

ACCG1001

Accounting and Governance

This unit focuses on the role of accounting in governance and accountability. The link between accounting and governance is discussed through the concepts of measurement, valuation, conceptual framework, reporting and communication of financial and non-financial information.

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Each chapter gives the idea first, then the entry or the calculation, then the mistakes that are easy to make. Worked examples are stepped through in full; cover the working and attempt them before reading on.

PART ONE

Foundations

What accounting is, how its machinery works, and why a society bothers to regulate it. Nothing here can be skipped: the three chapters in this part supply the vocabulary and the mechanics that every later chapter assumes.

How accounting works

None of this is a lecture topic in ACCG1001, and all of it is assumed in every topic that follows. If you are coming in cold, this section is the one to get solid first — everything later is built out of it.

What accounting is for

Accounting is the language of business. Its primary function is to **provide financial information for decision making**. Who is deciding splits the discipline in two:

- **Financial accounting** provides information to assist *external* users' decision making — shareholders, banks, suppliers, the ATO.
- **Management accounting** provides information for decision making *within* the business — managers, production supervisors, directors.

This unit is almost entirely financial accounting.

The four financial statements

STATEMENT	ANSWERS	COVERS
Statement of profit or loss <i>income statement</i>	Did we make money?	A period — a month, a year
Statement of financial position <i>balance sheet</i>	What do we own and owe?	A single instant — "as at 30 June"
Statement of changes in equity	How did the owners' stake move?	A period
Statement of cash flows	Where did the cash go?	A period

Notice that profit and cash are different questions, answered by different statements. A business can be profitable and still run out of cash — that gap is the reason receivables management, inventory turnover and working capital all matter later.

The accounting equation

THE EQUATION EVERYTHING RESTS ON

$$\text{Assets} = \text{Liabilities} + \text{Equity}$$

What the business controls equals what it owes to outsiders plus what it owes to its owners. Rearranged: **Equity = Assets – Liabilities**, which is why equity is called the *residual* interest — owners get whatever is left after creditors are paid.

Expanded to include the period's trading:

$$\text{Assets} = \text{Liabilities} + \text{Share capital} + \text{Retained earnings} + \text{Income} - \text{Expenses} - \text{Dividends/Drawings}$$

Every transaction keeps this equation in balance. That is not a coincidence or a check performed afterwards — it is built into how transactions are recorded, which is the next idea.

Debits and credits

Every transaction affects at least two accounts, and the amounts recorded on the left must equal the amounts recorded on the right. Left is **debit** (Dr), right is **credit** (Cr). That is all the words mean. Debit does not mean increase, decrease, good or bad — it means *left*.

Which side increases an account depends on which side of the equation it sits:

ELEMENT	INCREASES ON	DECREASES ON	NORMAL BALANCE
Asset	Debit	Credit	Debit
Expense	Debit	Credit	Debit
Drawings / Dividends	Debit	Credit	Debit
Liability	Credit	Debit	Credit
Equity	Credit	Debit	Credit
Income / Revenue	Credit	Debit	Credit

IN PLAIN TERMS

Assets sit on the left of the equation, so they grow on the left — debit. Liabilities and equity sit on the right, so they grow on the right — credit. Expenses reduce equity, so they behave *opposite* to equity: they grow with a debit. Income increases equity, so it grows with a credit. If you can remember which side of the equation something lives on, you can derive the whole table rather than memorise it.

A worked example. The business buys \$2,000 of inventory on credit:

Inventory <i>asset up, so debit</i>	2,000
Accounts Payable <i>liability up, so credit</i>	2,000

Assets rose \$2,000 and liabilities rose \$2,000. The equation still balances, and debits equal credits. Those two facts are the same fact.

Contra accounts

A **contra account** sits against a parent account and carries the opposite normal balance, so it reduces the parent without erasing it. You keep both numbers visible.

