemed to be irrecoverable 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 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.

**Example**

On 29 April 2025, 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 2025, the business received $440 (Rec. 128) and the owner decided to write-off the remaining amount as a **bad debt** (**Memo 41**).

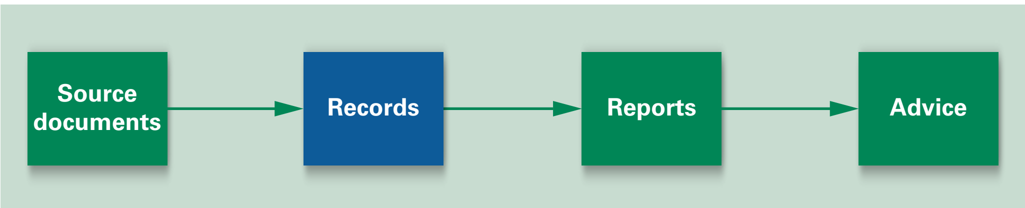
### Source document




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. In this case, the total cash received would increase to $9305 and the cash received from Accounts Receivable would increase to $3392.

However, the remaining **$550** which will *not* be collected must be 'written off' the balance of the Accounts Receivable. Of this amount, $50 will be 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.

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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 (including GST) | Inv. 92 | **990** | 1 210 |
| 18 | Receipt | EFT Rec. 20 | (220) | 990 |
| 30 | Receipt | Rec. 128 | 440 | |
| | **Bad debt** (including GST) | **Memo 41** | **550** | nil |

## 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 2025) |
| + Credit sales including GST | 4301 | From the Sales Journal |
| | 5 061 | |
| – Sales returns including GST | (220) | |
| – Receipts from Accounts Receivable | (3 392) | From the Cash Receipts Journal |
| – Discount expense | (88) | |
| **– Bad debts** including GST | **(550)** | |
| **Accounts Receivable balance at end** | **$811** | **For the *next* Balance Sheet (as at 30 April 2025)** |

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, $880 from the balance of Decorators' World, and record the balance of Home Junction as zero.)

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**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 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 sale will be verified by a sales invoice and recorded in the Sales Journal, which summarises all credit sales in a reporting period.
- 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 and to the ATO.
- Discount expense reduces both the cash received and the balance owed by the Account Receivable.
- Bad debts expense reduces the balance owed by Accounts Receivable
- Credit sales are recorded in the OUT column of the appropriate inventory card, and they decrease the balance of Inventory on hand.
- Individual Account Receivable records are maintained to aid in the recording, reporting and management of Accounts Receivable.
- The balance of Accounts Receivable at the end of the period can be calculated using either a formula or an Accounts Receivable Schedule.
- The Accounts Receivable 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 14.1

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### Source documents

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 2025**

***Charge to:*** Davey Street Clinic
Davey St Frankston Victoria 3199

| Item | Description | Qty | Unit cost | $ |
|---|---|---|---|---|
| C3 | Chesterfield – 3 seater | 3 | 3 600 | 10 800 |
| | GST | | | 1 080 |
| | Total | | $ | 11 880 |

**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

WB page 253

### Sales Journal

Oz Business Machines sells photocopiers and fax machines and has provided the following list of its transactions for February 2025:

| | | |
|---|---|---|
| Feb. | 4 | Sold 1 photocopier on credit to CS Accounting for $1 230 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 $1 452 including GST (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.

*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 2025 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 2025.
**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 2025.

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## Exercise 14.3

W B page 254

### Sales Journal and Cash Receipts Journal

Hot Glass sells glass products such as wine glasses, vases and bowls. As at 30 September 2025, its Accounts Receivable records showed the following balances:

| | |
|---|---|
| Zucchets Restaurant | $2 400 |
| Barlington Hotel | 4 500 |
| **Balance of Accounts Receivable as at 30 September 2025** | **$ 6 900** |

During October 2025, 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) |

Credit terms are strictly 30 days.

*Required*

**a** **Explain** why the transaction on 1 October 2025 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 2025 in the journals of Hot Glass.
**d** **Calculate** the balance of Accounts Receivable as at 31 October 2025.
**e** **Explain** whether all Accounts Receivable have met the credit terms during October 2025.

## Exercise 14.4

W B page 256

### Journals and Accounts Receivable

Loony Letterboxes specialises in the sale of novelty letterboxes and as at 30 April 2025 its Accounts Receivable records showed the following information:

| | |
|---|---|
| Harry's Hardware | 3 400 |
| Trident 20 | 2 800 |
| **Balance of Accounts Receivable as at 30 April 2025** | **$ 6 200** |

Loony Letterboxes uses the Identified Cost method of inventory valuation and as at 30 April 2025 the inventory card for 55 Elvis letterboxes showed the following:

| | |
|---|---|
| 30 letterboxes @ $90 | 2 700 |
| 25 letterboxes @ $95 | 2 375 |
| **Value of Elvis letterboxes** | **$ 5 075** |

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During May 2025, the following transactions occurred:

| | | |
|---|---|---|
| May | 1 | Sold 40 letterboxes on credit to Best Value for $140 plus GST each (Inv. A314). 22 of the letterboxes had a cost price of $90 each and 18 had a cost price of $95 each. |
| | 4 | Cash sales – $1 232 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 $3 500 plus GST (Inv. A315) |
| | 11 | The owner contributed $12 000 cash (Rec. 392) |
| | 15 | Credit sales to Harry's Hardware worth $6 930 including GST (Inv. A316) |
| | 18 | Sales – $770 including GST (Rec. 393) |
| | 21 | Best Value paid $3 000 cash (Rec. 394) |
| | 23 | Sold inventory to GlenCo Homes for $10 780 including GST (Inv. A317) |
| | 27 | Received $2 000 from Trident 20 (EFT Rec. 95) |
| | 31 | Harry's Hardware purchased inventory for $3 200 plus GST (Inv. A318) |

*Required*

**a** **Record** the transaction on 1 May 2025 in the inventory card for Elvis letterboxes.

**b** **State** the effect of the transaction on 1 May 2025 on the Accounting equation of Loony Letterboxes.

* **c** **Record** the transactions for May 2025 in the journals of Loony Letterboxes.

**d** **Record** the transactions for May 2025 in the Accounts Receivable records of Loony Letterboxes.

**e** **Prepare** an Accounts Receivable Schedule for Loony Letterboxes as at 31 May 2025.

**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 2025 if the transaction on 1 May 2025 had been recorded using the FIFO method of inventory valuation.

## Exercise 14.5

WB page 259

## Sales returns

Kaveesha Silva owns Silva Footwear which sells shoes. As at 31 December 2024, 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 2025:

| | | |
|---|---|---|
| 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) |

*Required*

**a** **Identify** the special journals in which the following documents would be recorded:
- Invoice x201
- Invoice 93.

**b** **Record** the transactions for January 2025 in the inventory card for Angelina Shoes.

**c** **Record** the transactions for January 2025 in the Accounts Receivable record for Ryan's Academy.

**d** **Explain** the effect on the Accounting equation of the transaction on 29 January 2025.

**e** **Discuss** whether Silva Footwear should have accepted the Sales return on 29 January 2025.

**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

WB page 261

### Discount expense

Jules and Loz sells clothing and as at 1 January it 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 2025 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*

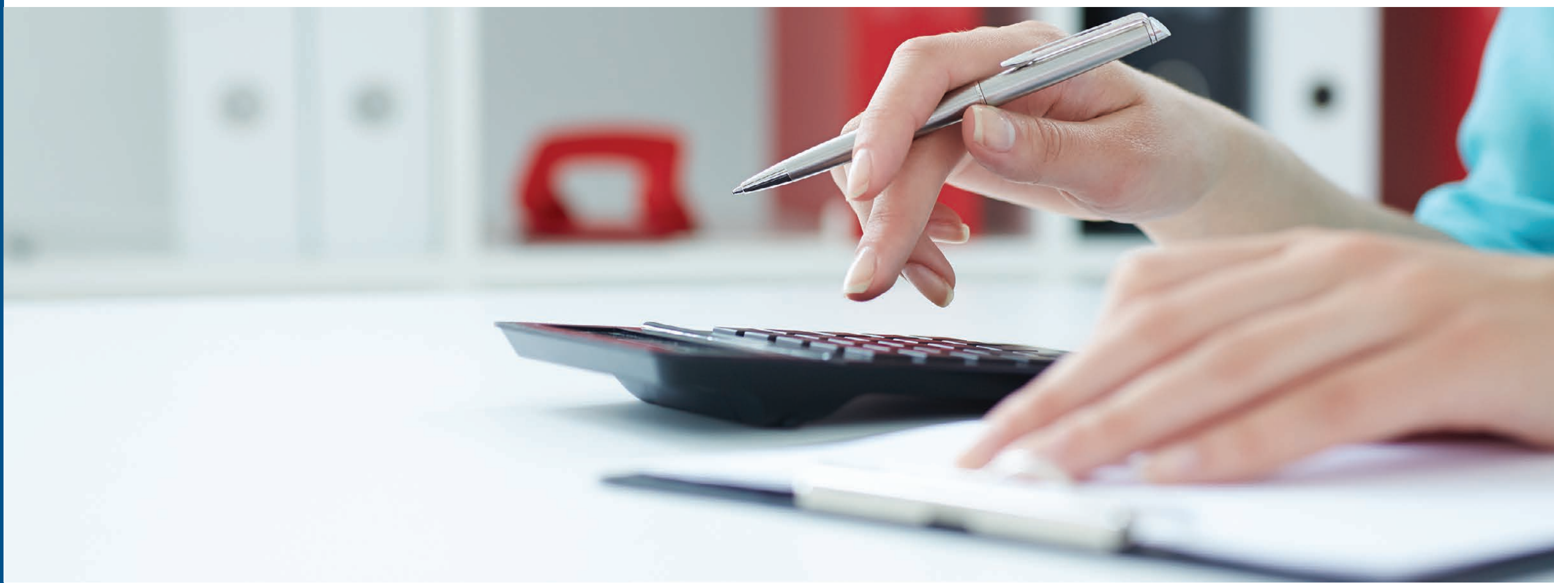
**a** **Explain** why Viv's Boutique was not entitled to a discount on 9 July 2025.

**b** **Explain** why a discount given to Accounts Receivable is recognised as an expense.

**c** Referring to the transaction on 20 July 2025, **calculate**:
- the discount expense incurred
- the cash received from Account Receivable – Viv's Boutique.

**d** **Explain** the effect of the transaction on 20 July 2025 on the Accounting equation of Jules and Loz.

**e** **Record** the transactions for July 2025 in the Accounts Receivable record for Viv's Boutique.



## Exercise 14.7

WB page 263

### Bad debts

On 14 September 2025, 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 Chute 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 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 considerations**

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## Exercise 14.8

WB page 264

### Recording in journals and Accounts Receivable

Sports Bonanza is owned by Joe Little and on 30 November 2025 the business had the following balances in its Balance Sheet:

| | |
|---|---|
| **Accounts Receivable** | $2 420 |
| – Emerald CC | $1 320 |
| – St. Carl's PS | $1 100 |

During December 2025 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 debtor – 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. A cheque 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 2025 in the special journals of Sports Bonanza.

* **b** Using the formula, **calculate** the balance of Accounts Receivable as at 31 December 2025.

**c** **Record** the transactions for December 2025 in the Accounts Receivable records of Sports Bonanza.

* **d** **Prepare** an Accounts Receivable Schedule for Sports Bonanza as at 31 December 2025.

**e** **State** two benefits of offering discounts to debtors.

**f** **Explain** the effect of the transaction on 22 December 2025 on the Accounting equation of Sports Bonanza.

**g** **Explain** the effect of the transaction on 25 December 2025 on the GST liability of Sports Bonanza.

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## Exercise 14.9

WB page 267

## Accounts Receivable

Max Powers operates a lamp shop called Mojo Ltd, which specialises in the sale of lava lamps. On 31 March 2025, its Balance Sheet showed the following balances:

| | |
|---|---|
| **Accounts Receivable** | $3 300 |
| – Far Out Lights | $1 100 |
| – Liquid Lamps | $2 200 |

The journals for April 2025 showed the following:

**Cash Receipts Journal**

| Date | Details | Rec. No. | Bank | Accounts Receivable | Sales | Sundries | GST |
|---|---|---|---|---|---|---|---|
| April 1 | Far Out Lights | EFT 21 | 1 034 | 1 034 | | | |
| 5 | Cash sales | 772 | 660 | | 600 | | 60 |
| 8 | Cash sales | 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 | 774 | 5 000 | | | 5 000 | |
| 22 | Cash sales | 775 | 935 | | 850 | | 85 |
| 25 | Liquid Lamps | EFT 24 | 3 300 | 3 300 | | | |
| 29 | Cash sales | 776 | 1 320 | | 1 200 | | 120 |
| | **TOTALS** | **$** | **16 044** | **7 634** | **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 1 April 2025, Far Out Lights was granted a discount of $66.
- On 17 April 2025, Arty Facts returned inventory worth $440 including GST (Cr. Note 26). This inventory had been purchased by Mojo Ltd for $200 plus GST.
- On 30 April 2025, 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 2025.

**b** **Calculate** the percentage discount given to Far Out Lights on 1 April 2025.

* **c** Using the formula, **calculate** the balance of Accounts Receivable as at 30 April 2025.

**d** **Explain** the effect of the transaction on 17 April 2025 on the Accounting equation of Mojo Ltd.

**e** **Record** the transactions for April 2025 in the Accounts Receivable records of Mojo Ltd.

* **f** **Prepare** an Accounts Receivable Schedule for Mojo Ltd as at 30 April 2025.

**g** **Explain** how the use of subsidiary records can improve the management of Accounts Receivable.

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## Exercise 14.10

WB page 269

### Credit transactions

Meg Walker operates a sports store called Walker Sports. At 30 June 2025 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 2025** | **5 290** |

| **Accounts Payable** | **$** |
|---|---|
| Fitness Regime | 2 300 |
| Equipped Gear | 1 700 |
| **Balance of Accounts Payable as at 30 June 2025** | **4 000** |

The following transactions occurred during July 2025:

| | | |
|---|---|---|
| July | 1 | Paid monthly rent of $700 plus GST (Chq. 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 on account (Chq. 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 (Chq. 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 (Chq. 306) |
| | | Sold sporting goods to South Park Tennis Club for $495 including GST (Inv. 113) |
| | 26 | Paid Equipped Gear $3 000 on account (Chq. 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) |

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*Required*

* **a** **Record** the transactions for July 2025 in the special journals of Walker Sports.

**b** **State** whether the Bank balance of Walker Sports as at 31 July 2025 will be higher, lower or the same as it was as at 30 June 2025. **Justify** your answer.

**c** Using the appropriate formula, **calculate** the balance of Accounts Receivable and Accounts Payable as at 31 July 2025.

**d** **Record** the transactions for July 2025 in the Accounts Receivable and Accounts Payable records of Walker Sports.

**e** **Prepare** an Accounts Payable Schedule and an Accounts Receivable Schedule for Walker Sports as at 31 July 2025.

**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

WB page 273

Seeing is Believing is a store which sells video surveillance equipment, and has provided the following source documents:

**DOCUMENT A**

**Seeing is Believing**

ABN: 90 872 221 004
Electronic Security Systems
Laverton Victoria 3026

**Invoice** 44
**Terms: 5/7, n/30**
**8 May 2025**

***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 |

**DOCUMENT B**

**Date** 17th May 2025

**To** Hi-Tech Cameras

**For** Settlement of account

**Bal c/fwd $**

**Deposits $**

**Amount** $1 400

**Balance $**

CHQ no. 395

*Required*

**a** **Identify** the journal in which each document would be recorded.
**b** **Name** the asset which 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 2025.
**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

WB page 274

### Journals and subsidiary records

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 2025, 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 2025** | **1 720** |

| **Accounts Payable** | **$** |
|---|---|
| Felix Antiques | 410 |
| Oscar's Books | 260 |
| **Balance of Accounts Receivable as at 31 July 2025** | **670** |

The journals for August 2025 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** |

**Purchases Journal**

| Date | Account Payable | Inv. No. | Inventory | GST | Accounts Payable |
|---|---|---|---|---|---|
| Aug. 6 | Felix Antiques | Q54 | 270 | 27 | 297 |
| 12 | Oscar's Books | 1092 | 550 | 55 | 605 |
| 20 | Oscar's Books | 1105 | 320 | 32 | 352 |
| 27 | Felix Antiques | Q67 | 350 | 35 | 385 |
| | **TOTALS** | **$** | **1 490** | **149** | **1 639** |

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**Cash Receipts Journal**

| Date | Details | Rec. No. | Bank | Account Receivable | Sales | Sundries | GST |
|---|---|---|---|---|---|---|---|
| Aug. 1 | Cash sales | 202 | 165 | | 150 | | 15 |
| 5 | St. Swithin's University | EFT 75 | 684 | 684 | | | |
| 8 | Cash sales | 203 | 187 | | 170 | | 17 |
| 13 | Victoria College | EFT 76 | 1 100 | 1 100 | | | |
| 18 | Macrae Institute | EFT 77 | 572 | 572 | | | |
| 22 | Cash sales | 204 | 132 | | 120 | | 12 |
| 26 | Loan – Uni Bank | BS | 8 000 | | | 8 000 | |
| 28 | St. Swithin's University | EFT 78 | 380 | 380 | | | |
| | **TOTALS** | **$** | **11 220** | **2 736** | **440** | **8 000** | **44** |

**Cash Payments Journal**

| Date | Details | Doc. | Bank | Account Payable | Drawings | Wages | Sundries | GST |
|---|---|---|---|---|---|---|---|---|
| Aug. 3 | Stationery | 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 | 60 | 350 | 350 | | | | |
| 14 | Advertising | 61 | 198 | | | | 180 | 18 |
| 17 | Oscar's Books | EFT 35 | 360 | 360 | | | | |
| 21 | Drawings | 62 | 320 | | 320 | | | |
| 25 | Wages | EFT 36 | 470 | | | 470 | | |
| 30 | Felix Antiques | 63 | 150 | 150 | | | | |
| | **TOTALS** | **$** | **3 140** | **1 120** | **710** | **980** | **300** | **30** |

**Additional information:**

- St. Swithin's University was granted a discount of 5% on its first payment.
- On 17 August 2025, Oscar's Books granted a discount of $40.
- On 23 August 2025, books worth were returned $110 including GST Oscar's Books (Cr. Note 54).
- On 26 August 2025, 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 2025 would be recorded.
**c** **State** two reasons why the transaction in on 4 August 2025 should **not** be reported as an expense.
**d** Using the appropriate formula, **calculate** the balance of Accounts Payable and Accounts Receivable as at 31 August 2025.
**e** **Complete** the Accounts Payable record for Oscar's Books as at 31 August 2025.
**f** **Complete** the Accounts Receivable record for St. Swithin's University as at 31 August 2025.
**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

## Where are we headed?

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 which 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** 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:

- Accrual Accounting
- Accounts Payable Turnover (APTO)
- Accounts Receivable Turnover (ARTO).


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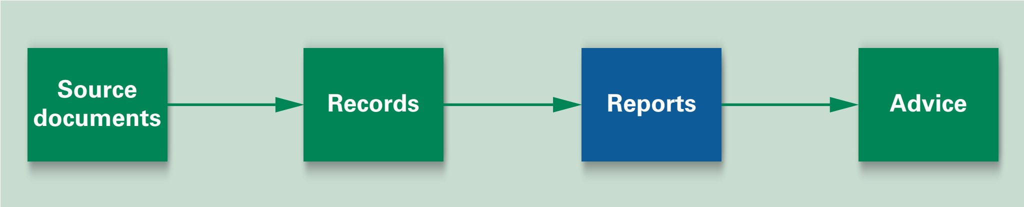
## 15.1 Accounting reports and credit transactions




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.

Chapters 13 and 14 pointed out that a credit sale or purchase is in fact two separate (but related) transactions: an exchange of goods and an exchange of cash. And because each part of the transaction will occur on a different day, be verified by a different source document, and be recorded in a different journal, the two parts to a credit transaction will be reported differently in the Accounting reports.

The information to be presented in these 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).

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. **List** the Accounting reports we have used so far in this course.
4. **Explain** the relationship between Accounting records and Accounting reports.

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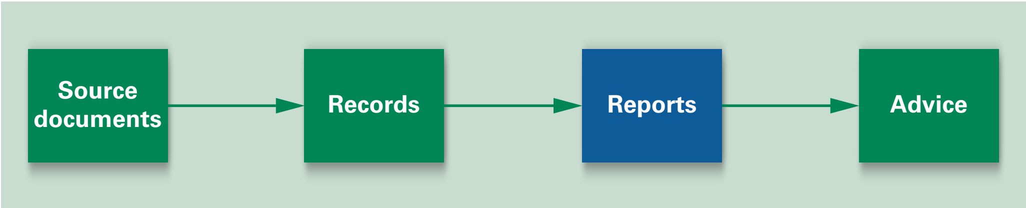
## 15.2 The Cash Flow Statement




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 receipt or cash payment in the Cash Flow Statement.