CONTRA ACCOUNT	SITS AGAINST	TYPE	NORMAL BALANCE
Allowance for Doubtful Debts	Accounts Receivable	Contra-asset	Credit
Accumulated Depreciation	The non-current asset	Contra-asset	Credit
Sales Returns and Allowances	Sales Revenue	Contra-revenue	Debit
Discount Allowed	Sales Revenue	Contra-revenue	Debit
Purchase Returns and Allowances	Purchases <i>periodic only</i>	Contra-expense	Credit

WHY BOTHER

You could just reduce Accounts Receivable directly. But then a reader could not see how much is owed versus how much you expect to lose. The contra account preserves both: "customers owe us \$91,960, of which we expect \$1,050 will never arrive." Two useful facts instead of one vague one. The same logic applies to Accumulated Depreciation — the balance sheet shows original cost *and* how much has been used up.

The accounting cycle

The sequence a business runs every reporting period:

- 1 **Analyse the transaction** — which accounts move, and in which direction?
- 2 **Journalise** — record it as a journal entry, debits first.
- 3 **Post to the ledger** — transfer each line to its own account.
- 4 **Prepare an unadjusted trial balance** — list every account balance and check total debits equal total credits.
- 5 **Journalise and post adjusting entries** — fix the cut-off, see below.

- 6 Prepare an adjusted trial balance.
- 7 Prepare the financial statements from the adjusted trial balance.
- 8 Journalise and post closing entries — reset income and expense accounts to zero.
- 9 Prepare a post-closing trial balance — only balance-sheet accounts should remain.

A **trial balance** proves that debits equal credits. It does not prove the accounts are right — an entry posted to the wrong account, or omitted entirely, still balances.

Adjusting entries

The problem adjusting entries solve: the period in which cash moves often does not match the period in which the income is earned or the expense incurred. Because of the **accounting period concept**, we cut a continuous business into artificial periods, and at the cut-off some items sit in the wrong one. On the last day of the period we adjust.

THE RULE THAT IDENTIFIES EVERY ADJUSTING ENTRY

Every adjusting entry hits **exactly one income-statement account and exactly one balance-sheet account**. Never two of the same kind, and never Cash — if cash had moved, you would already have recorded it.

TYPE	THE SITUATION	DEBIT	CREDIT
Prepaid expense	Cash paid in advance; now partly used up	Expense	Prepaid (asset)
Revenue received in advance <i>unearned revenue</i>	Cash received in advance; now partly earned	Unearned Revenue (liability)	Revenue
Accrued expense	Incurred, not yet paid or recorded	Expense	Payable (liability)
Accrued revenue	Earned, not yet received or recorded	Receivable (asset)	Revenue
Depreciation	A non-current asset partly used up	Depreciation Expense	Accumulated Depreciation
Bad debts	Some receivables will never be collected	Bad Debts Expense	Allowance for Doubtful Debts

Prepaid. On 1 January the business paid \$18,000 for a year's insurance and debited Prepaid Insurance. At 30 June, six months have been consumed.

30 Jun	Insurance Expense $18,000 \times 6/12$	9,000
	Prepaid Insurance	9,000

Revenue received in advance. A customer paid \$12,000 upfront for four months of service; one month has been delivered.

30 Jun	Revenue Received in Advance	3,000
	Service Revenue	3,000

Accrued expense. Staff earned \$5,200 in the last week of June, payable in July.

30 Jun	Salaries and Wages Expense	5,200
	Salaries and Wages Payable	5,200

Accrued revenue. \$2,750 of work was completed in June but has not been invoiced.

30 Jun	Accounts Receivable	2,750
	Service Revenue	2,750

THE SUPPLIES QUESTION, AND WHY PEOPLE GET IT WRONG

You bought \$6,500 of supplies and debited the asset. A count at period end shows \$2,300 still on the shelf. The expense is what you *used* — $\$6,500 - \$2,300 = \$4,200$.
Dr Office Supplies Expense 4,200 / Cr Office Supplies 4,200.

The wrong answer is \$2,300, which is what is *left*. The count tells you the closing asset; the expense is the difference. The same shape appears in periodic inventory later, where the stocktake gives you closing inventory and cost of sales is the balancing figure.

Closing entries

Income and expense accounts measure *one period*. At period end they must be reset to zero so the next period starts clean. Balance-sheet accounts are not closed — an asset you own on 30 June you still own on 1 July.

A **Profit or Loss Summary** account is used as a staging post. Close all income accounts to it (debit each income account, credit the summary), close all expenses to it (credit each expense, debit the summary), and the balance left in the summary is the period's profit or loss. Transfer that to Retained Earnings (or to the owner's Capital account in a sole trader or partnership). Finally close Drawings or Dividends to the same place.