**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 2025 are listed below:

| Assets | $ | Equities | $ |
|---|---|---|---|
| Bank | 3 500 | Accounts Payable | 12 600 |
| Inventory | 21 000 | GST payable | 310 |
| Accounts Receivable | 8 300 | Loan – QS Finance | 30 000 |
| Shelving | 35 000 | Capital – Windsor | 36 890 |
| Office equipment | 12 000 | | |
| **Total Assets** | **79 800** | **Total Equities** | **79 800** |

Inventory is sold on both cash and credit terms, and the business has provided the following information from its Accounting records for October 2025:

**Sales Journal**

| Date | Account Receivable | Inv. No. | Sales | GST | Accounts Receivable |
|---|---|---|---|---|---|
| Oct. | **TOTALS** | **$** | **20 000** | **2 000** | **22 000** |

**Purchases Journal**

| Date | Account Payable | Inv. No. | Inventory | GST | Accounts Payable |
|---|---|---|---|---|---|
| Oct. | **TOTALS** | **$** | **18 000** | **1 800** | **19 800** |

**Cash Receipts Journal**

| Date | Details | Rec. No. | Bank | Accounts Receivable | Sales | Sundries | GST |
|---|---|---|---|---|---|---|---|
| Oct. | Capital | | | | | 1 000 | |
| | **TOTALS** | **$** | **30 200** | **16 000** | **12 000** | **1 000** | **1 200** |

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Example (continued)

**Cash Payments Journal**

| Date | Details | Doc. | Bank | Accounts Payable | Drawings | Wages | Sundries | GST |
|---|---|---|---|---|---|---|---|---|
| Oct. | Freight In | | | | | | 600 | |
| | Loan (principal) | | | | | | 750 | |
| | Interest | | | | | | 150 | |
| | Advertising | | | | | | 1 400 | |
| | Rent | | | | | | 2 000 | |
| | Shelving | | | | | | 3 000 | |
| | **TOTALS** | **$** | **36 200** | **17 000** | **3 700** | **6 900** | **7 900** | **700** |

**Additional information:**

| | | |
|---|---|---|
| Inventory on hand as per physical count as at 31 October 2025 | $21 600 | |
| Cost of sales for October 2025 | 16 700 | |
| Inventory loss for October 2025 | 420 | |
| Sales returns | 500 | plus GST |
| Purchase returns | 300 | plus GST |
| Discount expense | 120 | |
| Discount revenue | 100 | |
| Bad debts | 200 | |

Figure 15.1 shows the Cash Flow Statement for Full Boards for October 2025:

**Figure 15.1** Cash Flow Statement

**FULL BOARDS**
**Cash Flow Statement for October 2025**

| | $ | $ |
|---|---|---|
| **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 Operations** | | **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 2025)** | | **3 500** |
| **Bank Balance at end (31 October 2025)** | | **(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.

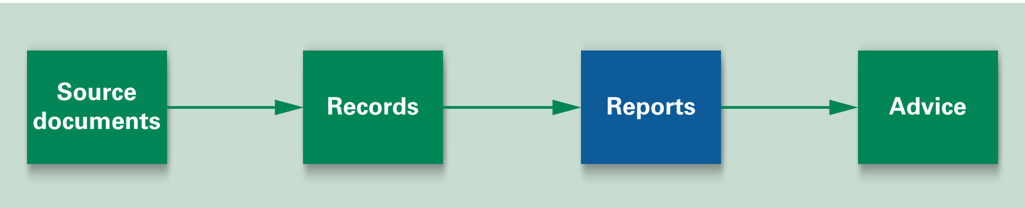
**Study tip**

If an item is recorded in a cash journal, it is reported in the Cash Flow Statement – no questions asked!

**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 so that revenue 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).

**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.

### Sales returns

Sales returns must also be reported in the Income Statement as they are negative revenue, and reduce the revenue earned from sales.

### Receipts from Accounts Receivable

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.

**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 (see below).

### Credit purchases

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 has a different effect on the Accounting equation, but it 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 fails 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).

Using the same data provided earlier, Figure 15.2 shows the Income Statement for Full Boards for October 2025:

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**Figure 15.2** Income Statement

**FULL BOARDS**
**Income Statement for October 2025**

| | $ | $ |
|---|---|---|
| **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 | 16 700 | |
| Freight in | 700 | 17 400 |
| **Gross Profit**[3] | | **14 100** |
| Less Inventory loss | | 420 |
| **Adjusted Gross Profit**[4] | | **13 680** |
| **Add Other revenue**[5] | | |
| Discount revenue | | 100 |
| | | **13 780** |
| **Less Other expenses**[6] | | |
| Interest on loan | 150 | |
| Wages | 6 900 | |
| Advertising | 1 300 | |
| Rent | 2 000 | |
| Discount expense | 120 | |
| Bad debts | 200 | 10 670 |
| **Net Profit**[7] | | $3 110 |

**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 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.

(In an Income Statement the heading 'Revenue' may not even be necessary, particularly where there is only one figure for Sales.)

**Study tip**

Cost of Sales is determined in the inventory cards and will include inventory sold on cash and credit.

**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 period costs, like Freight in, also included.

Sales returns are recorded in the IN column of the inventory cards and must be accounted for in the calculation of Cost of Sales.

**3 Gross Profit**

As the difference between Net Sales ($31 500) and Cost of Goods Sold ($17 400), **Gross Profit** reflects the profit earned directly from the sale of inventory.

Further, as both 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.

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**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**. 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 are 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 (**$13 780** 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 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*) is 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 would be 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, **$13 780** less $10 670) or by deducting Total expenses from Total revenue. It is this Net Profit figure of $3 110, which represents the net increase (or decrease) in owner's equity as a result of the firm's trading activities for the period.

## Review questions 15.3

1 **Define** the term 'Accrual Accounting'.
2 **Explain** why credit sales is 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.

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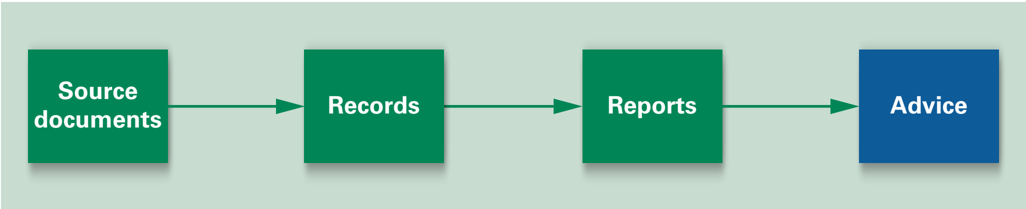
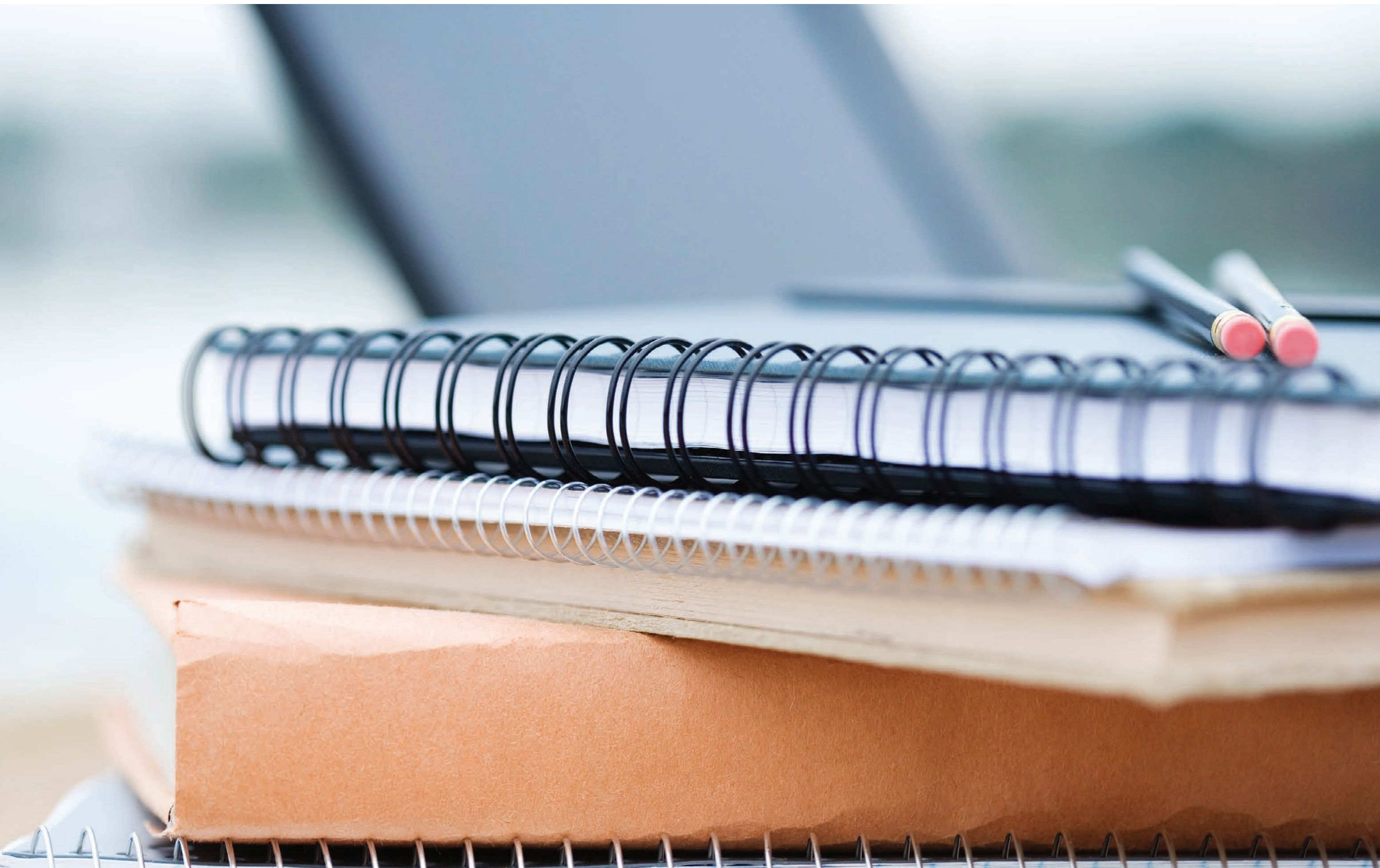
## 15.4 Uses of the Income Statement




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 following page.)
- **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 the 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 pages and in more detail in Chapter 18.)



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## Strategies to earn profit

In basic terms, earning profit involves two simple yet complex activities:

1. earning revenue
2. controlling expenses.

### 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 of 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:
  - maintain an appropriate inventory mix
  - promote the sale of complementary goods
  - ensure inventory is up to date
  - rotate inventory.
- *Move to a better location* which 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 cheaper 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*

and even

- *the number of website hits*
- *the predicted weather for the next month*

can all influence which strategies are implemented.

**Ethical consideration**

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.

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Buying 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 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.

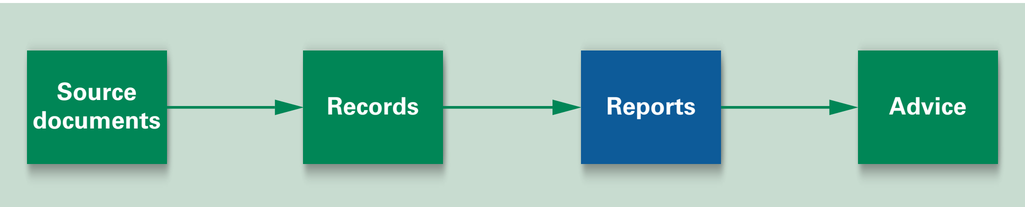
Unethical businesses may generate gains in the short-term, but in the longer term may find that customers are unwilling to buy from a business that puts its own immediate profit before the longer-term considerations of society and the environment.

**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.

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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.

## Accounts Payable formula

Chapter 13 discussed 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 2025:

**Figure 15.3** Accounts Payable formula

| | | |
|---|---|---|
| Accounts Payable balance at start | 12 600 | From the *previous* Balance Sheet (30 Sept. 2025) |
| + Credit purchases (including GST) | **19 800** | From the Purchases Journal |
| | 32 400 | |
| – Purchase returns (including GST) | **(330)** | From the Additonal Information |
| – Payments to Accounts Payable | (17 000) | From the Cash Payments Journal |
| – Discount revenue | (100) | From the Add. Information / Income Statement |
| **Accounts Payable balance at end** | **$14 970** | **For the *next* Balance Sheet (31 Oct. 2025)** |

**Study tip**

Choose between the formula and schedule to calculate Accounts Receivable or Accounts Payable based on the information available in the question.

This **$14 970** 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 2025:

**Figure 15.4** Accounts Receivable formula

| | | |
|---|---|---|
| Accounts Receivable balance at start | 8 300 | From the previous Balance Sheet (30 Sept. 2025) |
| + Credit sales including GST | 22 000 | From the Sales Journal |
| | 30 300 | |
| – Sales returns including GST | (550) | From the Add. Information / Income Statement |
| – Receipts from Accounts Receivable | (16 000) | From the Cash Receipts Journal |
| – Discount expense | (120) | From the Add. Information / Income Statement |
| – Bad debts including GST | (220) | From the Add. Information / Income Statement |
| **Accounts Receivable balance at end** | **$13 410** | **For the *next* Balance Sheet (31 Oct. 2025)** |

This **$13 410** 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 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 is 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 2025:

**Figure 15.5** GST formula

| | | |
|---|---|---|
| GST balance at start | 310 | From the *previous* Balance Sheet (30 Sept. 2025) |
| + 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 |
| | 3 460 | |
| – GST on Cash purchases | (700) | From the Cash Payments Journal |
| – GST on Credit purchases | (1 800) | From the PJ |
| + GST on Purchase returns | 30 | From the Additional information |
| **GST balance at end** | **$990** | **For the *next* Balance Sheet (31 Oct. 2025)** |

This **$990** 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 2025**

| | $ | $ | | $ | $ |
|---|---|---|---|---|---|
| **Current Assets** | | | **Current Liabilities** | | |
| Inventory[2] | 21 600 | | Bank[1] | **2 500** | |
| Accounts Receivable[3] | **13 410** | 35 010 | Accounts Payable[6] | **14 970** | |
| **Non-Current Assets** | | | GST Payable[7] | **990** | |
| Shelving[4] | 38 000 | | Loan – QS Finance[8] | 9 000 | 27 460 |
| Office Equipment[5] | 12 000 | 50 000 | **Non-Current Liabilities** | | |
| | | | Loan – QS Finance[8] | | 20 250 |
| | | | **Owner's equity** | | |
| | | | Capital – Windsor[9] | 37 890 | |
| | | | + Net Profit[10] | 3 110 | |
| | | | | 40 800 | |
| | | | Less Drawings[11] | 3 700 | 37 300 |
| **Total Assets** | | **85 010** | **Total Equities** | | **85 010** |

## 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* $3 000 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 Bank | Previous Balance Sheet:<br>Current: $750 per month × 12 months<br>Non-current: remainder ($30 000 – $750 repayment * – $9 000) |
| **9** | Capital | Previous Balance Sheet *plus* $1 000 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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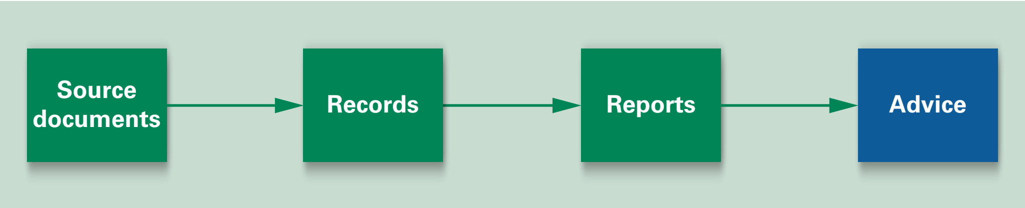
## 15.6 Managing Accounts Payable




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

$$\textbf{Accounts Payable Turnover (APTO)} = \frac{\textbf{Average Accounts Payable}}{\textbf{Net Credit Purchases (plus GST)}} \times 365$$

$$= \textbf{Average number of days}$$

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 2025.

| | |
|---|---|
| Credit purchases plus GST | $203 500 |
| Purchase returns plus GST | $2 750 |
| Accounts Payable as at 1 July 2024 | **$23 000** |
| Accounts Payable as at 30 June 2025 | **$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

$$\textbf{APTO} = \frac{(\$23\,000 + \$17\,000)\ /\ 2}{\$203\,500 - \$2\,750} \times 365$$

$$= \frac{\$\ 20\,000}{\$\ 200\,750} \times 365$$

$$= 37^{*}\ \text{days}\ (36.36\ \text{rounded up to the nearest day})$$

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The Accounts Payable Turnover indicates that in the year ended 30 June 2025, it took an average of 37 days to pay Accounts Payable – eight days before the credit terms required payment.

**Study tip**

Changes in APTO should be described as *faster* or *slower*: than previous periods; than budgeted; than similar businesses; than credit terms.

## Analysing Accounts Payable Turnover

When assessing any aspect of business performance, it can be useful to compare its 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 retain its cash longer and use it 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 refusal of credit facilities by the supplier
- a reduction in the firm's credit rating (which may jeopardise future borrowing).

## 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)
- *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 Officer / Clerk* 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 on time as other payment arrangements may be possible.

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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.

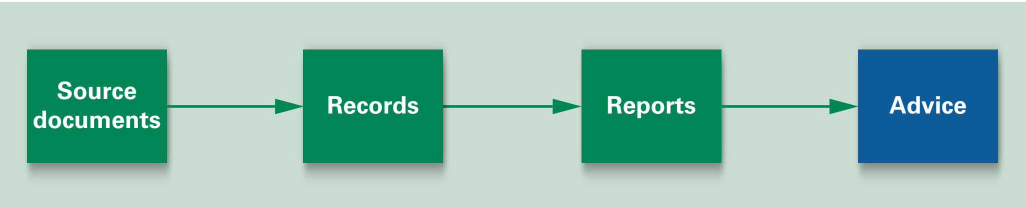
**Ethical considerations**

**Review questions 15.6**

1 **State** what is measured by Accounts Payable Turnover (APTO).
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**

## 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 role 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.

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## 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.

**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

The Accounts Receivable Turnover is calculated as shown in Figure 15.9:

**Figure 15.9** Formula: Accounts Receivable Turnover

$$\textbf{Accounts Receivable Turnover (ARTO)} = \frac{\textbf{Average Accounts Receivable}}{\textbf{Net Credit Sales (plus GST)}} \times 365$$

$$= \textbf{Average number of days}$$

**Study tip**

When entering these figures in your calculator, press = before dividing by 2, or your answer will be incorrect.

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 2025:

| | |
|---|---|
| Credit sales plus GST | $220 000 |
| Sales returns plus GST | $19 800 |
| Accounts Receivable as at 1 July 2024 | **$35 000** |
| Accounts Receivable as at 30 June 2025 | **$45 000** |
| Credit terms offered to customers | 60 days |
| Accounts Payable Turnover | 37 days |

## Calculating Accounts Receivable Turnover (ARTO)

The Accounts Payable Turnover for Fulton Furniture would be calculated as is shown in Figure 15.10:

**Figure 15.10** Calculation: Accounts Receivable Turnover

$$\text{ARTO} = \frac{\mathbf{(\$35\,000 + \$45\,000)}/2}{\$220\,000 - \$19\,800} \times 365$$

$$= \frac{\mathbf{\$40\,000}}{\$200\,200} \times 365$$

$$= 73^{*} \text{ days } (72.9 \text{ rounded up to the nearest day})$$

The Accounts Receivable Turnover indicates that in the year ended 30 June 2025, it took an average of 73 days to collect cash from Accounts Receivable.

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## 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*).

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), so until it has 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 Officer / Clerk* 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.

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- *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**

*Acting in an ethical manner* also 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.

### 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 (ARTO).
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.
- 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

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### Reporting credit transactions

Larkham Interiors sells office furniture and has provided the following information about its activities for April 2025:

**LARKHAM INTERIORS**

**Balance Sheet (unclassified) as at 31 March 2025**

| 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 2025 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 | Rec. No. | Bank | Accounts Receivable | Sales | Sundries | GST |
|---|---|---|---|---|---|---|---|
| April | Loan – nab | | | | | 15 000 | |
| | **TOTALS** | **$** | **30 500** | **5 600** | **9 000** | **15 000** | **900** |

**Cash Payments Journal**

| Date | Details | Doc. | Bank | 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** | **4 900** | **1 500** | **2 000** | **17 600** | **1 760** |

**Additional information:**

- Inventory on hand as at 30 April 2025 (physical count) was $30 500.
- Cost of Sales for April 2025 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 2025.

* **b** **Prepare** an Income Statement for Larkham Interiors for April 2025.

**c** Referring to one Accounting assumption, **explain** why credit sales is classified as revenue.

**d** **Calculate** the balance of Accounts Receivable and Accounts Payable as at 30 April 2025.

**e** **Calculate** the GST balance as at 30 April 2025.

* **f** **Prepare** a Balance Sheet for Larkham Interiors as at 30 April 2025.

**g** Referring to your answer to part ‘f’, **explain** your treatment of GST.

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## Exercise 15.2

WB page 280

### Reporting credit transactions

Smith's Hardware has provided the following information about its activities for 2025:

**SMITH'S HARDWARE**

**Balance Sheet (unclassified) as at 31 December 2024**

| 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 2025 have been summarised in the journals below:

**Sales Journal**

| Date | Account Receivable | Inv. No. | Sales | GST | Accounts Receivable |
|---|---|---|---|---|---|
| 2025 | **TOTALS** | **$** | **46 000** | **4 600** | **50 600** |

**Purchases Journal**

| Date | Account Payable | Inv. No. | Inventory | GST | Accounts Payable |
|---|---|---|---|---|---|
| 2025 | **TOTALS** | **$** | **36 000** | **3 600** | **39 600** |

**Cash Receipts Journal**

| Date | Details | Rec. No. | Bank | Accounts Receivable | Sales | Sundries | GST |
|---|---|---|---|---|---|---|---|
| 2025 | Capital | | | | | 5 000 | |
| | **TOTALS** | **$** | **92 600** | **32 600** | **50 000** | **5 000** | **5 000** |

**Cash Payments Journal**

| Date | Details | Doc. | Bank | Accounts Payable | Drawings | Wages | Sundries | GST |
|---|---|---|---|---|---|---|---|---|
| 2025 | Advertising | | | | | | 2 000 | 200 |
| | Loan – ANZ | | | | | | 3 000 | |
| | Interest on loan | | | | | | 1 000 | |
| | Rent | | | | | | 9 000 | 900 |
| | **TOTALS** | **$** | **94 100** | **19 000** | **35 000** | **24 000** | **15 000** | **1 100** |

**Additional information:**

- Sales returns for 2025 were $1 000 plus GST.
- Purchase returns for 2025 were $330 including GST.
- Cost of Sales for 2025 was $34 000.
- As at 31 December 2025, the inventory cards showed inventory on hand worth $22 700.
- A physical count on 31 December 2025 showed inventory on hand of $22 200.
- The loan is repayable in instalments of $3 000 per year.
- Discount expense for 2025 was $460.
- Discount revenue for 2025 was $190.
- Smith's Hardware is thinking of changing to a cheaper supplier for 2026 but there have been discussions in the media about poisonous lead in their paint.

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*Required*

* **a** **Prepare** a Cash Flow Statement for Smith's Hardware for 2025.

* **b** **Prepare** an Income Statement for Smith's Hardware for 2025.

**c** Referring to one Qualitative characteristic, **explain** why receipts from Accounts Receivable is **not** reported in the Income Statement.

**d** **Explain** two reasons why Smith's Hardware suffered a cash deficit despite earning a profit for 2025.

**e** Referring to financial and ethical considerations, **discuss** whether Smith's Hardware should change to the cheaper supplier for 2026.

Ethical considerations

**f** **Calculate** the balance of Accounts Receivable and Accounts Payable as at 31 December 2025.

**g** **Calculate** the GST balance as at 31 December 2025.

* **h** **Prepare** a Balance Sheet for Smith's Hardware as at 31 December 2025.

**i** **Explain** one technique Smith's Hardware is using to ensure its Balance Sheet provides a Faithful representation of its financial position.

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## Exercise 15.3

WB page 284

### Reporting credit transactions

Cozy Imij sells home decorations and furnishings, and has provided the following information about its activities for August 2025:

**COZY IMIJ**

**Balance Sheet (unclassified) as at 31 July 2025**

| Assets | $ | Equities | $ |
|---|---|---|---|
| Accounts Receivable | 18400 | Bank | 2000 |
| Inventory | 12600 | Accounts Payable | 700 |
| Shop fittings | 5000 | GST payable | 390 |
| | | Loan – nab | 9000 |
| | | Capital – Baird | 23910 |
| **Total Assets** | **36000** | **Total Equities** | **36000** |

**COZY IMIJ**

**Cash Flow Statement for August 2025**

| | $ | $ |
|---|---|---|
| **CASH FLOWS FROM OPERATING ACTIVITIES** | | |
| **Cash Receipts** | | |
| Cash sales | 5000 | |
| Receipts from Accounts Receivable | 4400 | |
| GST received | 500 | 9900 |
| Payments to Accounts Payable | (2500) | |
| Wages | (1950) | |
| GST paid | (160) | |
| Interest on loan | (150) | |
| GST settlement | (390) | 5150 |
| **Net Cash Flows from Operations** | | **4750** |
| **CASH FLOWS FROM INVESTING ACTIVITIES** | | |
| Computer equipment | | (1600) |
| **Net Cash Flows from Investing activities** | | **(1600)** |
| **CASH FLOWS FROM FINANCING ACTIVITIES** | | |
| Capital contribution | | 3000 |
| Drawings | | (1400) |
| **Net Cash Flows from Financing activities** | | **1600** |
| **Net Increase (Decrease) in cash position** | | **4750** |
| **Add Bank Balance at start (1 August 2025)** | | **(2000)** |
| **Bank Balance at end (31 August 2025)** | | **2750** |

**Additional information:**

- Credit sales for August 2025 were $4200 plus GST.
- Sales returns for August 2025 were $330 including GST.
- Credit purchases for August 2025 were $8700 plus GST.
- Purchase returns for August 2025 were $110 including GST.
- Cost of Sales for August 2025 were $7500.
- Inventory balance as per inventory cards as at 31 August 2025 was $13700.
- Physical inventory count as at 31 August 2025 was $13900.
- Discount granted to customers $140.
- Discount received from suppliers $80.

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- During August 2025, 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 $500 per month.

*Required*

* **a** **Prepare** an Income Statement for Cozy Imij for August 2025.
**b** **Explain** why payments to Accounts Payable is 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.
**d** **Explain** two reasons why Cozy Imij made a Net Loss yet generated a Net Increase in cash for August 2025.
**e** **Calculate** the balance of Accounts Receivable, Accounts Payable and the GST balance as at 31 August 2025.
* **f** **Prepare** a Balance Sheet for Cozy Imij as at 31 August 2025.
**g** Referring to your answer to part 'e', **explain** your treatment of GST.

Ethical considerations

## Exercise 15.4

W B page 287

### Managing Accounts Payable

Pennington Prints purchases all of its inventory on credit. The following information relates to the year ended 30 November 2025:

| | | |
|---|---|---|
| Credit purchases | $71 900 | plus GST |
| Purchase returns | $2 600 | plus GST |
| Accounts Payable (1 December 2025) | $13 600 | |
| Accounts Payable (30 November 2025) | $12 400 | |
| Credit terms offered by suppliers | 60 days | |

*Required*

**a** **Calculate** Accounts Payable Turnover for Pennington Prints for the year ended 30 November 2025.
**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

W B page 288

### Managing Accounts Payable

Mildura Fashions makes all its sales and purchases on credit and has provided the following information relating to the year ended 31 March 2025:

| | | |
|---|---|---|
| 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 2025 | 42 days | |

*Required*

**a** **Calculate** Accounts Payable Turnover for the year ended 31 March 2025.
**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.

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## Exercise 15.6

WB page 289

### Managing Accounts Receivable

Wainwright HiFi sells all of its inventory on credit. The following information relates to the year ended 30 September 2025:

| | | |
|---|---|---|
| Credit sales | $155 000 | plus GST |
| Sales returns | $10 000 | plus GST |
| Accounts Receivable (1 October 2024) | $16 700 | |
| Accounts Receivable (30 September 2025) | $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 | |

*Required*

**a** **Calculate** Accounts Receivable Turnover for Wainright HiFi for the year ended 30 September 2025.

**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 Wainright HiFi may have difficulty in meeting the terms offered by its suppliers.

## Exercise 15.7

WB page 290

### Managing Accounts Receivable

Bendigo Bikes has provided the following information regarding its activities for the year ended 31 May 2025:

**BENDIGO BIKES**

**Income Statement for the year ended 31 May 2025**

| | $ | $ |
|---|---|---|
| Cash sales | 990 000 | |
| Credit sales | 11 000 | |
| Less Sales returns | 1 000 | 1 000 000 |
| 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 2025 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 2025.

**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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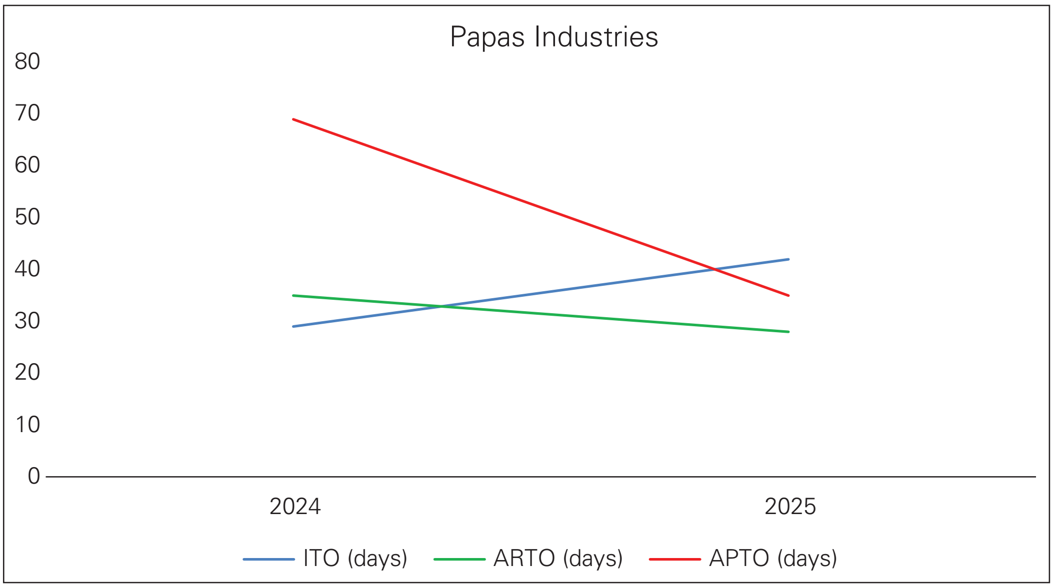
## Exercise 15.8

WB page 291

### Managing Accounts Payable and Accounts Receivable

Papas Calculators sells calculators and other business machines and has provided the following information for 2024 and 2025:




**Additional information:**

- Papas Industries offers credit terms of 10/7, n/30 and all sales are made on credit.
- Accounts Payable provide credit terms of n/60.

*Required*

**a** **Suggest** two actions Papas Industries may have taken which lead to the change in Accounts Receivable Turnover in 2025.

**b** **Discuss** the performance of Papas Industries in managing its inventory, Accounts Receivable and Accounts Payable in 2025 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 2026.

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## Exercise 15.9

WB page 292

### Reporting credit transactions

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 2025:

**MADDING HATTERS**

**Balance Sheet (unclassified) as at 30 June 2025**

| 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** |

The transactions for July 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 | Rec. No. | Bank | Accounts Receivable | Sales | Sundries | GST |
|---|---|---|---|---|---|---|---|
| July | **TOTALS** | **$** | **54 400** | **32 400** | **20 000** | **nil** | **2 000** |

**Cash Payments Journal**

| Date | Details | Doc. | Bank | 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** | **26 500** | **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 |
| Discount revenue | $250 | |

| | |
|---|---|
| Accounts Receivable as at 31 July 2025 | $58 540 |
| Accounts Payable as at 31 July 2025 | $40 150 |
| Inventory on hand as at 31 July 2025 (inventory cards) | $10 400 |
| Inventory on hand as at 31 July 2025 (physical count) | $10 200 |
| The Loan – QuickFin is repayable at | $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.

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*Required*

**a** **Calculate** the Bank balance of Madding Hatters as at 31 July 2025.

**b** Use the Accounts Receivable formula to **calculate** Discount expense for July 2025.

* **c** **Prepare** an Income Statement for Madding Hatters for July 2025.

**d** **Explain**, giving two examples from the information provided, how Madding Hatters generated a Net Profit despite suffering a cash deficit for July 2025.

**e** **Calculate** the GST balance as at 31 July 2025.

* **f** **Prepare** a Balance Sheet for Madding Hatters as at 31 July 2025.

**g** **Explain** why most businesses will end up with GST payable at the end of the period.

## Exercise 15.10

WB page 296

## Reporting credit transactions

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 2025:

**PAINTER'S CHOICE**

**Balance Sheet (unclassified) as at 31 May 2025**

| Assets | $ | Equities | $ |
|---|---|---|---|
| Accounts Receivable | 3 500 | Bank | 2 000 |
| Inventory | 29 500 | Accounts Payable | 3 000 |
| GST receivable | 200 | Loan – ANZ | 12 000 |
| Shop fittings | 13 500 | Capital – Houston | 29 700 |
| **Total Assets** | **46 700** | **Total Equities** | **46 700** |

**PAINTER'S CHOICE**

**Cash Flow Statement for June 2025**

| | $ | $ |
|---|---|---|
| **CASH FLOWS FROM OPERATING ACTIVITIES** | | |
| Cash sales | 2 000 | |
| Receipts from Accounts Receivable | 10 390 | |
| GST received | 200 | 12 590 |
| Payments to Accounts Payable | (7 700) | |
| Wages | (1 750) | |
| GST paid | (70) | |
| Freight in | (200) | |
| Interest | (100) | |
| Rent | (500) | 10 320 |
| **Net Cash Flows from Operations** | | **2 270** |
| **CASH FLOWS FROM FINANCING ACTIVITIES** | | |
| Capital contribution | | 5 000 |
| Drawings | | (3 400) |
| **Net Cash Flows from Financing activities** | | **1 600** |
| **Net Increase (Decrease) in cash position** | | **3 870** |
| **Bank Balance at start (1 June 2025)** | | **(2 000)** |
| **Bank Balance at end (30 June 2025)** | | **1 870** |

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**Additional information:**

| | | |
|---|---|---|
| Credit sales | $8 900 | plus $890 GST |
| Sales returns | $330 | including GST |
| Cost of Sales | $8 300 | |
| Inventory on hand as at 30 June 2025 (inventory cards) | $30 590 | |
| Inventory on hand as at 30 June 2025 (physical count) | $30 400 | |

- Accounts Receivable were granted discounts of $140 during June 2025 but a bad debt worth $165 was also written off.
- Discount revenue for the June 2025 was $90.
- As at 30 June 2025, Painter's Choice had a GST liability.

*Required*

**a** **Suggest** one possible reason to explain how Painter's Choice generated GST receivable as at 31 May 2025.

* **b** **Prepare** an Income Statement for Painter's Choice for June 2025.

**c** **Explain**, giving two examples from the information provided, how Painter's Choice generated an increase in cash despite suffering a Net Loss for June 2025.

**d** **Calculate** the balance of Accounts Receivable as at 30 June 2025.

**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 2025.

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Chapter 16

# Managing non-current assets

## Where are we headed?

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
- **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).


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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 and 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 who sells cars, the majority of their vehicles would be considered inventory and therefore a current asset.

### Tangible and intangible non-current assets

**tangible assets**
assets that have a physical form that can be touched or held

**intangible assets**
assets that do not have a physical form

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, 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 position (location e.g. transit costs) and specific condition (modified 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 *capitalised* so they will be recorded as part of the non-current asset's cost (excluding GST).

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*. For example, computer equipment, which was purchased 12 months previously by the owner, is contributed to the business. In the records of the business, this computer equipment 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.

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.

**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

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 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/amortisation
- Usage for relevant assets such as kilometres travelled for vehicles, 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/amortisation* – 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 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 | 1/06/2020 | $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 has 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 their non-current assets within their business are not potentially dangerous.

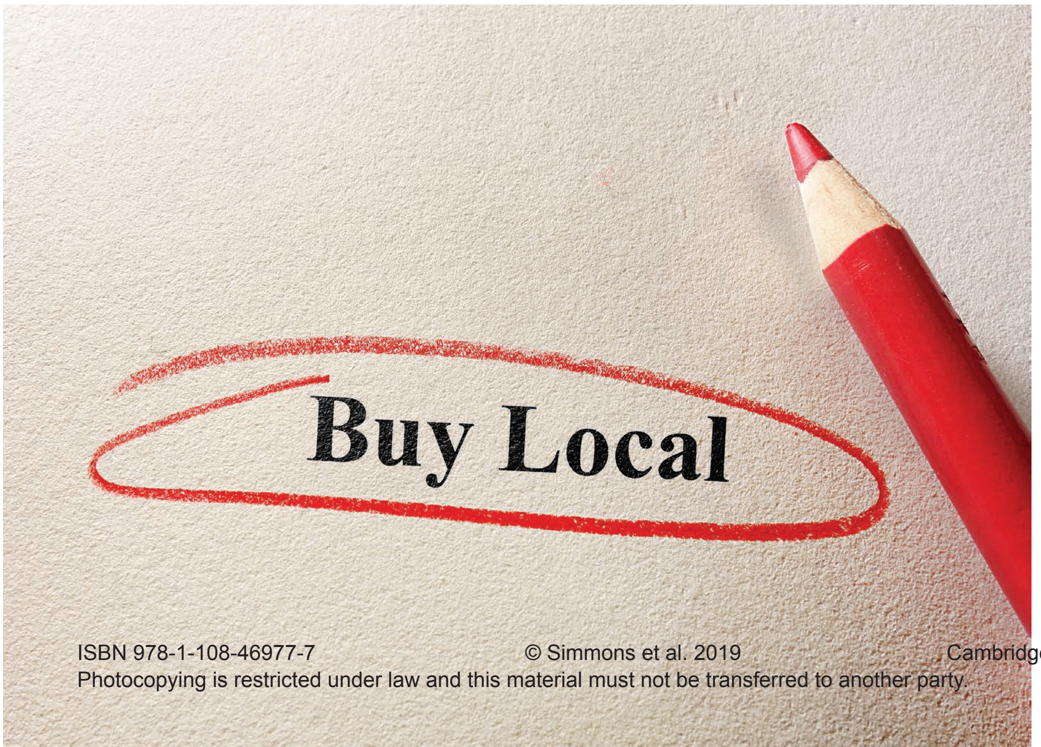
Financially, the business needs to consider ethically:

- *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

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

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.

**depreciation expense**
that part of the cost of a non-current asset that has been consumed in the current reporting period

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.

Tangible assets are depreciated over their Useful life, while intangible assets are amortised.

(Depreciation and Amortisation do 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 and amortisation affect only the Income Statement and the Balance Sheet.)

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On 1 July 2024, Mickleson Books paid $16 000 (plus $1 600 GST) for new shelving that is expected to last for four years.

**Example**

*How should this shelving be reported?*

At purchase date – **1 July 2024** – the shelving is clearly a non-current asset: none 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 as at **30 June 2025**? 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 2025** 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 1/4 of its life, and therefore 1/4 of its value. Thus, of the $16 000 of future economic benefit, $4 000 (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 Straight-line depreciation

Although there are a number of different methods for depreciating a non-current asset, this course concentrates on only one – the *straight-line method of depreciation*. This method of calculating 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 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

**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 2024, 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.

$$\textbf{Depreciation expense} = \frac{\text{HC less RV}}{\text{Life}}$$

$$= \frac{\$8\,000 - 500}{5 \text{ years}}$$

$$= \frac{\textbf{\$7500}}{\textbf{5}}$$

$$= \$1500 \text{ per annum}$$

**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.)

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

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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.

**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.

**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 SLM question take particular note of the dates, the length of the Accounting period and the date the asset was acquired.

## 16.7 Reporting depreciation

### Income Statement

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 2025 would report the $1 500 which has been consumed as Depreciation of Shop fittings under the heading 'Other expenses'.

**Study tip**

Depreciation is reported along with all the 'Other expenses' such as Wages, Advertising and Rent.

### 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.

**Accumulated depreciation** the value of a non-current asset that has been consumed over its life so far

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.

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Figure 16.3 shows how the shop fittings would be reported in the Balance Sheet:

**Figure 16.3** Balance Sheet: Accumulated depreciation

**Dells Luggage**
**Balance Sheet (extract) as at 30 June 2025**

| Non-Current Assets | $ | $ |
|---|---|---|
| Shop fittings | 1 8000 | |
| Less Accumulated depreciation | 2 1500 | 3 6500 |

Instead of just reporting the asset as one figure, three are now involved:

**1** Historical cost $8000
To ensure the reports remain as *free from bias* (and therefore as *Reliable*) 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 $1500
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.

**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 $6500
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.

**Study tip**

Carrying value is also known as carrying cost, written down value, unallocated cost and book value.

## 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) | 1500 |
| **Liabilities** | No effect | |
| **Owner's equity** | Decrease (Depreciation expense decreases Net Profit) | 1500 |

Like all balance day adjustments, depreciation does not involve any payment of cash, and only affects the Income Statement and the Balance Sheet.

## Successive periods

Although Depreciation expense 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 as is shown in Figure 16.4:

**Study tip**

As Accumulated depreciation increases, the Carrying value decreases.

**Figure 16.4** Successive Balance Sheets: Accumulated depreciation

**Dells Luggage**
**Balance Sheet (extract) as at 30 June**

| Non-Current Assets | 2025 | 2026 | 2027 | 2028 |
|---|---|---|---|---|
| Shop fittings | 8000 | 8000 | 8000 | 8000 |
| Less Accumulated depreciation | 1500 | 3000 | 4500 | 6000 |
| | 6500 | 5000 | 3500 | 2000 |

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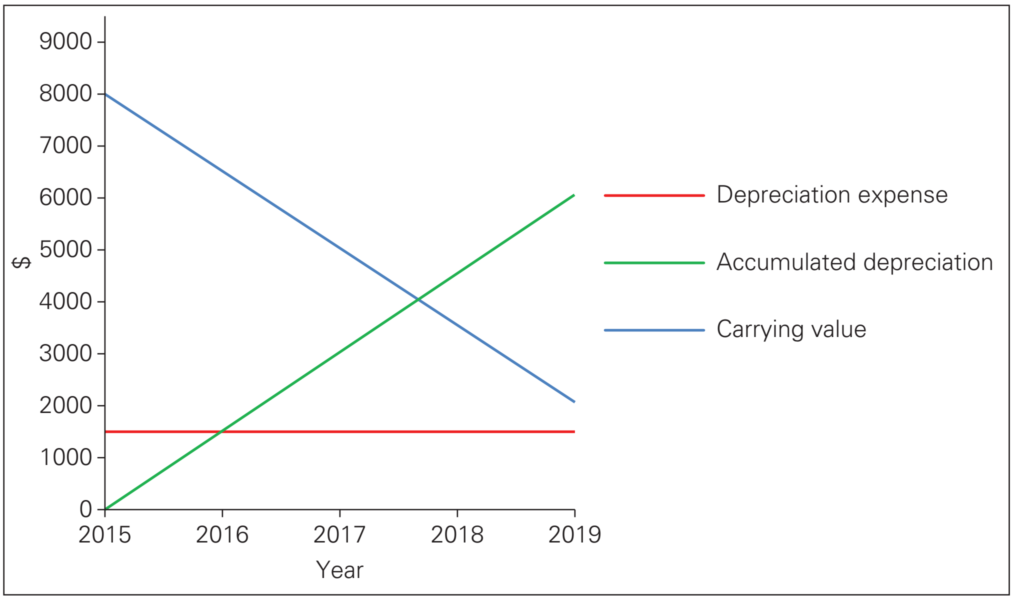
## Representing depreciation graphically

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 16.5 shows how the Depreciation expense, Accumulated depreciation and Carrying value could be represented graphically:

**Figure 16.5** Graphing depreciation




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).