The accounting principles

Six ideas that sit underneath everything and that written questions expect you to name:

PRINCIPLE	WHAT IT SAYS	WHY IT MATTERS
Monetary principle	Only items that can be expressed in monetary terms are recorded	A brilliant workforce or a strong brand never appears as an asset
Cost principle	Assets are initially recorded at their purchase price or cost	Entities sometimes depart from it where that is more useful — e.g. revaluation of non-current assets
Accounting entity concept	The entity is identified and accounted for separately from its owners	The owner's private car is not a business asset, even in a sole trader
Going concern	The business will continue operating for the foreseeable future	Justifies carrying assets at cost rather than what they would fetch in a fire sale, and justifies depreciating them over years
Accounting period concept	The life of the entity is divided into artificial periods of equal length	This is exactly what creates the need for adjusting entries
Full disclosure	Anything that could make a difference to a decision must be disclosed	Justifies the notes to the financial statements, where contingent liabilities and accounting policies live

That is the machinery. It explains how a transaction becomes a number in a report, but not why anyone insists the records be kept at all, nor who decides what they must contain. Those are the questions the unit proper begins with.

Accounting and governance

The groundwork chapter showed how accounting records a transaction. It said nothing about why a society insists those records be kept, published and audited. The answer is that the people who own a business are frequently not the people running it, and someone has to be able to check.

This chapter supplies the vocabulary for that idea. The definitions are short and quotable, and they are what written answers throughout the unit are judged against, so learning them word for word is genuinely worth doing.

Who uses accounting information, and what they ask

INTERNAL USERS

Managers, production supervisors, marketing managers, directors.

- How much profit did we make?
- What should be produced?
- What resources are available?
- How much does it cost?
- How much do we owe?
- Do we have enough cash?
- Are we meeting the budget?

EXTERNAL USERS

Investors, customers, suppliers and banks, government authorities such as the ATO and ASIC.

- Should we invest?
- How solvent is the business?
- Can they repay us?
- Will they make a profit?
- Are their products socially and environmentally responsible?
- Is the business performing better this year?

Financial versus management accounting

There are **five** points of difference. Note what is *not* among them: understandability. Both kinds of report are meant to be understandable.

	FINANCIAL ACCOUNTING	MANAGEMENT ACCOUNTING
Main users	External — shareholders and creditors	Internal — officers, department heads, managers
Types and frequency of reports	Classified financial statements; delayed and historical; issued quarterly, half-yearly and annually	Internal reports; current and future-oriented; issued as frequently as the need arises
Purpose of reports	General purpose information for all users	Special purpose information for a particular user for a specific reason
Contents of reports	Pertains to the entity as a whole and is highly aggregated; limited to double-entry and cost data; reporting standard is GAAP	Pertains to sub-units and may be very detailed; may extend beyond double entry to any relevant data; reporting standard is relevance to the decision

	FINANCIAL ACCOUNTING	MANAGEMENT ACCOUNTING
Verification	Annual independent audit by an external auditor	No independent audit

The diverse roles of accountants

TYPE	WHERE THEY WORK	WHAT THEY DO
Commercial / corporate	Industry and commerce	Management accounting and financial accounting roles
Public	Practices ranging from small firms to multinationals	Provide professional services to the public — auditing (the primary service), taxation and advisory
Government	Local councils, state and federal government	Financial accounting and auditing among other roles
Not-for-profit	The not-for-profit sector	Planning, decision making, preparing financial and management reports for internal and external users

Forms of business organisation

FORM	OWNERS	SEPARATE ACCOUNTING ENTITY?	SEPARATE LEGAL ENTITY?	LIABILITY	EXAMPLES
Sole proprietorship	One person	Yes	No	Unlimited	Restaurants, painters, dentists
Partnership	Two or more	Yes	No	Unlimited	Accountants, lawyers, doctors
Company	Shareholders	Yes	Yes	Usually limited	BHP, Westpac, CSR

THE DISTINCTION WORTH HOLDING ONTO

A sole trader and a partnership are separate **accounting** entities but not separate **legal** entities. The business keeps its own books, but in the eyes of the law the business and the owners are the same person — which is why the owners are personally liable for business debts, without limit. A company is a separate legal person, which is what makes limited liability possible.