### 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.

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## 16.8 Depreciation: calculation issues

### Rate of depreciation

The formula used earlier calculates the *amount* of Depreciation expense, expressed in dollar terms, but depreciation can also be expressed as a rate – a percentage of the cost.

#### Depreciation rate: formula

**Figure 16.6** Formula: Depreciation rate

$$\textbf{Depreciation rate (\% per annum)} = \frac{\textbf{Depreciation expense}}{\textbf{Historical cost}} \times 100$$

The figures from the earlier example were:

| | | |
|---|---|---|
| Historical cost | = | \$8 000 |
| Residual value | = | \$500 |
| Useful life | = | 5 years |
| Depreciation expense | = | \$1 500 per year |

The rate of depreciation would thus be calculated as is shown in Figure 16.7:

**Figure 16.7** Calculation: Depreciation rate

$$\textbf{Depreciation rate (\% per annum)} = \frac{\text{Depreciation expense}}{\text{Historical cost}} \times 100$$

$$= \frac{\$1\,500}{\$8\,000} \times 100$$

$$= 18.75\% \text{ per annum}$$

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.)

**Example**

On 1 July 2024, Jiggles Clothing purchased a delivery vehicle for \$25 300 (including GST). The vehicle is to be depreciated at 12% per annum. Balance day is 30 June 2025.

If the rate is known, the Depreciation expense (in dollar terms) can be calculated by simply multiplying the rate by the Historical cost as is shown in Figure 16.8:

**Figure 16.8** Calculation: Depreciation expense

$$\textbf{Depreciation expense (\% per annum)} = \text{Depreciation rate} \times \text{Historical cost}$$

$$= 12\% \times \$23\,000$$

$$= \$2\,760 \text{ per annum}$$

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## Depreciation for less than a year

Because the life of the asset is usually measured in years, the formula 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 (1/12 of a year) should be charged as an expense.

Referring to the example on the previous page, if Jiggles Clothing had purchased the vehicle on 1 February 2025 (rather than 1 July 2024), then by balance day – 30 June 2025 – 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 2025. This is shown in Figure 16.9:

**Study tip**

Note when the asset is purchased to calculate how many months worth of depreciation should be reported.

**Figure 16.9** Calculating depreciation: less than a year

$$\textbf{Depreciation expense} = \$2\,760 \text{ per annum} \times \frac{5}{12}$$

$$= \$1\,150$$

**Study tip**

Rather than multiply by fractions like 1/4 or 1/2, it is safer to multiply by the number of months out of 12, e.g. 3/12 or 6/12.

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 2025. 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 2026 should report Depreciation expense as $2 760.

## 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 balance day adjustments are reported, consider the following example.

**Example**

Kingsmill Music has provided the following information relating to its trading activities for March 2025:

| | | |
|---|---|---|
| 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:

- Depreciation of van for March 2025 was $150.
- The van was purchased for $28 000, and as at 28 February 2025, Accumulated depreciation on the van amounted to $7 000.

The Income Statement for Kingsmill Music is shown in Figure 16.10:

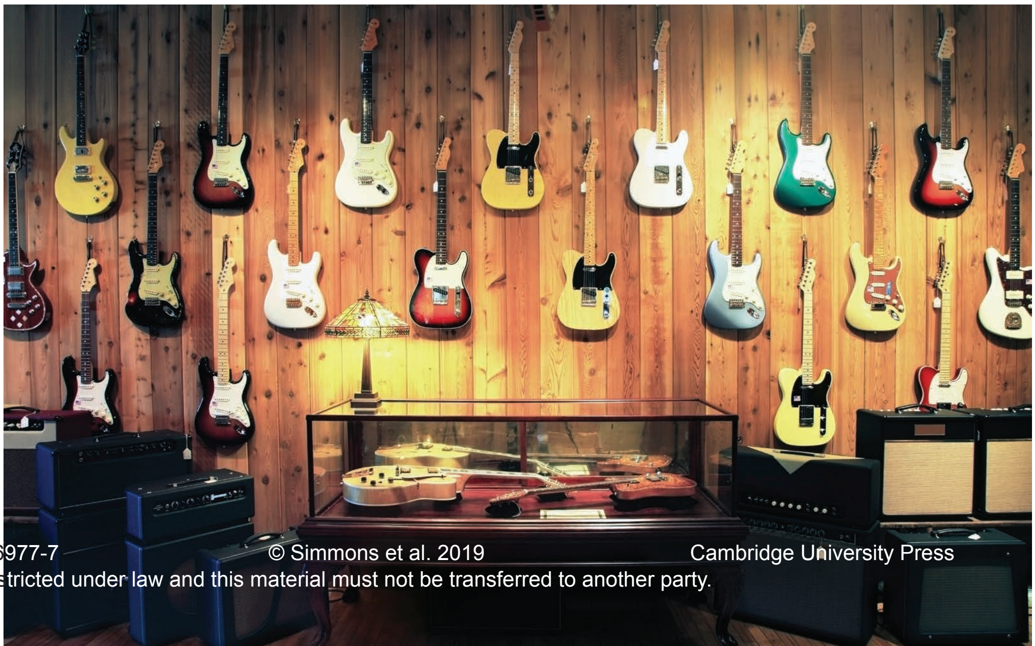
**Study tip**

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.

**Figure 16.10** Income Statement: balance day adjustments

**KINGSMILL MUSIC**
**Income Statement for March 2025**

| | $ | $ |
|---|---|---|
| **Revenue** | | |
| Sales | | 63 000 |
| **Less Cost of Goods Sold** | | |
| Cost of Sales | | 28 000 |
| **Gross Profit** | | **35 000** |
| **Less Other expenses** | | |
| Wages expense | 14 700 | |
| Advertising | 800 | |
| Rent expense | 1 200 | |
| Depreciation of van | 150 | 18 150 |
| **Net Profit** | | **16 850** |



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The Balance Sheet for Kingsmill Music as at 31 March 2025 is shown in Figure 16.11:

**Figure 16.11** Balance Sheet: balance day adjustments

**KINGSMILL MUSIC**
**Balance Sheet as at 31 March 2025**

| | $ | $ | | $ | $ |
|---|---|---|---|---|---|
| **Current Assets** | | | **Current Liabilities** | | |
| Bank | * 1 200 | | Accounts Payable | * 15 400 | |
| Inventory | * 60 500 | | GST payable | * 1 300 | |
| Accounts Receivable | * 20 300 | 82 000 | Loan – Qs Finance | * 9 700 | 26 400 |
| | | | | | |
| **Non-Current Assets** | | | **Non-Current Liabilities** | | |
| Van | 28 000 | | Loan – Qs Finance | | * 21 000 |
| Less Accum. dep. | 7 150 | 20 850 | | | |
| | | | **Owner's equity** | | |
| | | | Capital – Kingsmill | * 42 600 | |
| | | | **+ Net Profit** | **16 850** | |
| | | | | 59 450 | |
| | | | Less Drawings | * 4 000 | 55 450 |
| **Total Assets** | | **102 850** | **Total Equities** | | **102 850** |

* Additional figures have been made up to create a realistic Balance Sheet.

## 16.10 Financial indicators and non-current assets

Non-current assets will be used by a business for many years or at least greater 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 business's 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 16.12:

**Figure 16.12** Formula: Asset Turnover

$$\textbf{Asset Turnover (ATO)} = \frac{\textbf{Net Sales}}{\textbf{Average Total Assets}}$$

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.

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**Example**

Using the information from the previous example:
In March 2025, Kingsmill Music had earned $63 000 in Net Sales and had an Average Total Assets of $102 850.

The Asset Turnover of Kingsmill Music would be calculated as shown in Figure 16.13:

**Figure 16.13** Calculation: Asset Turnover

$$\textbf{ATO} = \frac{\text{Net Sales}}{\text{Average Total Assets}}$$

$$= \frac{\$63\,000}{\$102\,850}$$

$$= 0.61 \text{ times}$$

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 0.61 times indicates that for every dollar of assets in the business it earned revenue of 61 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).

## 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.

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 (ROA)** a profitability indicator that assesses how effectively a business has used its assets to earn profit

## Return on Assets formula

The formula for calculating Return of Assets is given in Figure 16.14:

**Figure 16.14** 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.

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Example

Using the information from the previous example:
In March 2025, Kingsmill Music had achieved $16 850 in Net Profit and had Average Total Assets of $102 850.

The Return on Assets of Kingsmill Music would be calculated as shown in Figure 16.15:

**Figure 16.15** Calculation: Return on Assets

$$\text{ROA} = \frac{\text{Net Profit}}{\text{Average Total Assets}} \times 100$$

$$= \frac{\$16\,850}{\$102\,850} \times 100$$

$$= 16.38\,\%$$

Return on Assets measures Net Profit earned per dollar of assets controlled by the business. A Return on Assets of 16.38% means that for every dollar of assets under the control of Kingsmill Music, it has earned 16 cents 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.

### 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 16.9

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 the Return on Assets.
6. **Explain** the relationship between Net Profit Margin, Asset Turnover and Return on Assets.

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## 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.
- Balance day adjustments are necessary so that an accurate profit is calculated by comparing revenue earned in the same reporting period and expenses incurred in the same reporting period.
- Depreciation is the allocation of the cost of a non-current asset over its Useful life.
- Depreciation is calculated using the straight-line method.
- Each balance day adjustment for expenses increases the expense, thus decreasing profit and owner's equity.
- Balance day adjustments have no effect on cash but will change Net Profit and the items in the Balance Sheet.
- Without balance day adjustments, the reports will not include all the information that is useful for decision-making (*Relevance*).
- Depreciation is reported in the Income Statement (depreciation expense) and the Balance Sheet (accumulated depreciation).
- Depreciation is calculated for a year; however, can also be determined for partial reporting periods.

## 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

WB page 299

### Asset register and depreciation

On 1 July 2024, 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.

*Required*

**a** **Define** the term 'depreciation'.
**b** **Calculate** Depreciation of photocopier for the year ending 30 June 2025.
**c** **Calculate** the rate of depreciation.
**d** **Create** an asset register in 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 2025.

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## Exercise 16.2

W B page 302

### Depreciation

On 1 January 2025, Aroma World purchased office furniture for $12 000 (plus GST). The office furniture has an estimated Useful life of 10 years, with a Residual value of $1 000.

*Required*

- **a** Referring to one Accounting assumption, **explain** why it is necessary to depreciate non-current assets.
- **b** **Calculate** Depreciation of Office furniture for 2025.
- **c** **Show** how Office furniture would be reported in the Balance Sheet of Aroma World as at 31 December 2025.
- **d** **Explain** the Effect of depreciation of Office furniture on the Balance Sheet of Aroma World as at 31 December 2025.

## Exercise 16.3

W B page 303

### Depreciation rate

On 1 July 2024, Finnigan's Wave Boards purchased new polishing equipment, paying $17 600 cash (including GST). The equipment is expected to last for 5 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 2025.
- **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 2025, 2026 and 2027.
- **d** Referring to one Qualitative characteristic, **explain** why the equipment must be shown in the Balance Sheet at its Carrying value.

## Exercise 16.4

W B page 305

### Depreciation – less than 12 months

On 1 October 2024, Lukin Motors purchased a new computer for $2 400 (plus GST). The computer will be depreciated at a rate of 15% per annum.

*Required*

- **a** **Calculate** Depreciation of computer for the year ending 30 June 2025.
- **b** **State** the effect on the Accounting equation of Lukin Motors as at 30 June 2025 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 2025, 2026 and 2027.

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## Exercise 16.5

WB page 306

## Depreciation – less than 12 months

Wangaratta Watches has provided the following extract from its Balance Sheet as at 1 July 2024:

**WANGARATTA WATCHES**
**Balance Sheet (extract) as at 1 July 2024**

| Non-Current Assets | $ | $ |
|---|---|---|
| Display cases | 32 000 | |
| Less Accumulated depreciation | 8 000 | 24 000 |

**Additional information:**

- A new display case was purchased on 30 November 2024 for $3 600 (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 2025.

**b** **Show** how Display cases would appear in the Balance Sheet of Wangaratta Watches as at 30 June 2025.

**c** **Explain** the effect on the Balance Sheet of Wangaratta Watches as at 30 June 2025 if the balance day adjustment for depreciation had not been made.

## Exercise 16.6

WB page 307

## Reporting depreciation

Wayne's Fountains sells fountains and other garden ornaments. Its assets and equities as at 1 October 2024 were as follows:

**WAYNE'S FOUNTAINS**
**Assets and Equities as at 1 October 2024**

| Assets | $ | $ | Equities | $ | $ |
|---|---|---|---|---|---|
| Stock | | 127 000 | Bank overdraft | | 2 800 |
| Accounts Receivable | | 4 900 | Accounts Payable | | 64 000 |
| Premises | 265 000 | | GST payable | | 2 700 |
| less Accum. 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 2025:

**Sales Journal**

| Date | Account Receivable | Inv. No. | Sales | GST | Total Accounts Receivable |
|---|---|---|---|---|---|
| | **TOTALS** | **$** | **18 000** | **1 800** | **19 800** |

**Purchases Journal**

| Date | Account Payable | Inv. No. | Stock | GST | Total Accounts Payable |
|---|---|---|---|---|---|
| | **TOTALS** | **$** | 16 000 | 1 600 | 17 600 |

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**Cash Receipts Journal**

| Date | Details | Rec. No. | Bank | Accounts Receivable | Sales | Sundries | GST |
|---|---|---|---|---|---|---|---|
| Sept. | Loan – FIX Finance | | | | | 20 000 | |
| | **TOTALS** | **$** | **97 100** | **21 000** | **51 000** | **20 000** | **5 100** |

**Cash Payments Journal**

| Date | Details | Doc. | Bank | Accounts Payable | Drawings | Wages | Sundries | GST |
|---|---|---|---|---|---|---|---|---|
| | Electricity | | | | | | 6300 | |
| | Advertising | | | | | | 4 000 | |
| | Insurance | | | | | | 2 400 | |
| | GST Clearing | | | | | | 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.
- Due to effective inventory management techniques, both the inventory cards and the physical count as at 30 September 2025 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 making balance day adjustments.

**b** **Calculate** Depreciation of Premises for the year ending 30 September 2025.

* **c** **Prepare** a Cash Flow Statement for Wayne's Fountains for the year ending 30 September 2025.

* **d** **Prepare** an Income Statement for Wayne's Fountains for the year ending 30 September 2025.

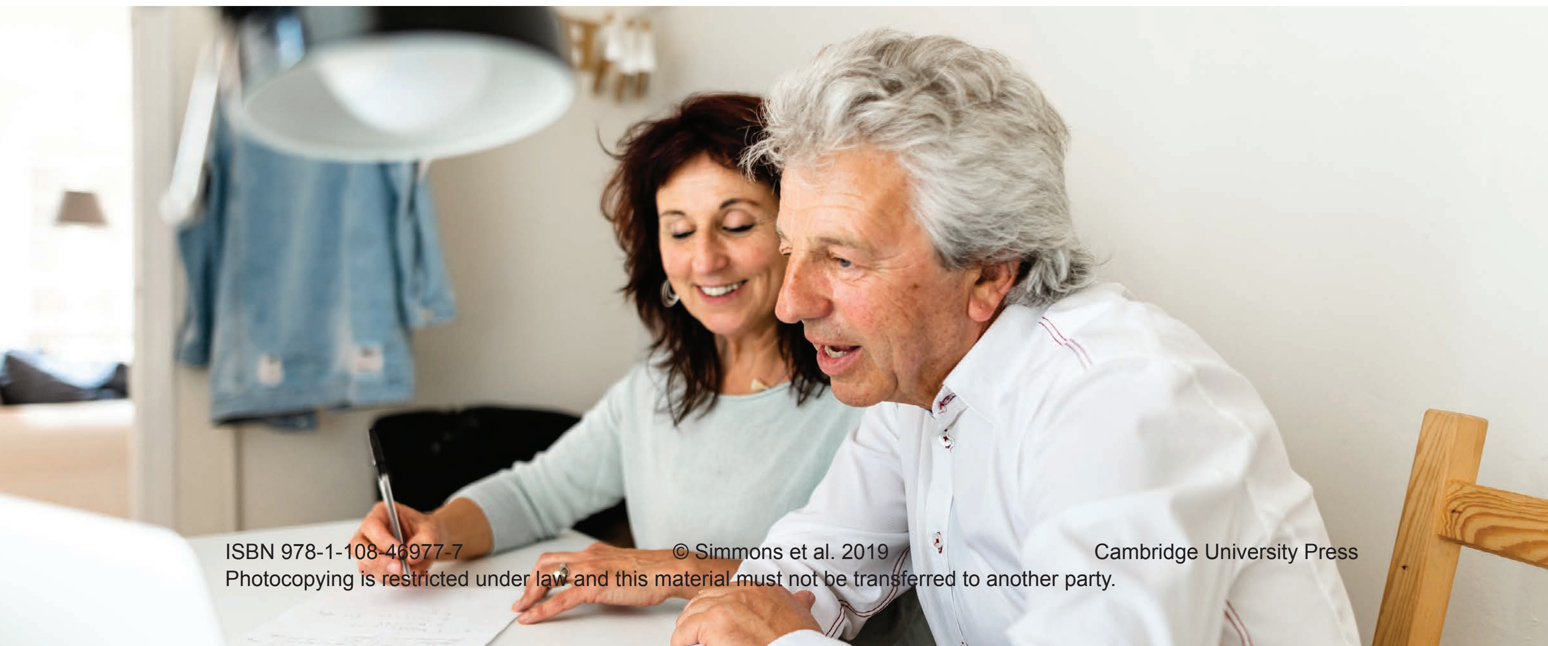
**e** **State** three reasons why Wayne's Fountains was able to generate a Net Cash inflow despite incurring a Net Loss for the year ending 30 September 2025.

**f** **Calculate** the following balances as at 30 September 2025:

- Accounts Receivable
- Accounts Payable
- GST payable.

* **g** **Prepare** a classified Balance Sheet for Wayne's Fountains as at 30 September 2025.

**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 ATO was 0.86 times and ROA of 5%.



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## Exercise 16.7

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### Reporting depreciation

That Bike Shop sells bikes and riding gear and has provided the following information relating to its trading activities for June 2025:

**THAT BIKE SHOP**
**Assets and equities as at 31 May 2025**

| Assets | $ | $ | Equities | $ | $ |
|---|---|---|---|---|---|
| Bank | | 1 650 | Accounts Payable | | 18 650 |
| Stock | | 69 700 | GST payable | | 1 900 |
| Accounts Receivable | | 40 500 | Loan – GH Bank | | 27 000 |
| Shop fittings | 50 000 | | Capital – Melven | | 97 200 |
| Less Accum. depreciation | 17 100 | 32 900 | | | |
| **Total Assets** | | **144 750** | **Total Equities** | | **144 750** |

**THAT BIKE SHOP**
**Cash Flow Statement for June 2025**

| | $ | $ |
|---|---|---|
| **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 2025)** | | **1 650** |
| **Bank balance at end (30 June 2025)** | | **(490)** |

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**Additional information:**

- The credit journals for June 2025 showed:

| | | |
|---|---|---|
| Credit sales | $40 000 | plus GST |
| Credit purchases | $15 000 | plus GST |

- The inventory cards for June 2025 showed:

| | |
|---|---|
| Cost of Sales | $18 000 |
| Stock on hand as at 30 June 2025 | $66 700 |
| Sales returns | $1 200 |

- A physical count on 30 June 2025 revealed an inventory loss of $200.
- Shop fittings are depreciated at 12% p.a.
- The Principal of the loan – GH Bank is repayable at $3 000 per annum.

### *Required*

**a** **Explain** how balance day adjustments ensure *Relevance* in the financial reports.

**b** **Calculate** Depreciation of Shop fittings for June 2025.

* **c** **Prepare** an Income Statement for That Bike Shop for June 2025.

**d** **Explain** two reasons why That Bike Shop was able to earn a profit despite suffering a cash deficit in June 2025.

**e** **Calculate** the Accounts Receivable and Accounts Payable balances as at 30 June 2025.

**f** **Calculate** the GST balance as at 30 June 2025.

* **g** **Prepare** a classified Balance Sheet for That Bike Shop as at 30 June 2025.