Corporate governance

FOUR DEFINITIONS TO MEMORISE

Corporate governance — "the system of checks and balances, both internal and external to companies, which ensures that companies discharge their accountability to all their stakeholders and act in a socially responsible way in all areas of their business activity" (Solomon).

Accountability — "the readiness or preparedness of an organisation to give an explanation and a justification to relevant stakeholders for its judgements, intentions, acts and omissions when appropriately called upon to do so" (Rasche & Esser).

Stakeholder — "any group or individual who can affect or is affected by the achievement of the organisation's objectives" (Freeman).

Stewardship — "financial statements show how the managers have accounted for the resources entrusted to them by the shareholders. This accountability is often called stewardship" (Solomon).

INTERNAL AND EXTERNAL CHECKS AND BALANCES

INTERNAL

- Internal control systems
- Risk management
- An independent board of directors
- Internal audit

EXTERNAL

- Codes and principles of good corporate governance
- Industry guidelines
- External audit
- Regulators — ASIC, ASX

ACCOUNTING AS AN INSTRUMENT OF GOVERNANCE

- Accounting information is the **basis for decision making**.
- It helps managers **discharge accountability** to stakeholders, especially shareholders.
- It provides the **stewardship record** — the statements show how managers used the resources entrusted to them.
- It has a direct role in **providing information to facilitate the mechanisms of corporate governance** — audit committees, internal control and risk management all run on accounting data.
- It **tracks financial performance** over time.

WHY GOVERNANCE MATTERS

- Prevents organisational fraud and scandals.
- Protects investors' interests and promotes investor confidence.
- Enhances organisational reputation.
- Lowers the cost of capital — a well-governed company with a good reputation borrows more cheaply, because lenders price it as lower risk.

A COMMON CONFUSION

Accounting does *not* "help establish stakeholders". Stakeholders exist whether or not anyone keeps accounts. Accounting helps **discharge accountability** to them. The distinction is easy to blur and worth holding onto.

Governance, then, is why financial reports exist and why they have to be trustworthy. That raises an obvious question: who decides what goes in them, and against what principles?

Accounting regulation and the conceptual framework

If financial reports are going to hold managers accountable, they must be consistent enough to be trusted and comparable enough to be useful. Neither happens on its own. This chapter covers the institutions that make the rules in Australia and the framework of concepts those rules are built from.

It is the most self-contained topic in the unit — almost entirely definitional, and stable from year to year — but it is not optional. The definitions of an asset, a liability and an expense settled here are what every later chapter applies.

Where the rules come from

Australian **GAAP** — generally accepted accounting principles — is the whole body of authority:

- Accounting concepts and principles (the six from §0)
- Accounting standards (AASB standards, which are IFRS adapted for Australia)
- The Conceptual Framework
- Company law — the *Corporations Act 2001*
- ASX Listing Rules, for listed entities

Who regulates accounting in Australia

BODY	ROLE
AASB <i>Australian Accounting Standards Board</i>	Develops accounting standards under the <i>Corporations Act</i> ; formulates standards for other purposes such as the public and not-for-profit sectors; participates in developing a single set of standards for worldwide use; develops the conceptual framework.
FRC <i>Financial Reporting Council</i>	Oversees and advises the AASB and the Auditing and Assurance Standards Board (AUASB); determines broad strategic direction, monitors priorities and appoints members; monitors auditor independence in Australia; monitors the development of international standards; ensures AASB standards are at least in harmony with international standards. The FRC cannot direct the AASB on a particular standard and cannot veto a standard.
ASIC <i>Australian Securities & Investments Commission</i>	Administers the <i>Corporations Act</i> ; monitors implementation, and investigates and prosecutes companies for breaches; promotes confidence in the financial system.

BODY	ROLE
ASX <i>Australian Securities Exchange</i>	Administers the Listing Rules; played a major role in influencing the AASB's adoption of IASB standards.
IASB <i>International Accounting Standards Board</i>	An independent, privately funded standard setter overseen by the IFRS Foundation, established in 2001 to replace the IASC. Committed to a single set of high-quality, enforceable global standards.
IFRS IC <i>IFRS Interpretations Committee</i>	A sub-committee of the IASB. Considers issues of widespread importance not covered by IFRS standards; its interpretations are adapted by the AASB for the Australian environment.
Professional bodies	CPA Australia, CA ANZ, IPA — ethical and professional standards and member discipline.

POLITICAL LOBBYING ON STANDARD SETTING

Standard setting is a public process, and interested parties try to influence it. **Lobbying** includes writing submissions or giving oral testimony at hearings arranged by a standard setter to expose its tentative views to public comment — the legitimate route. It also includes overt or covert threats to seek intervention to overturn a proposed standard, or to compromise the standard setter's reputation, independence or powers; pressure may take the form of threats to withdraw funding or appeals to public opinion.

WHY THIS IS IN THE SYLLABUS

It undercuts any idea that accounting standards descend from pure logic. They are negotiated, and the parties with most at stake — large companies and industry groups — push hardest. That is one practical reason a conceptual framework matters: it gives the standard setter a principled position to defend when it is being leaned on.

The conceptual framework

DEFINITION

A **conceptual framework** is a set of concepts defining the nature, purpose and content of general purpose financial reporting, to be followed by preparers of financial statements and by standard setters.

It is intended to: **develop logical and consistent standards; provide guidance where no standard exists; and enhance the understanding of users.**

A conceptual framework is a set of concepts defining the nature, purpose and content of general purpose financial reporting, to be followed by preparers and standard setters.

Without a framework, accounting standards would not be based on any agreed set of concepts. Each standard would be developed on its own terms, which would produce **inconsistencies between standards and inconsistencies in accounting practice**. Developing a framework is therefore necessary to improve the standard-setting process and produce consistency in practice, and it also guides preparers where no standard covers the transaction in front of them.

Example. Suppose there were no agreed definition of a liability. One standard might require a company to recognise a warranty obligation on the face of the balance sheet, while another allowed a similar obligation to be left in the notes. Two companies with economically identical obligations would then report materially different total liabilities and different gearing, and a user could not compare them. Because the framework supplies one definition of a liability that every standard applies, both companies must account for the obligation the same way.

Note: a question phrased “use an example to explain” requires an actual example. A perfect definition on its own is an incomplete answer.

The objective of general purpose financial reporting

The objective is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity. The decisions in question are **buying, selling or holding investments, and providing loans or other forms of credit**.

There are two perspectives on that objective, and you should be able to distinguish them:

STEWARDSHIP / ACCOUNTABILITY

Concerns how general purpose financial reports support the stewardship and accountability function *where ownership is separated from control* — shareholders own, managers run. Managers use the reports to show owners they are fulfilling their stewardship function and managing the entrusted resources effectively. Shareholders use the same reports to check on managers and hold them accountable.

Looks *backwards*: what did you do with what we gave you?

DECISION-USEFULNESS

Concerns how the reports help users make economic decisions. The objective is to provide information that is useful for making and evaluating decisions about the *allocation of scarce resources* — that is, whether to commit money to this entity rather than another.

Looks *forwards*: should I put money in?

Users of general purpose financial reports

GROUP	WHO	NOTE
Primary users	The resource providers — equity investors (shareholders, holders of partnership interests), lenders (banks, purchasers of traded debt), other creditors (employees, suppliers, customers)	The framework is written for these users
Other users	Recipients of goods and services (customers, beneficiaries); parties performing a review or oversight function (regulators, media, governments, trade unions, special interest groups)	May find the reports useful but they are not the target
Internal users	Managers who plan, organise and run the business	Do not rely on GPFR — they can command whatever internal information they need

The reporting entity

Two formulations circulate in ACCG1001 materials, and both are worth knowing.

- **The traditional definition:** an entity in which it is reasonable to expect the existence of users who depend on general purpose financial reports for information to enable them to make and evaluate economic decisions.
- **The current framework's version:** an entity that is required, or chooses, to prepare financial statements. It can be a single entity, a portion of an entity, or more than one entity, and it is not necessarily a legal entity.

A reporting entity must produce financial reports that comply with accounting standards issued by the AASB. The driving factor is the **information needs of the primary users**. Three indicators help decide:

1. **Separation of management from ownership** — is it managed by people who are not the owners?
2. **Economic or political importance** — does it have influence over the welfare of external parties?
3. **Financial characteristics** — is it sizeable in terms of sales, assets, borrowings, customers or employees?