**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 ATO was 0.28 times and return on Assets was 4%.


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## Exercise 16.8

W B page 317

### Reporting depreciation

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 2025:

**BETWEEN THE LINES**
**Assets and Equities as at 31 December 2024**

| Assets | $ | $ | Equities | $ | $ |
|---|---|---|---|---|---|
| Bank | | 2 400 | Accounts Payable | | 9 000 |
| Inventory | | 32 000 | GST payable | | 1 500 |
| Accounts Receivable | | 5 000 | Loan – ANZ | | 28 000 |
| Shelving | 48 000 | | Capital – Devitt | | 34 500 |
| Less Accum. depreciation | 14 400 | 33 600 | | | |
| **Total Assets** | | **73 000** | **Total Equities** | | **73 000** |

**BETWEEN THE LINES**
**Statement of Receipts and Payments for the quarter ending 31 March 2025**

| | $ | $ |
|---|---|---|
| **CASH FLOWS FROM OPERATING ACTIVITIES** | | |
| Cash Sales | 42 000 | |
| Receipts from Account Receivables | 14 000 | |
| GST received | 4 200 | **60 200** |
| Payments to Account Payables | 31 500 | |
| Wages | 18 000 | |
| Freight in | 250 | |
| Interest | 280 | |
| Advertising | 3 000 | |
| GST paid | 325 | **53 355** |
| **Net Cash Flows from Operating activities** | | **6 845** |
| **CASH FLOW FROM FINANCING ACTIVITIES** | | |
| Drawings | 3 900 | |
| Loan principal | 1 200 | 5 100 |
| **Net Cash Flows from Financing activities** | | **(5 100)** |
| **Net Increase (Decrease) in cash position** | | **1 745** |
| **Bank balance at start (1 January 2025)** | | **2 400** |
| **Bank balance at end (31 March 2025)** | | **4 145** |

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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 2025 showed:

| | |
|---|---|
| Cost of Sales | $40 000 |
| Drawings of inventory | $300 |
| Inventory on hand as at 31 March 2025 | $21 700 |

- A physical count on 31 March 2025 revealed inventory on hand of $21 410.
- Depreciation of shelving is charged at 15% p.a. on cost.
- The Principal of the loan – ANZ is repayable at $400 per month.
- Selected balances as at 31 March 2025:

| | |
|---|---|
| Accounts Payable | $10 500 |
| Accounts Receivable | $7 500 |
| GST payable | $3 875 |

### *Required*

**a** **Calculate** Depreciation of Shelving for the quarter ending 31 March 2025.

**b** **Calculate** Credit sales for the quarter ending 31 March 2025.

* **c** **Prepare** an Income Statement for Between the Lines for the quarter ending 31 March 2025.

**d** **Explain** two reasons why Between the Lines was able to generate a Cash Surplus despite suffering a Net Loss for the quarter ending 31 March 2025.

* **e** **Prepare** a Balance Sheet for Between the Lines as at 31 March 2025.


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Chapter 17

# Budgets

## Where are we headed?

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
- Budgeted Cash Flow Statement Variance Report
- variance
- Income Statement Variance Report.


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## 17.1 Budgeting

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**
the process of predicting/estimating the financial consequences of future events

Budgeting is the process of preparing reports that estimate or predict the financial consequences of likely future transactions. 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 which 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.

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 for the budget period.
3. *Budgeted Balance Sheet*, which shows expected assets and liabilities at the end of the budget period.

**Study tip**

If you can prepare actual reports, you can prepare budgeted reports as they contain the same types of items.

### 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*.

**Ethical considerations**

7 **Explain** the relationship between ethical considerations and *Relevance* in budgeted reports.


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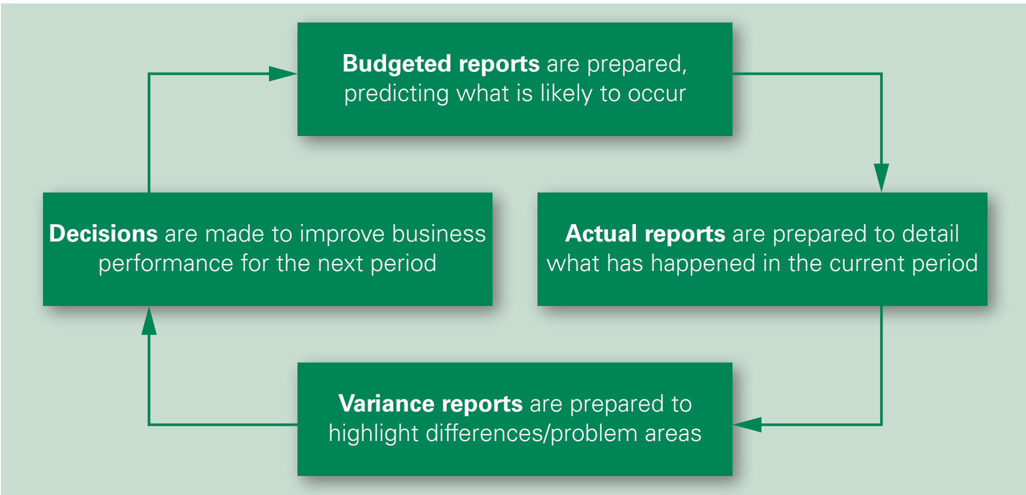
## 17.2 The budgeting process

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 effect 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
- 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 2025, the business had the following assets and equities:

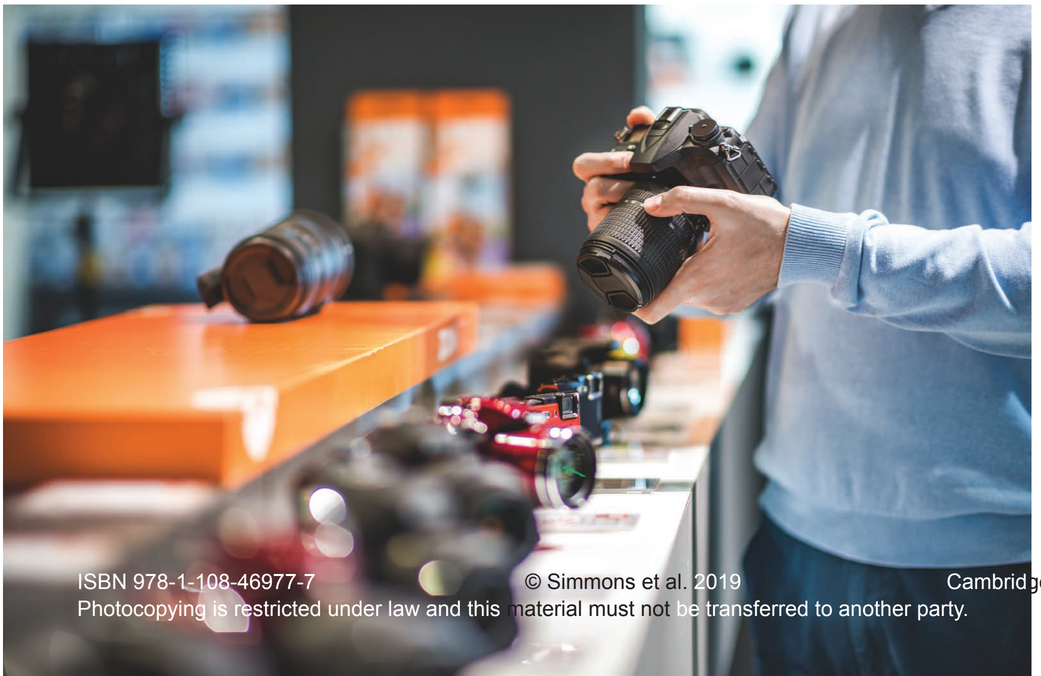
| Assets | $ | Equities | $ |
|---|---|---|---|
| Bank | 1 800 | GST payable | 450 |
| Inventory | 52 000 | Accounts Payable | 14 300 |
| Accounts Receivable | 10 000 | Capital | 249 050 |
| Premises | 200 000 | | |
| **Total Assets** | **263 800** | **Total Assets** | **263 800** |

Karl has predicted the following transactions for October 2025:

- 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 sale, earning a discount of 10%. As at 30 September 2025, 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 2025, Accounts Payable was $14 300 and this will be paid for in October 2025, earning a 5% discount. Credit purchases for October 2025 are expected to be $14 000 plus GST. No purchase returns are expected.
- The following expenses will be paid during October 2025:

| | | |
|---|---|---|
| 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 2025 and depreciated at 10% p.a. using the straight-line method.
- During October 2025, 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 2025.



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The Budgeted Cash Flow Statement for Perfect Portraits for October 2025 is shown in Figure 17.2:

**Figure 17.2** Budgeted Cash Flow Statement

**PERFECT PORTRAITS**
**Budgeted Cash Flow Statement for October 2025**

| | $ | $ |
|---|---|---|
| **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 Operations** | | **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 2025)** | | **1 800** |
| **Bank Balance at end (31 October 2025)** | | **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 eq.) |

Compared to 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).

In this example, Perfect Portraits is expecting to generate an increase in cash of **$22 145** for October 2025. As a result, its bank balance as at 31 October 2025 will increase to **$23 945** (provided all goes according to budget).

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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 2025, because they do not involve cash. Among others, the Credit sales, Sales returns, Credit purchases and Drawings of inventory have all been excluded as they are *non-cash transactions*.

**Study tip**

Reading skills are essential in budgeting questions: you will find most of the answers in the question itself – if you look hard enough.

## 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 problems 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, 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 action to:

- increase sales (see Chapter 15)
- increase receipts from Accounts Receivable (see Chapter 14)
- reduce cash payments for expenses (see Chapter 15)
- make a cash capital contribution
- defer the purchase of non-current assets, or use credit facilities or 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 the expenses provide may be vital in the earning of sales. For example, reducing advertising may mean less exposure and reducing hours worked by employees might not only decrease service (and thus sales) but undermine commitment to the business.

**Ethical considerations**

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### 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, employing more staff etc.

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

Further, each business needs to consider the ethical as well as financial consequences of its decisions. Lower wages (which increases 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.

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## 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 2025 could be prepared and presented side-by-side to show trends in receipts and payments from month to month.

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 2025**

| | $ | $ | $ |
|---|---|---|---|
| **CASH FLOWS FROM OPERATING ACTIVITIES** | | | |
| Cash sales | 18 000 | 15 000 | 21 000 |
| GST received | 1 800 | 1 500 | 2 100 |
| Receipts from Accounts Receivable | 9 000 | 10 584 | 8 820 |
| **Total Operating Cash Inflows** | **28 800** | **27 084** | **31 920** |
| Payments to Accounts Payable | (13 585) | (14 630) | (12 540) |
| Supplies | (700) | (500) | (900) |
| Wages | (7 500) | (6 250) | (8 750) |
| Advertising | (600) | (600) | (1 200) |
| Interest | (150) | (150) | (150) |
| GST settlement | (450) | | |
| GST paid | (370) | (3 610) | (210) |
| **Total Operating Cash Outflows** | **(23 355)** | **(25 740)** | **(23 750)** |
| **Net Cash Flows from Operations** | **5 445** | **1 344** | **8 170** |
| **CASH FLOWS FROM INVESTING ACTIVITIES** | | | |
| Office equipment | (2 400) | | - |
| Company car | | (35 000) | - |
| **Net Cash Flows from Investing activities** | **(2 400)** | **(35 000)** | **-** |
| **CASH FLOWS FROM FINANCING ACTIVITIES** | | | |
| Loan – DolFin | 20 000 | | |
| Capital Contribution | | | 10 000 |
| Loan Principal | | (850) | (850) |
| Drawings | (900) | (900) | (900) |
| **Net Cash Flows from Financing activities** | **19 100** | **(1 750)** | **8 250** |
| **Net Increase (Decrease) in cash position** | **22 145** | **(35 406)** | **16 420** |
| **Add Bank Balance at start** | **1 800** | **23 945** | **(11 461)** |
| **Bank Balance at end** | **23 945** | **(11 461)** | **4 959** |

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Note how the balance at the end of October (**$23 945**) is then transferred to become the balance at the start of November; November's closing balance (**$11 461**) 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 2025 (**$23 945**) is healthy, but is expected to fall into overdraft (of **$11 461**) by the end of November 2025 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 2025 (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 2025, he may elect to bring the capital contribution forward into November 2025.

### 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.

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## 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.

**Budgeted Income Statement** an Accounting report that predicts revenue earned and expenses incurred, and thus the expected Net Profit for the budget period

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:

**Example**

Perfect Portraits is run by Karl Rubens and sells photography equipment. As at 30 September 2025, 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 2025:

- 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 2025, 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 2025, Accounts Payable was $14 300 and this will be paid for in October 2025, earning a 5% discount. Credit purchases for October 2025 are expected to be $14 000 plus GST. No purchase returns are expected.
- The following expenses will be paid during October 2025:

| | | |
|---|---|---|
| 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 2025 and depreciated at 10% p.a. using the straight-line method.
- During October 2025, 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 2025.

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The budgeted Income Statement for Perfect Portraits for October 2025 is shown in Figure 17.4:

**Figure 17.4** Budgeted Income Statement

**PERFECT PORTRAITS**
**Budgeted Income Statement for October 2025**

| | $ | $ |
|---|---|---|
| **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 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 × 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 $14 700 and a Net Profit of **$5 325** for October 2025.

## 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 2025 (of **$5 325**) is **not** the same as the budgeted increase in cash (of **$23 945**). 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.

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## 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.<br>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.<br>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:

| | |
|---|---|
| **Revenue that is not a cash inflow** | This revenue will increase budgeted Net Profit but is not a cash flow so will not affect budgeted cash.<br>It may explain why the business has earned a profit even when cash has decreased. |
| Inventory gain | |
| **Expenses that are not cash outflows** | These expenses will decrease budgeted Net Profit but are not cash flows so will not affect budgeted cash.<br>They may explain why the business has suffered a loss even though cash has increased. |
| Inventory loss | |
| Bad debts expense | |
| Depreciation expense | |

### 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 are greater than receipts from Accounts Receivable, profit will increase more than cash. * |
| Cost of Sales | Payments for Inventory | If Cost of Sales are 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 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.

**Budgeted Balance Sheet** an Accounting report that predicts assets, liabilities and owner's equity at the end of the budget period.

Let's use the same information for Perfect Portraits to illustrate the Budgeted Balance Sheet:

**Example**

Perfect Portraits is run by Karl Rubens and sells photography equipment. As at 30 September 2025, 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 2025:

- 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 sale, earning a discount of 10%. As at 30 September 2025, 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 2025, Accounts Payable was $14 300 and this will be paid for in October 2025, earning a 5% discount. Credit purchases for October 2025 are expected to be $14 000 plus GST. No purchase returns are expected.
- The following expenses will be paid during October 2025:

| | | |
|---|---|---|
| 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 2025 and depreciated at 10% p.a. using the straight-line method.
- During October 2025, 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 2025.

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Figure 17.5 shows how the Budgeted Balance Sheet of Perfect Portaits would appear as at 31 October 2025:

**Figure 17.5** Budgeted Balance Sheet

**PERFECT PORTRAITS**
**Budgeted Balance Sheet as at 31 October 2025**

| | $ | $ | | $ | $ |
|---|---|---|---|---|---|
| **Current Assets** | | | **Current Liabilities** | | |
| Bank [1] | 23 945 | | Accounts Payable [5] | 15 400 | |
| Inventory [2] | 50 680 | | GST Payable [6] | 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 |

Note the following in Figure 17.5:

1 Bank from Budgeted Cash Flow Statement (Figure 17.2)

2 Inventory

| | | |
|---|---|---|
| Balance at start (30 September 2025) | | 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 | 15 320 |
| **Balance at end (31 October 2025)** | | **50 680** |

3 Accounts Receivable

| | | |
|---|---|---|
| Balance at start (30 September 2025) | | 10 000 |
| + Credit sales (incl. GST) | 13 200 | |
| – Sales returns (incl. GST) | 264 | 12 936 |
| | | 22 936 |
| – Receipts from Accounts Receivable (Fig. 17.2) | 9 000 | |
| – Discount expense (Fig. 17.4) | 1 000 | 10 000 |
| **Balance at end (31 October 2025)** | | **12 936** |

4 Office equipment from Budgeted Cash Flow Statement (Figure 17.2)
less Accumulated Depreciation from Budgeted Income Statement (Figure 17.4)

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**5** Accounts Payable

| | | |
|---|---|---|
| Balance at start (30 September 2025) | | 14300 |
| + Credit purchases (incl. GST) | | 15400 |
| | | 29700 |
| – Payments to Accounts Payable (Fig. 17.2) | 13585 | |
| – Discount revenue (Fig. 17.4) | 715 | |
| **Balance at end (31 October 2025)** | | **15400** |

**6** GST payable

| | | |
|---|---|---|
| Balance at start (30 September 2025) | | 450 |
| – GST settlement (Fig. 17.2) | | 450 |
| | | nil |
| + GST on sales ($30000 × 10%) | | 3000 |
| – GST on sales returns ($240 × 10%) | 24 | |
| – GST paid (Fig.17.2) | 370 | |
| – GST on credit purchases | 1400 | 1794 |
| **Balance at end (31 October 2025)** | | **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 to plan 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 which is capable of influencing decision-making.)

### 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.

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## 17.7 Variance reports

**variance report**
an Accounting report that compares actual and budgeted figures, highlighting variances so that problems can be identified and corrective action taken

**Budgeted 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'

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**.

### Budgeted Cash Flow Statement Variance Report

A **Budgeted 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 Budgeted 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.

Figure 17.6 shows the Budgeted Cash Flow Statement Variance Report for Perfect Portraits for October 2025:

**Figure 17.6** Budgeted Cash Flow Statement Variance Report

**PERFECT PORTRAITS**
**Budgeted Cash Flow Statement Variance Report for October 2025**

| | 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 Operations** | **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.
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!

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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 the liabilities will not decrease by as much does not affect its classification in the Budgeted 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 Budgeted 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.
- 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 $5 000 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 Budgeted 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.

**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

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.

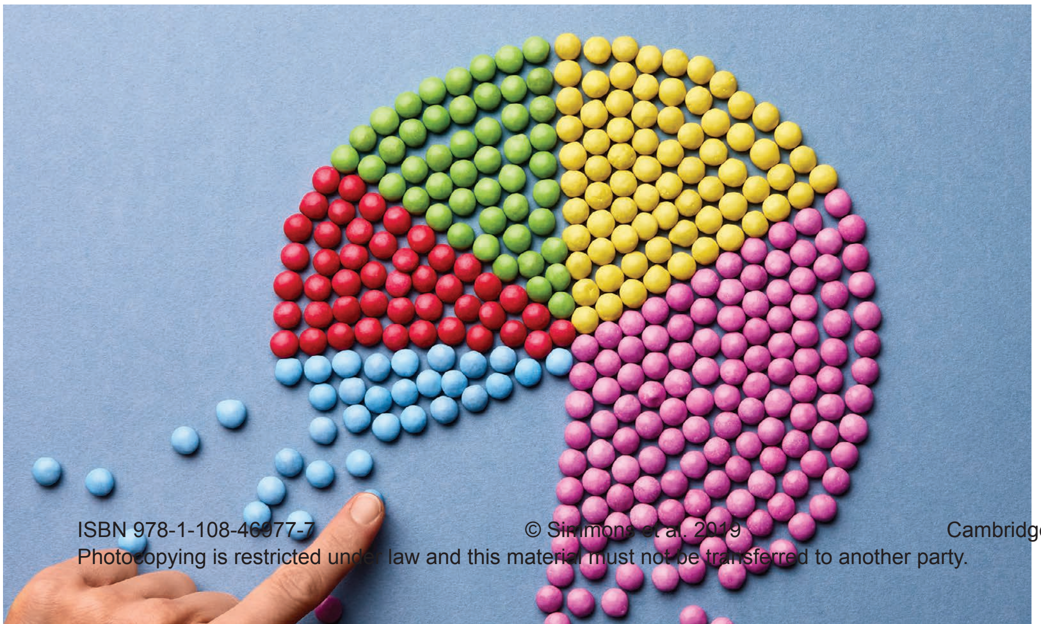

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Figure 17.7 shows the Income Statement Variance Report for Perfect Portraits for October 2025:

**Figure 17.7** Budgeted Income Statement Variance Report

**PERFECT PORTRAITS**

**Budgeted Income Statement Variance Report for October 2025**

| | Budget | Actual | Variance | F/U |
|---|---|---|---|---|
| Sales | 30 000 | 24 000 | 6 000 | U |
| Less Sales returns | 240 | 150 | 90 | F |
| **Net Sales** | **29 760** | **23 850** | **5 910** | **U** |
| **Less Cost of Goods Sold** | | | | |
| Cost of Sales | 14 880 | 14 500 | 380 | F |
| **Gross Profit** | **14 880** | **9 350** | **5 530** | **U** |
| Less Inventory loss | 300 | 350 | 50 | U |
| **Adjusted Gross Profit** | **14 580** | **9 000** | **5 580** | **U** |
| **Add Other revenue** | | | | |
| Discount revenue | 715 | 660 | 55 | U |
| | **15 295** | **9 660** | **5 635** | **U** |
| **Less Other expenses** | | | | |
| Discount expense | 1 000 | 800 | 200 | F |
| Supplies | 700 | 750 | 50 | U |
| Wages | 7 500 | 7 500 | - | - |
| Advertising | 600 | 200 | 400 | F |
| Interest | 150 | 150 | - | - |
| Depreciation of Office equipment | 20 | 25 | 5 | U |
| **Total Other expenses** | **9 970** | **9 425** | **545** | **F** |
| **Net Profit** | **5 325** | **235** | **5 090** | **U** |

## Interpreting the Income Statement Variance Report

In this example, Net Profit was $5 090 lower than was expected: why did this occur?

- Sales was $6 000 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 which are too high or inventory which 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 $5 090 lower than expected.