Qualitative characteristics of useful financial information

TIER	CHARACTERISTIC	WHAT IT REQUIRES
Fundamental	Relevance	Capable of making a difference to users' economic decisions. Must have <i>predictive value</i> , <i>confirmatory value</i> , or both. <i>Materiality</i> is entity-specific relevance — information is material if omitting, misstating or obscuring it could reasonably be expected to influence primary users' decisions.
	Faithful representation	Complete, neutral and free from material error.
Enhancing	Comparability	Users can compare the entity <i>over time</i> and <i>against other entities</i> .
	Verifiability	Different knowledgeable and independent observers could reach consensus that the information is a faithful representation of the economic phenomena.
	Timeliness	Available to decision makers in time to be capable of influencing their decisions.
	Understandability	Able to be comprehended by proficient users — classified, characterised and presented clearly.
Constraint	Cost versus benefit	The cost of providing information must not exceed the benefits derived from it. Both are difficult to measure.

FUNDAMENTAL VERSUS ENHANCING

The two fundamental characteristics are non-negotiable: information that is irrelevant, or that does not faithfully represent what it claims to, is useless no matter how nicely presented. The four enhancing characteristics make already-useful information *more* useful — they cannot rescue information that fails the fundamentals.

The five elements

ELEMENT	DEFINITION	RECOGNISED WHEN
Asset	A present economic resource controlled by the entity as a result of past events. An economic resource is a right that has the potential to produce economic benefits.	Recognition provides information that is <i>relevant</i> and a <i>faithful representation</i> .

ELEMENT	DEFINITION	RECOGNISED WHEN
Liability	A present obligation of the entity to transfer an economic resource as a result of past events.	As above. The older formulation: probable that an outflow will result from settling the obligation, and the settlement amount is a faithful representation.
Equity	The residual interest in the assets of the entity after deducting all its liabilities.	Follows from assets and liabilities — it is not recognised independently.
Income	Increases in assets, or decreases in liabilities, that result in increases in equity, other than those relating to contributions from holders of equity claims.	At the same time as the initial recognition of an asset or an increase in its carrying amount, or the derecognition of a liability or a decrease in its carrying amount. In practice: when it is earned.
Expenses	Decreases in assets, or increases in liabilities, that result in decreases in equity, other than those relating to distributions to holders of equity claims.	At the same time as the initial recognition of a liability or an increase in its carrying amount, or the derecognition of an asset or a decrease in its carrying amount.

The matching principle: where expenses result directly or jointly from the same transaction as revenues, they should be recognised on the basis of a direct association with those revenues. This is the reasoning behind the allowance method for bad debts and behind depreciation — both put the expense in the period that enjoyed the benefit.

TWO VERSIONS OF THE RECOGNITION CRITERIA ARE IN CIRCULATION

Older notes give the test as "*probable* that the benefits will flow *and* the amount can be *measured reliably*". That is the pre-2019 framework. The current framework recognises an element where doing so provides information that is **relevant** and a **faithful representation**, weighed against cost. Both wordings appear in circulating ACCG1001 material. Use the current one, note that the older probable/reliable test was replaced, and check which your lecturer taught.

Measurement bases

Once an element is recognised, it has to be measured at some amount. The framework permits several bases, and different standards choose different ones:

BASIS	MEANING	WHERE YOU MEET IT IN THIS UNIT
Historical cost	The amount paid to acquire the asset, or received on incurring the liability	The default. PPE at cost, inventory at cost
Current cost	What it would cost to acquire an equivalent asset today	Rarely applied in this unit
Realisable value	What could be obtained by selling the asset now	The "net realisable value" half of the lower-of-cost-and-NRV rule for inventory
Present value	The discounted value of future net cash flows	Underlies long-term liability measurement
Fair value	The price in an orderly transaction between market participants	Assets contributed to a partnership on formation; revaluation of non-current assets

Professional judgement

The framework does not remove judgement, and a discussion question may ask why.

WHY IT IS REQUIRED

- The framework requires judgement about **substance over form** — what a transaction really is, not what it is labelled.
- The accounting treatment of some transactions is simply **unregulated**; no standard covers them.
- Many figures are unavoidably **estimates**.

THE PROBLEMS IT CREATES

- It is difficult to accept that judgement is genuinely **neutral and unbiased**, when the preparer benefits from a favourable answer.
- **Different judgements lead to different disclosures** — two accountants estimating an allowance for doubtful debts from identical data can reach different numbers, and both sets of accounts are defensible.

The framework describes what a good financial report looks like. The rest of the unit is the practical business of producing one, and that starts where the money does.

PART TWO

The operating cycle

A business buys stock, sells it, waits to be paid, and banks the money. These five chapters follow that cycle in order – the controls that protect the cash, the customers who owe you, the inventory itself, and the tax that rides along with every transaction.

Internal control and cash management

Cash is the asset a business can least afford to lose and the one most easily taken, so this is where the practical work begins. The chapter has two halves and they support each other: the systems that stop cash going missing, and the reconciliation that proves it has not.

Bank reconciliation is the calculation the topic is built around. Learn its layout as a fixed template and it becomes mechanical. The control theory around it carries just as many marks, so work through that first.

What internal control is

Internal control is an essential part of risk management. It consists of all the processes used by management and staff to provide efficient and effective operations and to comply with laws, regulations and internal policies. It incorporates the policies a business adopts to **safeguard its assets, enhance the accuracy and reliability of its accounting records, and permit the timely preparation of financial information.**

It has two aspects:

- **Administrative controls** — provide operational efficiency and adherence to policy and procedures.
- **Accounting controls** — the methods and procedures used to protect assets and ensure transactions are recorded appropriately.

The five principles of internal control

PRINCIPLE	WHAT IT MEANS IN PRACTICE
Establishment of responsibility	One named person is responsible for a given task, so errors can be traced to a person. Management should ensure the employees assigned are qualified, and should monitor compliance.
Segregation of duties	Related activities are assigned to different individuals. Above all, <i>responsibility for keeping the records of an asset must be separate from physical custody of that asset.</i>
Documentation procedures	Documents provide evidence that transactions and events occurred. Use pre-numbered documents, account for the sequence, and forward them promptly.
Physical, mechanical and electronic controls	Physical: safes, locked cabinets. Mechanical and electronic: alarms, monitors, computers with password access, time clocks.
Independent internal verification	The review, comparison and reconciliation of data prepared by employees, done by someone else. Four common elements: <i>checking procedures, supervisor monitoring, internal auditor verification, duty rotation.</i>

WHY SEGREGATION OF DUTIES IS THE IMPORTANT ONE

If the person who handles the cash is also the person who records it, they can take money and adjust the records to hide the gap — one person, no trace. Split those two jobs and concealment requires two people to agree to steal together. That is **collusion**, and it is much rarer and much riskier for the participants. Segregation does not make fraud impossible; it makes it require a conspiracy.

THE THREE LIMITATIONS

- **Cost versus benefit.** No entity can afford controls against every conceivable risk; the control must cost less than the loss it prevents.
- **The human element.** Fatigue, carelessness and misunderstanding cause errors — and collusion defeats segregation of duties entirely.
- **Business size.** A business with three staff cannot meaningfully segregate duties among them.

THREE POINTS THAT ARE EASY TO GET BACKWARDS

- Internal controls are **not** designed to safeguard assets from *natural disasters*. They address theft, unauthorised use and robbery — human risks. Floods and fires are what insurance is for.
- *Overstating liabilities "to be conservative"* is **not** an objective of internal control. Deliberate misstatement in any direction is the opposite of accuracy and reliability.
- Using a **periodic inventory system is poor internal control** over stock, because it cannot distinguish goods that were sold from goods that were stolen.

Internal control applied to cash

Cash is the asset most subject to theft, so a good control system over handling and recording it is essential. You should be able to apply the five principles to a specific cycle, so learn both columns.