## Using the Variance reports

Assuming the variances are not caused by poor estimates, then both the Budgeted 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.

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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 Budgeted 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 Budgeted 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.

## 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 17.1

WB page 321

### Budgeted Cash Flow Statement

On 31 December 2025, Finishing Touch Paints had $1 600 in its bank account. It has provided the following list of expected transactions for January 2026:

| | | |
|---|---|---|
| • Cash sales | $24 000 | plus GST |
| • Credit sales (to begin in January 2026) | 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 | |
| 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 2026.

* **c** **Prepare** a Budgeted Cash Flow Statement for Finishing Touch for January 2026.

**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 for January 2026 might be different from its budgeted Net increase (decrease) in cash. **Explain** your answer.

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## Exercise 17.2
## Budgeted Cash Flow Statement

WB page 323

Langwarrin Laundry Equipment (LLE) sells washing machines and dryers to hotels and hospitals. The firm's expected transactions for July 2025 are listed below:

- Sales are expected to be $143 000 including $1 300 GST. All sales are made on credit, but 90% of Accounts Receivable pay in the month of sale. Actual sales for June 2025 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 2025, 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 2025.
- The owner plans to withdraw $1 000 cash and contribute her own computer worth $1 200 for business use.
- As at 30 June 2025, 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 2025:
- 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 2025.

**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

W B page 325

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 2025:

- As at 1 October 2025, 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 sales (excluding GST).
- Administration expenses are usually $275 (including GST) per month.
- Stationery supplies are purchased every month or so with the next payment of $350 plus GST due in December 2025.
- Advertising of $220 including GST will be paid in October 2025.
- The owner expects to receive a gift of $1 500 from a relative in November 2025 and is planning to contribute this cash to the business.
- A GST refund of $400 is due in October 2025.
- The owner plans to take $450 drawings per month.
- New shelving will be purchased for $12 000 plus GST in October.

*Required*

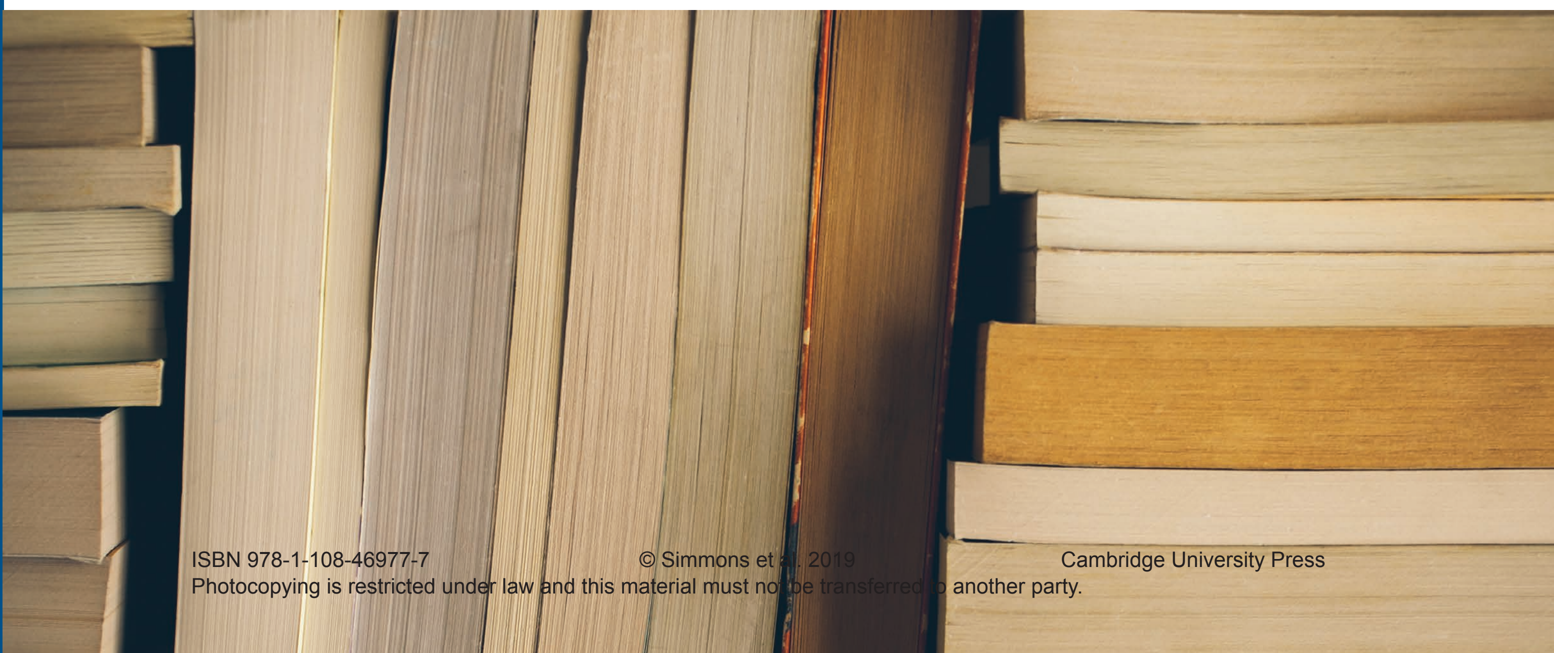
**a** **Explain** why the way Plato Says manages its sales and purchases of inventory might have negative consequences for its liquidity.

**b** **Calculate** cash and credit sales for October, November and December 2025.

**c** **Calculate** budgeted GST paid for October, November and December 2025.

* **d** **Prepare** a Budgeted Cash Flow Statement for Plato Says for October, November and December 2025.

**e** Plato Says needs new shelving, which is currently on sale a special price of $12 000 plus GST. From 1 November 2025, 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

WB page 328

### Budgeted Income Statement

Melinda Fricke runs Sebastapol Electrics, which sells electrical parts in Western Victoria. She has provided the following information regarding its expected transactions for April 2025:

- Sales are estimated to be $54 000 (plus GST). One customer has permission to pay his account of $3 700 plus GST in May 2025.
- 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 2025:

| | | |
|---|---|---|
| Advertising | $1 320 | including GST |
| Rent | $1 000 | plus GST |
| Wages | $2 000 | |

- A GST settlement of $800 is due in April 2025.
- On 30 April 2025 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 2025.

**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 2025 might be different from its budgeted Net Profit. **Explain** your answer.

## Exercise 17.5

WB page 330

### Budgeted Income Statement

Magnificent Mowers sells mowing and gardening equipment, and has provided the following information regarding expected transactions for September 2025:

- Sales for July and August 2025 were $50 000 plus GST but sales are expected to grow by 20% in September 2025 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 2025.
- 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 2025.
- Drawings is usually $850, but the owner is planning to withdraw an extra $600 in September 2025 to make a deposit on a summer holiday.

*Required*

**a** **Calculate** Budgeted Sales for September 2025.

* **b** **Prepare** a Budgeted Income Statement for Magnificent Mowers for September 2025.

**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 2025.

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## Exercise 17.6

WB page 332

## Budgeted reports

On 1 December 2025, 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 2025.
- Shelving costing $11 000 including GST will be purchased using a loan from EK Finance. Monthly interest on the loan will be 3.6% p.a. The shelving will have a useful life of 5 years and a residual value of $2 500.
- All sales will be made for cash and in December 2025 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 2025 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 2025.

### *Required*

**a** **Calculate** the following budgeted amounts for December 2025:
- Administration expenses
- GST paid
- Interest expense
- Payments to Accounts Payable.

* **b** **Prepare** a Budgeted Cash Flow Statement for BTrue2 for December 2025.

**c** **Calculate** budgeted Depreciation of Shelving for December 2025.

* **d** **Prepare** a Budgeted Income Statement for BTrue2 for December 2025.

**e** **Identify** two reasons why BTrue2 is expecting to suffer a Net decrease in cash despite earning a Net Profit for September 2025. **Explain** your answer.

**f** **Calculate** the following budgeted balances as at 31 December 2025:
- Inventory
- GST payable or receivable.

* **g** **Prepare** a Budgeted Balance Sheet for BTrue2 as at 31 December 2025.

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## Exercise 17.7
## Budgeted reports

WB page 337

BHM Tradings is owned and operated by Bob Bevan and sells hardware. As at 31 July 2025, 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 2025:

- Sales are estimated to be $60 000 plus GST. All sales are made on credit and sales returns are usually 2.5% of credit sales.
- 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 10% discount.
- 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 (excluding GST):

| | | |
|---|---|---|
| Wages | 30% | |
| Administration expenses | 5% | plus GST |
| Bad debts | 1.5% | |

- Depreciation of Office furniture is calculated using the reducing balance method at 12% p.a.
- The loan from EastBank was taken out in July 2025 and will be put towards the purchase of a van worth $33 000 including GST in September 2025. 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 $2 100 per month but also expects to withdraw inventory worth $400.
- A GST refund is expected on 3 August 2025.

### *Required*

**a** **Calculate** the following budgeted amounts for August 2025:
- Discount expense
- Receipts from Accounts Receivable
- GST paid.

* **b** **Prepare** a Budgeted Cash Flow Statement for BHM Trading for August 2025.

* **c** **Prepare** a Budgeted Income Statement for BHM Trading for August 2025.

**d** **Explain** two reasons why BHM Tradings is expecting to suffer a Net Loss despite generating a Net increase in cash for August 2025.

**e** **Suggest** two strategies Bob could employ to improve budgeted Net Profit for August 2025.

**f** **Calculate** the following budgeted balances as at 31 August 2025:
- Inventory
- GST payable or receivable.

* **g** **Prepare** a Budgeted Balance Sheet for BHM Trading as at 31 August 2025.

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## Exercise 17.8

WB page 342

## Budgeted Cash Flow Statement Variance Report

Hair Apparent has provided the following partially complete report:

**HAIR APPARENT**

**Budgeted Cash Flow Statement Variance Report for June 2025**

| | Budget | Actual | Variance | F/U |
|---|---|---|---|---|
| **CASH FLOWS FROM OPERATING ACTIVITIES** | | | | |
| Cash sales | 8 970 | 9 500 | | |
| GST received | 897 | 950 | | |
| **Total Operating Cash Inflows** | **9 867** | **10 450** | | |
| Cash purchase of inventory | (3 500) | (4 900) | | |
| Advertising | (800) | (950) | | |
| Wages | (1 700) | (2 300) | | |
| Interest on loan | (100) | (120) | | |
| GST paid | (430) | (825) | | |
| **Total Operating Cash Outflows** | **6 530** | **9 095** | | |
| **Net Cash Flows from Operations** | **3 337** | **1 355** | | |
| **CASH FLOWS FROM INVESTING ACTIVITIES** | | | | |
| Cash register | – | (2 400) | | |
| **Net Cash Flows from Investing activities** | – | **(2 400)** | | |
| **CASH FLOWS FROM FINANCING ACTIVITIES** | | | | |
| Capital contribution | – | 2 000 | | |
| Loan principal | (700) | (500) | | |
| Drawings | (1 420) | (1 200) | | |
| **Net Cash Flows from Financing activities** | **(2 120)** | **300** | | |
| **Net increase (decrease) in cash** | **1 217** | **(745)** | | |
| **Add Bank Balance at start (1 June 2025)** | **360** | **360** | | |
| **Bank Balance at end (30 June 2025)** | **1 577** | **(385)** | | |

The proprietor, Sophie, had organised an overdraft limit with the bank of $1 000.

### *Required*

**a** **Complete** the Budgeted Cash Flow Statement Variance Report for Hair Apparent for June 2025.

**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 Budgeted Cash Flow Statement Variance Report can be used to assist decision-making.

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## Exercise 17.9
## Budgeted Cash Flow Statement Variance Report

WB page 344

Huntingdale Plumbing Supplies has provided the following partially complete report:

**HUNTINGDALE PLUMBING SUPPLIES**
**Budgeted Cash Flow Statement Variance Report (extract) for March 2025**

| | 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 Operations** | | | | |
| **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 2025)** | **(5 600)** | **(5 600)** | | |
| **Bank Balance at end (31 March 2025)** | | | | |

### *Required*

**a** **Complete** the Budgeted Cash Flow Statement Variance Report for Huntingdale Plumbing Supplies for March 2025.

**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 2025 that will differ as a consequence of the variances in the Budgeted Cash Flow Statement Variance Report. **Justify** your answer.

**d** **Explain** how a Budgeted Cash Flow Statement Variance Report can be used to assist planning.

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## Exercise 17.10

## Income Statement Variance Report

WB page 346

Easy Motors has provided the following partially complete report:

**EASY MOTORS**

**Income Statement Variance Report for December 2025**

| | 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** | **12 100** | | |
| **Add Other revenue** | | | | |
| Discount revenue | 350 | 400 | | |
| | **11 750** | **12 500** | | |
| **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** | **4 160** | | |

*Required*

**a** **Complete** the Income Statement Variance Report for Easy Motors for December 2025.

**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 2025 were helpful in earning profit.

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## Exercise 17.11

WB page 348

## Income Statement Variance Report

Hutchesson Sports has provided the following partially complete report:

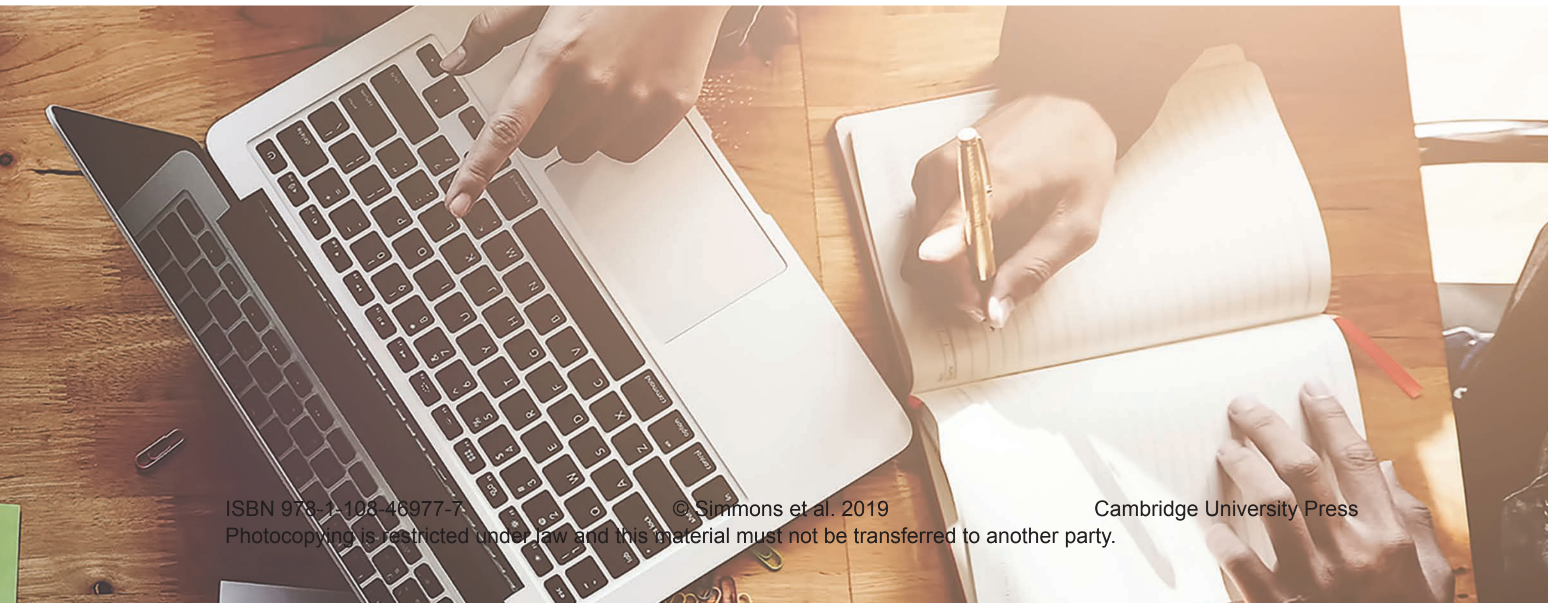
**HUTCHESSON SPORTS**
**Income Statement Variance Report for April 2025**

| | 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 2025, the business started purchasing inventory from a cheaper supplier.

*Required*

- **a** **Complete** the Income Statement Variance Report for Hutchesson Sports for April 2025.
- **b** **Identify** one item that has varied favourably and one item that has varied unfavourable 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

## Where are we headed?

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:

- analysing
- interpreting
- efficiency
- trend
- benchmark
- financial indicator
- gearing
- expense control
- vertical analysis
- Quick Asset Ratio (QAR).


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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.

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.

**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

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. This would include an assessment of Inventory Turnover, Accounts Receivable Turnover and Accounts Payable Turnover, covered in Chapters 12 and 15.)


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## Tools for assessing performance

There are various tools available to assess performance, including:

- trends
- variances
- benchmarks
- financial indicators.

### Trends

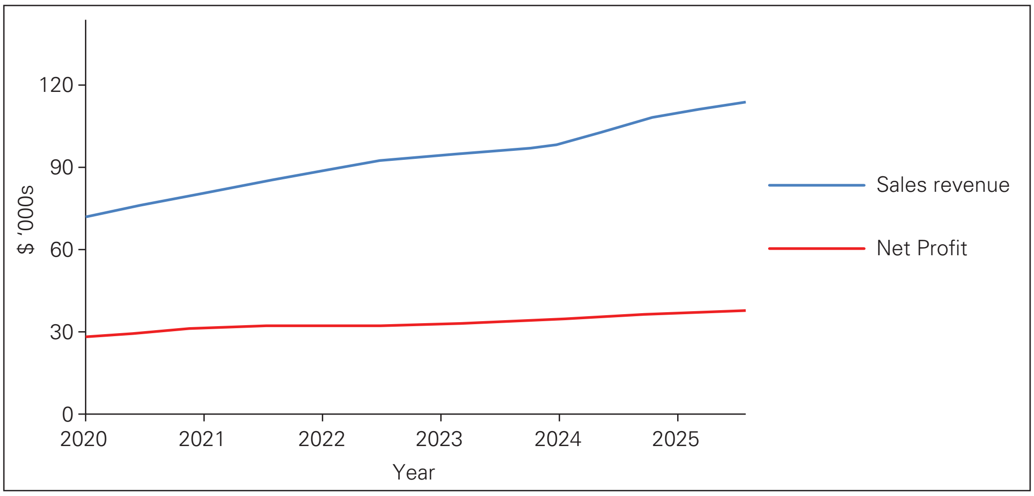
**trend**
the pattern formed by changes in an item over a number of periods

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.

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 2020 to 2025:

**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 don't 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

**benchmark**
an acceptable standard against which the firm's actual performance can be assessed

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

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(sometimes known as a yardstick). 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.

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*.

## Financial indicators

In addition to the tools outlined above, 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.

**financial indicator**
a measure that expresses business performance in terms of the relationship between two different elements of that performance

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.

**Study tip**

Strictly speaking, Asset Turnover is an efficiency indicator, but its significance for profitability means it is part of our discussion here.

A similar approach can be used to assess liquidity, by measuring the funds available to meet short-term debts and comparing it against the level of debts which must be met. Liquidity indicators include:

- Working Capital Ratio (WCR)
- Quick Asset Ratio (QAR)
- Cash Flow Cover Ratio.

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.

*continued*

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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 which can be used to assess profitability.
8 **List** the indicators which can be used to assess liquidity.
9 **Explain** how turnover indicators affect liquidity.

## 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.

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## 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

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

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 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 2024 | $234 000 |
| Capital – 30 June 2025 | $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

$$\textbf{ROI} = \frac{\$33\,600}{(\$234\,000 + \$246\,000)/2} \times 100$$

$$= \frac{\$33\,600}{\$240\,000} \times 100$$

$$= 14\%$$

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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
- the dividend 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

**gearing**
the extent to which the business relies on borrowed funds to finance the purchase of its assets

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:

**Figure 18.5** Formula: Debt Ratio

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

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.

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Example

| | Hilda's Hardware | Steve's Supplies |
|---|---|---|
| Net Profit | $25 000 | $25 000 |
| Total Liabilities | $75 000 | $120 000 |
| Owner's equity | $125 000 | $80 000 |
| Total Assets | $200 000 | $200 000 |
| 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 to 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.

## 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.

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## 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

$$\textbf{Return on Assets (ROA)} = \frac{\textbf{Net Profit}}{\textbf{Average Total Assets}} \times 100$$

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 2025:

| | |
|---|---|
| Net Profit | $21 600 |
| Total Assets – 1 January 2025 | $175 000 |
| Total Assets – 31 December 2025 | $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.

### 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 size – 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.

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### 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.

## 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.

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## 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 return

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 2025:

| | |
|---|---|
| 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, Sales revenue was 2.7 times the size of assets.

### Assessing Asset Turnover

Just like Return on Assets, Asset Turnover expresses an element of profitability (in this case, Sales revenue) relative to assets, 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.)

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### 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.

**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 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

### 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 Sales revenue is retained as Net Profit (and thus – by extension – how much was consumed by expenses).

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**Example**

Kris Toyland has provided the following information for 2025:

| | |
|---|---|
| Sales revenue | $155 000 |
| Sales returns | $5 000 |
| Net Profit | $24 000 |

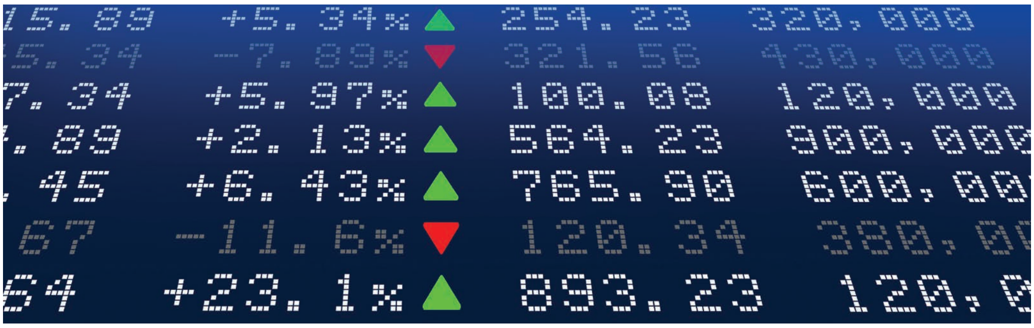
The Net Profit Margin would be calculated as is shown in Figure 18.11:

**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 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 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.

## 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.

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## 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

$$\textbf{Gross Profit Margin (GPM)} = \frac{\textbf{Gross Profit}}{\textbf{Net Sales}} \times \textbf{100}$$

**Example**

Geelong Car Sound has provided the following information for 2025:

| | |
|---|---|
| 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% |

The Gross Profit Margin would be calculated as is shown in Figure 18.13:

**Figure 18.13** Calculation: Gross Profit Margin

$$\textbf{GPM} = \frac{\$84\,000}{\$210\,000} \times 100$$

$$= 40\%$$

A Gross Profit Margin of 40% means that for every dollar of 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.

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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. 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 2025 is shown in Figure 18.14:

**Figure 18.14** Income Statement: Vertical analysis

**GEELONG CAR SOUND**

**Income Statement for 2025**

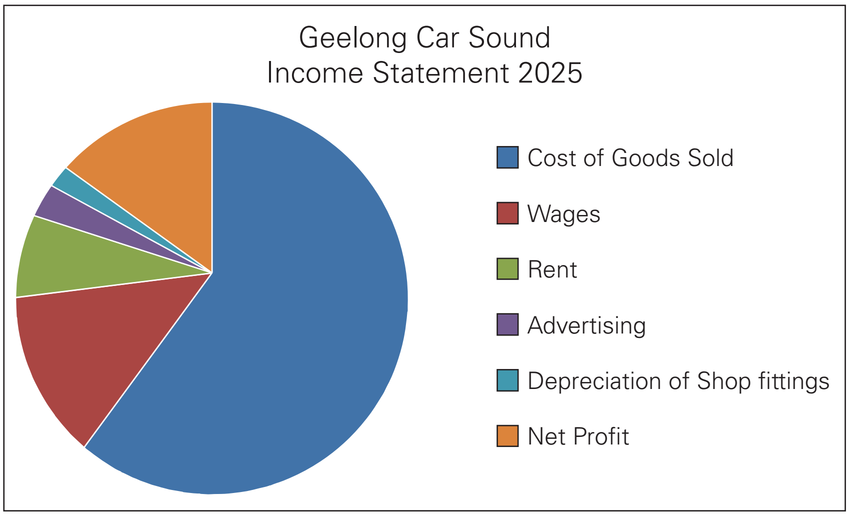
| 2025 | $ | % |
|---|---|---|
| Sales | 210 000 | 100 |
| Cost of Goods Sold | 126 000 | 60 |
| **Gross Profit** | **84 000** | 40 |
| **Less Other expenses** | | |
| Wages | 27 300 | 13 |
| Rent | 14 700 | 7 |
| Advertising | 6 300 | 3 |
| Depreciation of Shop fittings | 4 200 | 2 |
| **Net Profit** | **31 500** | 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 2025:

**Figure 18.15** Vertical analysis: pie chart




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.

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### Assessing the vertical analysis

The great benefit of preparing a vertical analysis is that we can see changes not just in expense amounts, but changes 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 credit facilities or a loan for their purchase
- defer loan repayments
- reduce cash drawings


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- 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.

## 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.

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## 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

$$\textbf{Working Capital Ratio (WCR)} = \frac{\textbf{Current Assets}}{\textbf{Current Liabilities}}$$

**Example**

**HOLDEN PLASTICS**
**Balance Sheet (extract) as at 30 June 2025**

| Current Assets | $ | Current Liabilities | $ |
|---|---|---|---|
| Bank | 4 000 | Accounts Payable | 26 000 |
| Accounts Receivable | 9 000 | Loan – GV Bank | 18 000 |
| Inventory | 45 000 | Accrued Wages | 5 000 |
| Prepaid Rent expense | 2 000 | GST payable | 1 000 |
| **Total Current Assets** | **60 000** | **Total Current Liabilities** | **50 000** |

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

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- 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 excessive 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* may not be able to be liquidated at all, especially if the business has entered into a written contract with the supplier.

On the other side of the equation, it is unlikely that a *bank overdraft* will be called in (for repayment). In fact, if the overdraft is below the limit, it may actually represent a source of funds rather than a debt that must be met using current assets.

**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

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:

**Figure 18.18** Formula: Quick Asset Ratio

$$\textbf{Quick Asset Ratio (QAR)} = \frac{\textbf{Current assets (excluding inventory and prepaid expenses)}}{\textbf{Current Liabilities}}$$

**Example**

**PRIORITY PARTS**
**Balance Sheet (extract) as at 30 September 2025**

| Current Assets | $ | Current Liabilities | $ |
|---|---|---|---|
| Accounts Receivable | 10 000 | Bank overdraft | 5 000 |
| Inventory | 29 000 | Accounts Payable | 19 000 |
| Prepaid Rent expense | 4 000 | Accrued Wages | 6 000 |
| 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 |
|---|---|
| **WCR** = $\frac{\$45\,000}{\$30\,000}$ = 1.5 : 1 | **QAR** = $\frac{\$12\,000}{\$30\,000}$ = 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.

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### 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*.

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 around 1:1. So what does it mean if the two indicators provide conflicting information?

In Figure 18.17, 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 example above, 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 Quick Asset 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 Ratio. The formula for Cash Flow Cover Ratio is shown in Figure 18.20:

**Figure 18.20** Formula: Cash Flow Cover Ratio

$$\textbf{Cash Flow Cover} = \frac{\textbf{Net Cash Flow from Operating Activities}}{\textbf{Average Current Liabilities}}$$

**Example**

**HOLDEN PLASTICS**
**Balance Sheet (extract) as at 30 June 2025**

| Current Assets | $ | Current Liabilities | $ |
|---|---|---|---|
| Bank | 4000 | Accounts Payable | 26000 |
| Accounts Receivable | 9000 | Loan – GV Bank | 18000 |
| Inventory | 45000 | Accrued Wages | 5000 |
| Prepaid Rent expense | 2000 | GST payable | 1000 |
| **Total Current Assets** | **60000** | **Total Current Liabilities** | **50000** |

Additional Information: Current Liabilities as at 1 July 2024 were $40000 and the Net Cash Flow from Operating Activities for the year ended 30 June 2025 was $67 500.

The Cash Flow Cover Ratio would be calculated as is shown in Figure 18.21:

**Figure 18.21** Calculation: Cash Flow Cover Ratio

$$\textbf{Cash Flow Cover} = \frac{\text{Net Cash Flow from Operating Activities}}{\text{Average Current Liabilities}}$$

$$= \frac{\$67500}{((\$40000 + \$50000)/2)}$$

$$= \frac{\$67500}{\$45000}$$

$$= 1.5\text{ times}$$

A Cash Flow Cover Ratio of 1.5 times means that the business can pay (cover) every dollar of current liabilities one and a half times. 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.

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### 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
- 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 times 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 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 a lot of short-term debt with long-term finance.

#### Review questions 18.12

1. **State** what is measured by the Cash Flow Cover Ratio.
2. **Show** the formula to calculate the Cash Flow Cover Ratio.
3. **Explain** why the Cash Flow Cover Ratio should be greater than 1 time.
4. **Explain** two courses of action if the Cash Flow Cover Ratio is high.
5. **State** two actions the owner may be required to take if Cash Flow Cover Ratio is too low.

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## 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.

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.

**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.

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

$$\textbf{Inventory Turnover} = \frac{\textbf{Average Inventory}}{\textbf{Cost of Goods Sold}} \times 365$$

*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 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

$$\textbf{Accounts Receivable Turnover} = \frac{\textbf{Average Accounts Receivable}}{\textbf{Net Credit Sales (plus GST)}} \times 365$$

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*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

By 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

$$\textbf{Accounts Payable Turnover} = \frac{\textbf{Average Accounts Payable}}{\textbf{Net Credit Purchases (plus GST)}} \times 365$$

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.

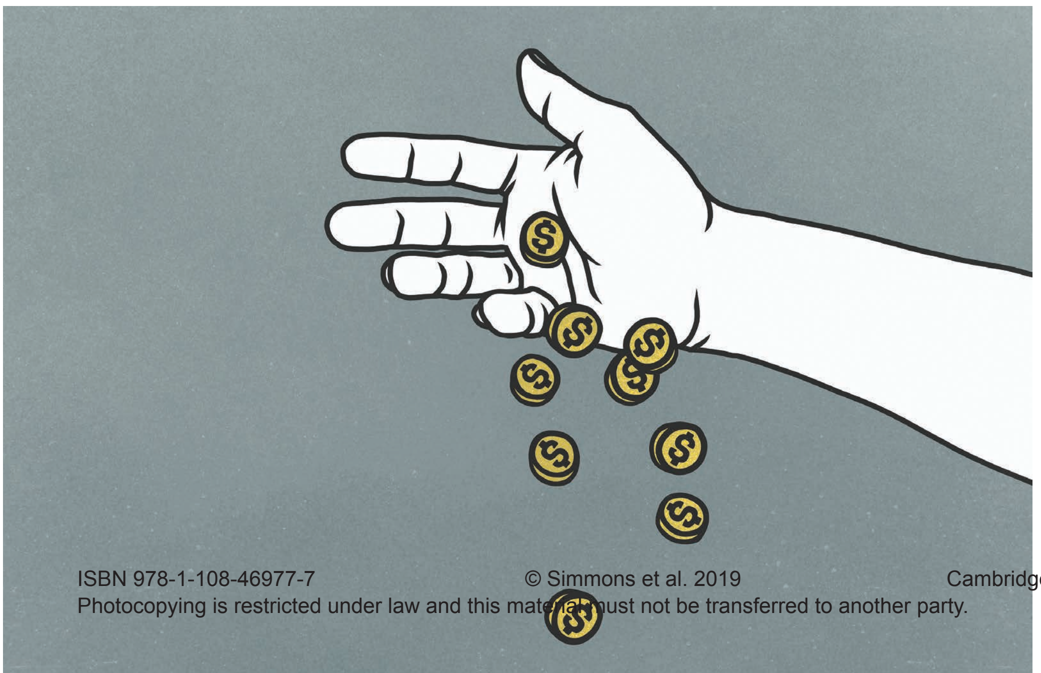

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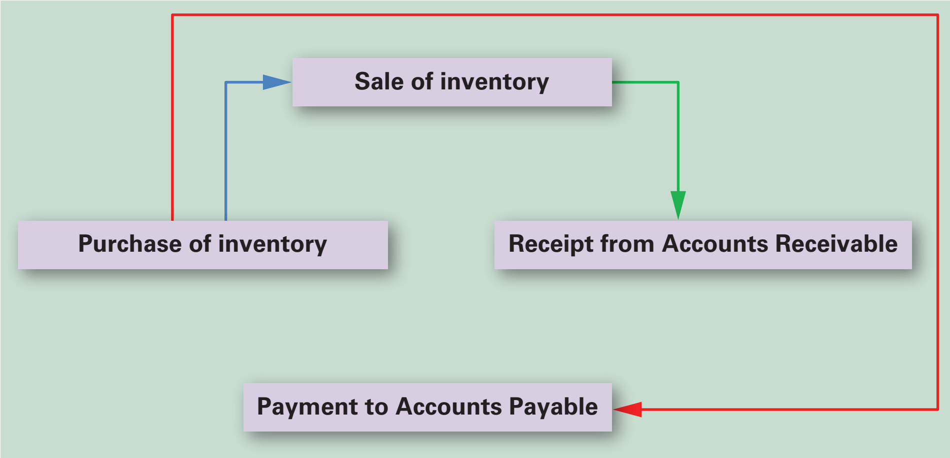
Figure 18.25 represents the relationship between these elements of the cash cycle:

**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.

## 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.

### 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.

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## 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 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.

## Exercises

### Exercise 18.1

WB page 351

### Profitability

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

WB page 352

### Return on Owner's Investment

Ceyda Sanli is the owner of Sandals and Saris, a beachwear shop in Apollo Bay. Ceyda has provided the following information relating to its performance:

| | 2025 | 2026 |
|---|---|---|
| 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 2026.
**b** Referring to your answer to part 'a', **explain** whether Ceyda should be satisfied with the firm's Return on Owner's Investment in 2026.
**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
W B page 353

### Return on Owner's Investment

Michael Gowland is the owner of Country House Furniture and has provided the following information relating to its performance over the past two years:

| | 2024 | 2025 |
|---|---|---|
| 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 2024 and 2025.
**b** **Explain** the cause(s) of the change in the Return on Owner's Investment from 2024 to 2025.
**c** **Explain** one reason why Michael should be concerned about the firm's profitability in 2025.

---

## Exercise 18.4
W B page 354

### Return on Owner's Investment and Return on Assets

Ferdinand Photography and Cara's Cameras both sell cameras and photographic equipment. The following information relates to their trading performance for 2025:

| | Ferdinand Photograph | 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 | 28% | 12% |

*Required*

**a** **Calculate** the Return on Assets for each firm for 2025.
**b** **Explain** one reason why the owner of Ferdinand Photography would be pleased with her firm's profitability in 2025.
**c** **Explain** one reason why the owner of Ferdinand Photography would be disappointed with her firm's profitability in 2025.
**d** **Explain** why a firm's Return on Owner's Investment will always be greater than its Return on Assets.

---

## Exercise 18.5
W B page 355

### Return on Owner's Investment and Return on Assets

G-Man and Chick Stuff are clothing boutiques in Armadale. The following information relates to their trading performance for 2024:

| | G-Man | Chick Stuff |
|---|---|---|
| Net Profit | $32 400 | $32 400 |
| Average Owner's equity | $180 000 | $80 000 |
| Average Total Assets | $240 000 | $240 000 |

*Required*

**a** **Calculate** the Return on Owner's Investment and Return on Assets for each business for 2024.
**b** **Identify** which business is the better investment. **Justify** your answer.
**c** **Calculate** the Debt Ratio for each business for 2024.
**d** **Discuss** the effects of a higher Debt Ratio.

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## Exercise 18.6

W B page 357

### Return on Assets and Asset Turnover

Zaheer Hussein owns The Game Golfer, which sells golf gear and clothing and has presented the following information relating to its performance for 2024 and 2025:

| | **2024** | **2025** |
|---|---|---|
| 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 2025 is evidence of improved profitability.

*Required*

**a** **Calculate** Asset Turnover for The Game Golfer for 2024 and 2025.
**b** **Explain** what is revealed by the change in Asset Turnover from 2024 to 2025.
**c** Using the information provided, **explain** whether expense control has improved or worsened in 2025.
**d** **Suggest** two strategies the owner could adopt to improve the Return on Assets without changing Asset Turnover.

## Exercise 18.7

W B page 358

### Asset Turnover and Net Profit Margin

Lowland Trailbikes has provided the following information relating to is performance for 2024:

| | **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

WB page 359

### Net Profit Margin

Christou Clocks has provided the following information about its trading performance for 2024 and 2025:

| | 2024 | 2025 |
|---|---|---|
| Sales | $150 000 | $160 000 |
| Sales return | $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 2024 and 2025.

**d** **Identify** two factors that support the claim that expense control improved in 2025. **Justify** your answer.

## Exercise 18.9

WB page 360

### Gross Profit Margin

Up There Trophies sells trophies and medals to sporting clubs and has provided the following information for 2024:

| | |
|---|---|
| Sales revenue | $163 500 |
| Sales return | $3 500 |
| Gross Profit | $72 000 |
| Net Profit | $88 000 |
| Budgeted Gross Profit Margin | 60% |

*Required*

**a** **Calculate** the Gross Profit Margin for 2025.

**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.

**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

WB page 361

### Vertical Analysis of the Income Statement

Wheelie Hot Wheels sells mag wheels and performance tyres and has provided the following information for the years ended 30 June 2024 and 2025:

**WHEELIE HOT WHEELS**

**Income Statement for the year ended 30 June**

| | 2024 | % | 2025 | % |
|---|---|---|---|---|
| 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 – Fittings | 4 500 | | 4 500 | |
| **Net Profit** | **$10 440** | | **$11 700** | |

*Required*

- **a** **Enter** the following information into a spreadsheet and **conduct** a vertical analysis.
- **b** Referring to your spreadsheet, **suggest** two reasons for the decrease in Sales revenue in 2025.
- **c** **State** whether overall expense control has improved or worsened in 2025. **Justify** your answer.
- **d** **Suggest** two possible reasons for the increase in the Gross Profit Margin in 2025.
- **e** **State** one reason why the owner should be concerned that Inventory loss is $1 800 in 2024 and 2025.
- **f** **Explain** why there has been no change in 'Depreciation – 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

WB page 362

### Liquidity

As at 1 July 2024, Harrington Hardware had $6 800 cash in the bank. By 30 June 2025, 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.

## Exercise 18.12

WB page 363

### Working Capital Ratio

Belle Formal Wear has provided the following information from its Balance Sheet as at 30 June 2024:

| | |
|---|---|
| Current assets | $67 500 |
| Current liabilities | $90 000 |

*Required*

- **a** **Calculate** the Working Capital Ratio for Belle Formal Wear as at 30 June 2024.
- **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.

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## Exercise 18.13

WB page 364

### Working Capital Ratio

Yackandandah Antiquities has provided the following information:

| | 2024 | 2025 |
|---|---|---|
| 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 2025.
**d** **Explain** how the Budgeted Cash Flow Statement could be used to assess liquidity.

## Exercise 18.14

WB page 365

### Working Capital Ratio, Quick Asset Ratio and Cash Flow Cover

Stoneham Sunglasses has provided the following extract from its Balance Sheet:

**STONEHAM SUNGLASSES**
**Balance Sheet (extract) as at 31 March 2025**

| Current Assets | $ | Current Liabilities | $ |
|---|---|---|---|
| Bank | 3 000 | Loan | 7 200 |
| Inventory | 27 000 | Accounts Payable | 19 800 |
| Accounts Receivable | 18 000 | Accrued Electricity | 600 |
| Prepaid Rent expense | 6 000 | GST payable | 2 400 |
| **Total Current Assets** | **54 000** | **Total Current Liabilities** | **30 000** |

The Working Capital Ratio of Stoneham Sunglasses as at 28 February 2025 was 2.5 : 1. Total Current Liabilities as at 1 April 2024 were $50 000. The Net Cash Flow from Operating activities for the year ended 31 March 2024 was $20 000.

*Required*

**a** **Calculate** the Working Capital Ratio for Stoneham Sunglasses as at 31 March 2025.
**b** **Calculate** the Quick Asset Ratio of Stoneham Sunglasses as at 31 March 2025.
**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 Assets.
**e** **Calculate** the Cash Flow Cover Ratio of Stoneham Sunglasses as at 31 March 2025.
**f** Referring to your answer to part 'e', **state** whether the Cash Flow Cover Ratio 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** **Explain** two courses of action necessary for Stoneham Sunglasses to improve its liquidity.

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## Exercise 18.15

W B page 367

### Working Capital Ratio, Quick Asset Ratio and Cash Flow Cover

Velocity Skates has provided the following extract from its Balance Sheet:

**VELOCITY SKATES**
**Balance Sheet (extract) as at 30 June 2024**

| 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 | 1 500 | 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 2023 were $55 000. The Net Cash Flow from Operating activities for the year ended 30 June 2024 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 2024.
- **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 Ratio of Velocity Skates as at 30 June 2024.
- **e** **State** two reasons why this firm may not have liquidity problems despite what is shown by its Quick Asset Ratio.

## Exercise 18.16

W B page 368

### Working Capital Ratio and Quick Asset Ratio

Atlas Weights has provided the following information:

| | 2024 | 2025 |
|---|---|---|
| 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

W B page 369

### Inventory Turnover

Bairnsdale Bricks sells bricks and pavers and has provided the following information for 2025:

| | |
|---|---|
| Cost of Goods Sold | $1 095 000 |
| Average Inventory | $120 000 |
| Budgeted Inventory Turnover | 35 days |

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*Required*

**a** **State** what is measured by Inventory Turnover.
**b** **Calculate** Inventory Turnover for Bairnsdale Bricks for 2025.
**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

W B page 370

### Accounts Receivable Turnover

Bubble On sells soaps, bath bombs and other toiletries, and has provided the following information relating to its activities for 2024:

| | |
|---|---|
| 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** Accounts Receivable Turnover for Bubble On for 2024.
**c** Referring to your answer to part 'b', **state** whether Accounts Receivable Turnover is satisfactory or unsatisfactory. **Justify** your answer.
**d** **Explain** why Bubble On may have liquidity problems in 2025.
**e** **State** two other pieces of information that may be useful in an assessment of the liquidity of Bubble On.

## Exercise 18.19

W B page 371

### Accounts Payable Turnover

Dewey Copiers sells photocopiers and fax machines and has provided the following information for the year ended 30 June 2025:

| | |
|---|---|
| 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 financial year.

*Required*

**a** **State** what is measured by Accounts Payable Turnover.
**b** **Calculate** Accounts Payable Turnover for Dewey Copiers for the year ended 30 June 2025.
**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.

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## Exercise 18.20

WB page 372

### Assessing performance

Bags of Bags sells luggage and other bags and has provided the following information relating to its activities for 2025 and 2026:

| | 2025 | 2026 |
|---|---|---|
| Return on Owner's Investment | 24% | 28% |
| Return on Assets | 16% | 15% |
| Asset Turnover | 0.75 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 2026.

**c** **Identify** two factors that suggest the firm's expense control worsened in 2026.

**d** **Explain** why a trading firm should buy its inventory on credit.

**e** **Suggest** one reason why the Accounts Payable Turnover has improved in 2026. **Justify** your answer.

**f** Referring to one other liquidity indicator, **explain** how this business could avoid liquidity problems without raising further external finance in 2026.

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# Glossary

**Accounting [p. 3]**
the collecting and recording of financial data to produce and report financial information to assist business owners in decision-making

**Accounting assumptions [p. 8]**
the generally accepted rules that govern the way Accounting information is recorded

**Accounting entity assumption [p. 8]**
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. 66]**
a supplier who is owed a debt by the business for goods or services purchased from them on credit

**Accounts Payable record [p. 308]**
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. 309]**
a listing of the name and balance of each Accounts Payable record

**Accounts Payable Turnover (APTO) [p. 367]**
an efficiency indicator that measures the average number of days it takes for a business to pay its Accounts Payable

**Account Receivable [p. 195]**
a customer who owes a debt to the business for goods or services sold to them on credit

**Accounts Receivable record [p. 333]**
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. 334]**
a listing of the name and balance of each Accounts Receivable record

**Accounts Receivable Turnover (ARTO) [p. 370]**
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. 357]**
calculating profit by comparing revenue earned against expenses incurred in a particular reporting period

**Accrual basis assumption [p. 9]**
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. 391]**
the value of a non-current asset that has been consumed over its life so far

**Adjusted Gross Profit [p. 283]**
Gross Profit less Inventory loss (or plus Inventory gain)

**advice [p. 7]**
the provision to the owner of a range of options appropriate to their aims/objectives, and recommendations as to their suitability

**analysing [p. 441]**
examining the financial reports in detail to identify changes or differences in performance

**asset [p. 16]**
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. 386]**
a document that shows the assets that a business owns

**Asset Turnover (ATO) [p. 397]**
an efficiency indicator that assesses how productively a business has used its assets to earn revenue

**Australian Business Number (ABN) [p. 40]**
a unique 11 digit number used to identify a business

**bad debt [p. 340]**
an expense incurred when a debt is written off because it is deemed to be irrecoverable

**Balance Sheet [p. 19]**
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. 66]**
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. 163]**
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 Statement [p. 164]**
an Accounting report that attempts to explain the difference between the bank balance determined in the firm's records and the bank balance reported on the Bank Statement

**Bank Statement [p. 116]**
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

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**benchmark [p. 442]**
an acceptable standard against which the firm's actual performance can be assessed

**bond [p. 50]**
a mechanism used by governments to raise funds from the general public in return for a fixed interest rate

**break-even point [p. 88]**
the level of sales where total revenue equals total expenses and the business makes neither a profit nor a loss

**Budgeted Balance Sheet [p. 423]**
an Accounting report that predicts assets, liabilities and owner's equity at the end of the budget period

**Budgeted Cash Flow Statement [p. 412]**
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 Cash Flow Statement Variance Report [p. 426]**
an Accounting report that compares actual and budgeted cash flows, highlighting variances so that problems can be identified and corrective action taken

**Budgeted Income Statement [p. 419]**
an Accounting report that predicts revenue earned and expenses incurred, and thus the expected Net Profit for the budget period

**budgeting [p. 409]**
the process of predicting/estimating the financial consequences of future events

**capital contribution [p. 65]**
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. 49]**
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. 54]**
a form of taxation charged when a gain is made on the sale of an asset

**capital loss [p. 56]**
the loss incurred when an asset is sold at a price less than its initial purchase price

**Carrying value [p. 392]**
the value of a non-current asset that is yet to be consumed/allocated as an expense, plus any Residual value

**cash control [p. 160]**
the procedures and strategies used to protect the firm's cash

**cash deficit [p. 138]**
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. 145]**
a liquidity indicator that assesses the ability of the business's Operating Cash flow to meet its short-term debts as they fall due

**Cash Flow Statement [p. 140]**
an Accounting report that reports all cash flows during a reporting period, classified as Operating, Investing and Financing activities

**Cash Payments Journal [p. 135]**
an Accounting record that classifies and summarises all cash paid to other entities during a particular reporting period

**cash receipt (1) [p. 109]**
a source document used to verify cash received

**cash receipt (2) [p. 109]**
a transaction that occurs when cash is received from another entity

**Cash Receipts Journal [p. 132]**
an Accounting record that classifies and summarises all cash received from other entities during a particular reporting period

**cash surplus [p. 138]**
an excess of cash receipts over cash payments, leading to an increase in a positive bank balance or decrease in a bank overdraft

**cheque butt [p. 114]**
a source document used to verify cash payments

**classifying/classification [p. 20]**
grouping together items that have some common characteristic

**Comparability [p. 11]**
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. 84]**
prices charged by businesses competing in the same market

**contribution margin [p. 89]**
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. 282]**
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. 243]**
the expense incurred when inventory flows out of the business due to a sale

**cost price [p. 39]**
the original purchase price of inventory

**cost-volume-profit analysis [p. 88]**
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. 200]**
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. 117]**
a document that evidences that there is a reduction in the amount owed by a customer

**credit purchase [p. 196]**
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. 327]**
the provision of inventory to a customer who is not required to pay until a later date

**credit terms [p. 301]**
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. 193]**
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. 20]**
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. 20]**
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

**debenture [p. 50]**
a mechanism used by companies to raise funds from the general public in return for a fixed interest rate

**Debt Ratio [p. 25]**
measures the proportion of the firm's assets that are funded by external sources

**delivery docket [p. 120]**
a document used to verify that the goods received are the goods ordered

**deposit not yet credited [p. 163]**
a cash deposit that is yet to appear on the Bank Statement (usually due to the timing of its preparation)

**depreciable asset [p. 388]**
a non-current asset that has a finite life, and thus must be depreciated over that life

**depreciable value [p. 390]**
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. 388]**
the allocation of the cost of a non-current asset over its Useful life

**depreciation expense [p. 388]**
that part of the cost of a non-current asset that has been consumed in the current reporting period

**direct credit [p. 163]**
a deposit of cash directly into a bank account

**direct debit [p. 163]**
a withdrawal of cash directly from a bank account

**discount expense [p. 337]**
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. 312]**
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

**dishonoured cheque [p. 163]**
a cheque that cannot be honoured/exchanged for cash because there are insufficient funds in the account of the drawer to allow the payment to be made

**dividend [p. 55]**
a share of the profit earned by a company that is distributed to shareholders

**drawee [p. 113]**
the financial institution or bank of the drawer

**drawer [p. 113]**
the entity writing the cheque

**efficiency [p. 441]**
the ability of the business to manage its assets and liabilities

**EFTPOS [p. 109]**
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. 18]**
claims on the assets of the firm, consisting of both liabilities and owner's equity

**ethical considerations [p. 5]**
the social and environmental consequences of a financial decision

**expense [p. 213]**
a decrease in assets (or increase in liabilities) that reduces owner's equity (except for Drawings)

**expense control [p. 451]**
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. 66]**
funds generated from sources outside the business

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**fair value [p. 385]**
the price received when selling an asset if it was sold at the time it was acquired by the business

**Faithful representation [p. 10]**
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. 4]**
raw facts and figures upon which financial information is based

**financial indicator [p. 443]**
a measure that expresses business performance in terms of the relationship between two different elements of that performance

**financial information [p. 4]**
financial data that has been sorted, classified and summarised into a more usable and understandable form

**Financing activities [p. 140]**
cash flows related to changes in the financial structure of the firm

**finite life [p. 388]**
the limited period of time (usually measured in years) for which a non-current asset will exist

**First In, First Out (FIFO) [p. 254]**
the assumption that the inventory that is purchased first will be sold first

**fixed costs [p. 88]**
costs that do not vary with the level of activity

**franchise [p. 45]**
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. 45]**
the entity that purchases the right to operate under the franchise agreement

**franchisor [p. 45]**
the entity that holds (and sells to the franchisee) the rights to operate under the franchise agreement

**franking credit [p. 55]**
dividend income received by the investor on which the company has already paid tax

**gearing [p. 446]**
the extent to which the business relies on borrowed funds to finance the purchase of its assets

**Going concern assumption [p. 8]**
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. 108]**
a 10% tax levied by the federal government on sales of goods and services

**goodwill [p. 44]**
an intangible asset representing the value of the firm's reputation, clientele, viability and future growth prospects

**Gross Profit [p. 242]**
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. 285]**
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. 143]**
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. 144]**
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. 144]**
a cash receipt from the ATO to clear GST receivable (operating inflow)

**GST settlement [p. 143]**
a payment made to the ATO by a small business to settle GST payable (operating outflow)

**Historical cost [p. 385]**
the cost of the asset when purchased

**Identified Cost (IC) [p. 254]**
the actual cost price of the inventory that is purchased and sold is identified and recorded

**Income Statement [p. 215]**
an Accounting report that details the revenue earned and expenses incurred during the reporting period

**Income Statement Variance Report [p. 427]**
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. 49]**
a return generated from an investment in the form of ongoing income such as interest, rent or dividends

**indicator [p. 24]**
a measure that expresses profitability, liquidity or stability in terms of the relationship between two different elements of performance

**intangible assets [p. 384]**
assets that do not have a physical form

**interest-only loan [p. 68]**
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. 159]**
the procedures and strategies used to protect the firm's assets from theft, damage and misuse

**internal finance [p. 65]**
funds generated by and within the firm

**interpreting [p. 441]**
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. 239]**
goods purchased by a trading firm for the purpose of resale at a profit

**inventory card [p. 242]**
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. 258]**
a revenue that occurs when the physical count shows more inventory on hand than is shown in the inventory card

**inventory loss [p. 257]**
an expense that occurs when the physical count shows less inventory than is shown on the inventory cards

**inventory sheet [p. 287]**
a listing of the quantity and value of each line of inventory on hand

**Inventory Turnover [p. 288]**
an efficiency indicator that measures the average number of days it takes for a business to convert its inventory into sales

**Investing activities [p. 140]**
cash flows related to the purchase and sale of non-current assets

**invoice [p. 117]**
a source document used to verify credit transactions

**journal [p. 131]**
an Accounting record that classifies and summarises transactions during a particular reporting period

**lease [p. 67]**
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. 67]**
the entity that is leasing the non-current asset

**lessor [p. 67]**
the entity that provides the non-current asset for lease

**liability [p. 17]**
a present obligation of the entity (as a result of past events) to transfer an economic resource

**limited liability [p. 42]**
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. 24]**
the ability of the business to meet its short-term debts as they fall due

**managed property fund [p. 54]**
an investment option that pools the resources of a number of investors to purchase property

**managed share fund [p. 56]**
an investment option that pools the resources of a number of investors to purchase shares in a variety of companies

**mark-up [p. 87]**
determining selling prices by adding to the cost price a predetermined profit margin

**market reaction [p. 84]**
the response of customers in a particular marketplace to price levels for a particular good or service

**market value [p. 385]**
the price an asset can be sold for

**memo [p. 122]**
a source document used to verify internal transactions

**minimum desired profit [p. 83]**
a lowest acceptable profit figure, usually similar to previous income plus a return on the amount invested

**mortgage [p. 67]**
a loan that is secured against property

**negative gearing [p. 53]**
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. 227]**
a profitability indicator that assesses expense control by calculating the percentage of Sales revenue that is retained as Net Profit

**Net Sales [p. 282]**
Total Sales less Sales Returns

**non-current asset [p. 20]**
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. 20]**
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. 4]**
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

**not negotiable [p. 113]**
a control mechanism that ensures that the cheque can only be deposited into the account of the nominated payee

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**Operating activities [p. 140]**
cash flows related to day-to-day trading activities

**owner's equity [p. 17]**
the residual interest in the assets of the entity after the liabilities are deducted

**partnership [p. 41]**
a business owned by two or more persons in business together with a view to making a profit

**payee [p. 113]**
the entity that is receiving the cheque or to whom the cheque is written

**Period assumption [p. 9]**
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. 242]**
system of Accounting for inventory that involves the continuous recording of inventory movements in inventory cards

**physical count [p. 257]**
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. 68]**
a loan that requires the borrower to make regular repayments of both the principal and interest over the life of the loan

**profitability [p. 227]**
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. 42]**
a business that exists as a separate legal entity that is entitled to do business in its own right

**prospectus [p. 50]**
a document that provides information about a financial product to assist the investor to make an informed decision

**purchase invoice [p. 194]**
a source document that verifies a credit purchase (usually of inventory)

**purchases [p. 242]**
the inventory bought by a trading firm for the purposes of resale

**Purchases Journal [p. 196]**
an Accounting record that summarises all transactions involving the purchase of materials or supplies on credit

**Qualitative characteristics [p. 10]**
the qualities of the information in Accounting reports

**Quick Asset Ratio (QAR) [p. 460]**
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. 85]**
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

**rate of return [p. 56]**
the percentage of the amount invested that is returned to the owner in the form of income or capital gains

**recommended retail price (RRP) [p. 84]**
a selling price that is recommended by the manufacturer or wholesaler

**recording [p. 7]**
sorting, classifying and summarising the information contained in the source documents so that it is more usable

**reducing balance interest [p. 71]**
interest calculated as a percentage of the current balance owing on the loan

**Relevance [p. 10]**
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. 7]**
the preparation of financial statements that communicate financial information to the owner

**retained earnings [p. 65]**
an internal source of finance consisting of funds generated from business profits that are not taken as drawings by the owner

**Return on Assets (ROA) [p. 398]**
a profitability indicator that assesses how effectively a business has used its assets to earn profit

**Return on Owner's Investment (ROI) [p. 75]**
a profitability indicator that measures how effectively a business has used the owner's capital to earn profit

**revenue [p. 212]**
an increase in assets or reduction in liabilities that leads to an increase in owner's equity (except for a Capital contribution)

**sales [p. 242]**
the revenue earned by a trading firm from the sale of inventory

**sales invoice [p. 194]**
a source document that verifies a credit sale of inventory

**Sales Journal [p. 200]**
an Accounting record that summarises all transactions involving the sale/performing of services on credit during a reporting period

**security/collateral [p. 50]**
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

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**service business [p. 130]**
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. 312]**
a reduction in the amount paid by a credit customer in return for early repayment

**share [p. 55]**
a document that verifies part-ownership in a public company

**shipping and order confirmation [p. 121]**
a document that indicates that an order has been dispatched (sent) and can be expected at some point

**simple interest [p. 70]**
interest calculated as a percentage of the original amount borrowed

**single-entry Accounting [p. 131]**
the process of recording transactions in journals and then using the summarised information to prepare reports

**small business [p. 34]**
a business in which the owner and manager is the same person, and which employs fewer than 20 people

**sole proprietorship [p. 40]**
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. 6]**
documents that provide both the evidence that a transaction has occurred and the details of the transaction itself

**stability [p. 25]**
the ability of the business to meet its debts and continue its operations in the long term

**stakeholder [p. 3]**
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. 119]**
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. 131]**
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. 384]**
assets that have a physical form that can be touched or held

**tax invoice [p. 108]**
a source document that contains specific information required by the ATO to substantiate GST amounts

**term deposit [p. 50]**
an investment option that requires the investor to agree to invest for a specified length of time

**term loan [p. 67]**
a form of external finance provided by banks and other lenders for a specific purpose and repaid over time

**Timeliness [p. 11]**
financial information should be available to decision makers in time to be capable of influencing their decisions

**trade credit [p. 66]**
a form of external finance offered by some suppliers, which allows customers to purchase goods/services and pay at a later date

**trading firms [p. 239]**
a business that aims to generate profit by purchasing goods and then selling them at a higher price

**transaction [p. 6]**
an exchange of goods or services with another party for payment

**trend [p. 442]**
the pattern formed by changes in an item over a number of periods

**Understandability [p. 12]**
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. 40]**
the legal status of sole proprietorships and partnerships is that they are not recognised as separate legal entities, so the owner(s) is personally liable for the debts of the business

**unpresented cheque [p. 164]**
a cheque that has not yet been presented for payment by the payee

**variable costs [p. 88]**
costs that vary directly with the level of activity

**variance [p. 426]**
the difference between an actual figure and a budgeted figure, expressed as 'favourable' or 'unfavourable'

**variance report [p. 426]**
an Accounting report that compares actual and budgeted figures, highlighting variances so that problems can be identified and corrective action taken

**Verifiability [p. 11]**
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. 455]**
a report that expresses every item as a percentage of a base figure (in this case, Sales revenue)

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**vertical analysis of the Income Statement [p. 225]**
a representation of individual expenses as a percentage of revenue to allow for an assessment of their relative importance

**Working Capital Ratio (WCR) [p. 24]**
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

**yield [p. 52]**
the effective interest rate on an investment that pays compounding interest

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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 = $139 000 |
| 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 Receipts Journal = $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 = $9 975 |
| | e | Bank balance = $8 045 |
| 7.6 | a | Cash Receipts Journal = $4 001 Cash Payments Journal = $3 055 |
| | c | Bank balance = $4 446 |
| 7.7 | f | Cash Receipts Journal = $4 136 Cash Payments Journal = $3 577 |
| | g | Bank balance = $1 400 |

## Chapter 8

| | | |
|---|---|---|
| 8.1 | a | Cash Receipts Journal = $2 582 Cash Payments Journal = $3 498 |
| | b/d | Bank balance = $319 |
| 8.2 | b | Cash Receipts Journal = $3 950 Cash Payments Journal = $2 005 |
| | c/d | Bank balance = $3 195 |
| 8.3 | a | Cash Receipts Journal = $3 200 Cash Payments Journal = $3 995 |
| | b/c | Bank balance = ($595) |
| 8.4 | a/b | Bank balance = ($380) |
| 8.5 | b | Cash Receipts Journal = $6 780 Cash Payments Journal = $5 455 |
| | c/d | Bank balance = $4 715 |
| 8.6 | a | Cash Receipts Journal = $15 620 Cash Payments Journal = $10 540 |
| | b/c | Bank balance = $2 080 |
| 8.7 | b | Cash Receipts Journal = $3 435 Cash Payments Journal = $3 175 |
| | d/e | Bank balance = ($290) |
| 8.8 | d/e | Bank balance = $450 |
| 8.9 | c/e | Bank balance = $705 |
| 8.10 | a | Cash Receipts Journal = $3 845 Cash Payments Journal = $4 410 |
| | b/c | Bank balance = ($895) |
| 8.11 | b | Cash Receipts Journal = $2 511 Cash Payments Journal = $3 024 |
| | c/d | Bank balance = ($393) |
| 8.12 | c | Cash Receipts Journal = $2 830 Cash Payments Journal = $3 605 |
| | d/e | Bank balance = ($1 130) |

## Chapter 9

| | | |
|---|---|---|
| 9.2 | b | Purchases Journal = $14 850 |
| 9.3 | a | Purchases Journal = $1 925 Cash Payments Journal = $ 6 980 |
| | c | Accounts Payable balance = $2 905 |

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| | | |
|---|---|---|
| 9.4 | a | Purchases Journal = $21 725<br>Cash Payments Journal = $ 36 394 |
| | b | Accounts Payable balance = $22 150 |
| 9.6 | b | Sales Journal = $2 607 |
| 9.7 | c | Sales Journal = $8 459<br>Cash Receipts Journal = $17 480 |
| | d | Accounts Receivable balance = $7 419 |
| 9.8 | a | Purchases Journal = $9 053<br>Sales Journal = $7 524<br>Cash Receipts Journal = $8 216<br>Cash Payments Journal = $8 759 |
| | b | Accounts Payable balance = $8 503<br>Accounts Receivable balance = $5 091 |

## Chapter 10

| | | |
|---|---|---|
| 10.2 | a | Bank at end = $1 993 |
| | b | cost of materials used = $2 850 |
| | c | net profit = $1 830 |
| | e | 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 = $(2 190) |
| | c | Net loss = $350 |
| | e | Total assets = $87 210 |
| 10.7 | d | Bank at end = $10 057 |
| | 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<br>Net profit = $7 000 |
| | c | Owner's equity = $44 500 |
| 12.4 | a | Net profit = $26 400 |
| | c | Owner's equity = $69 000 |
| 12.5 | a | Bank at end = ($10 300)<br>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<br>Cash Payments Journal = $10 240 |
| 13.4 | a | Purchase Journal = $32 010<br>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<br>Cash Receipts Journal = $17 990 |
| 14.4 | c | Sales Journal = $31 240<br>Cash Receipts Journal = $22 402 |
| 14.8 | a | Sales Journal = $4 400<br>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<br>Purchase Journal = $10 670<br>Cash Receipts Journal = $5 588<br>Cash Payments Journal = $8 794 |

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## 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 = $560 |
| | f | Total assets = $41 530 |
| 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 = $8 000 |
| | g | Total assets = $146 080 |
| 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 = $64 623 |
| 17.3 | d | Budgeted Bank at end (Oct)= $(7 789)<br>Budgeted Bank at end (Nov)= $(9 452)<br>Budgeted Bank at end (Dec)= $1 026 |
| 17.4 | a | Net Profit = $22 530 |
| 17.5 | b | Net loss = $6 148 |
| 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 = $1 763 |
| | c | Net loss = $5 049 |
| | g | Total assets = $172 153 |

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