PRINCIPLE	OVER CASH RECEIPTS	OVER CASH PAYMENTS
Establishment of responsibility	Only designated personnel (cashiers) are authorised to handle cash receipts	Only designated personnel (the financial manager) may sign cheques; cheques should carry two authorised signatories
Segregation of duties	Different individuals receive the cash, record the receipts, and hold the cash	Different individuals approve and make payments; cheque signers do not record payments; limit knowledge of EFT PINs

PRINCIPLE	OVER CASH RECEIPTS	OVER CASH PAYMENTS
Documentation procedures	Remittance advices for mail receipts, cash register tapes, deposit slips, sequentially numbered electronic receipts	Pre-numbered cheques accounted for in sequence; every cheque supported by an approved invoice; stamp invoices "paid"
Physical, mechanical and electronic controls	Store cash in safes and bank vaults; limit access to storage areas; bank frequently; use cash registers, or have customers pay by direct deposit or EFT	Store blank cheques in a safe with limited access; print cheque amounts by machine in indelible ink; use passwords and PINs
Independent internal verification	Supervisors count cash receipts daily; a banking clerk compares total receipts with bank deposits daily; reconcile accounting records to bank records regularly	Compare cheques with invoices; reconcile the bank account monthly

WHAT COUNTS AS CASH

- **Cash on hand** — notes and coins
- **Cash at bank** — cheque accounts
- **Cash equivalents** — bank overdrafts, deposits on the money market, 90-day bank acceptance bills

A **petty cash fund** is a small cash float used to pay relatively small amounts where writing a cheque or processing an EFT would cost more than the payment is worth.

HOW HAVING A BANK ACCOUNT IMPROVES CONTROL

1. It **minimises the amount of cash kept on hand**, and therefore the amount available to steal.
2. It provides a **double record** of all bank transactions — one kept by the business, one kept by the bank. Each is a check on the other.
3. It safeguards cash by acting as a **depository and clearing house** for payments received and made.

Electronic banking reinforces this. EFTPOS and credit card transactions reduce staff costs and the risks associated with handling physical cash, and electronic funds transfer provides near-instant payment at lower transaction cost.

Subsidiary ledgers and control accounts

A business may deal with hundreds of customers. Putting every customer in the general ledger would make it unusable, and putting them all in one account would lose the detail of who owes what. The solution is two layers.

HOW THE TWO LAYERS WORK

A **subsidiary ledger** is a group of accounts with a common characteristic — one account per customer, or one per supplier. The **control account** is the single general ledger account that summarises the subsidiary ledger's total.

The two must always agree: the sum of the individual customer balances equals the Accounts Receivable control account balance. If they disagree, something has been posted wrongly.

The two common subsidiary ledgers are **Accounts Receivable** (collecting transaction data for individual customers) and **Accounts Payable** (for individual creditors). A **schedule of accounts receivable** (or payable) is a list of all accounts and their balances in the subsidiary ledger at a particular date — this is what you reconcile to the control account.

A POINT THAT IS EASILY MISSED

Subsidiary ledger accounts sit **outside the general ledger** and are **not used when extracting the trial balance**. Only the control account appears there. Including both would double-count every receivable.

Advantages of using subsidiary ledgers:

- They show all transactions with one party in a single account, providing up-to-date information.
- They free the general ledger of excessive detail.
- They provide effective control, because the control account is an independent check on the detail.
- They enable segregation of duties — different people can maintain the subsidiary ledger and the general ledger.

SPECIAL JOURNALS

Special journals are used to record similar types of transactions together, rather than putting everything through the general journal. The usual four are the sales journal, purchases journal, cash receipts journal and cash payments journal. They **enable segregation of duties** and **simplify the posting process** to the general ledger, because the column total can be posted once rather than line by line.

THE DETAIL THAT GETS MISSED

The **total** of the sales journal is posted as a debit to the **Accounts Receivable control account in the general ledger** — one posting for the whole column. The *individual* customer accounts in the subsidiary ledger are posted separately, and usually daily.

Bank reconciliation

The Cash at Bank account balance in your ledger rarely agrees with the balance on the bank statement. That is normal, and a reconciliation explains the difference. Differences that cannot be explained may indicate fraud, which is the point of doing it.

WHY THE TWO BALANCES DIFFER

The bank can only record what it knows about. There are exactly two causes:

1. Timing differences — the two parties record the same transaction in different periods. You record a receipt the moment cash comes in; the bank records it when the deposit clears. You record a payment when the cheque or EFT is issued; the bank records it when it is presented.

2. Errors — by either party, in recording transactions.

Neither record is "wrong". They are at different points in time.

ITEM	KNOWN TO	EFFECT
Outstanding deposits <i>deposits in transit</i>	You, not yet the bank	Increase the bank statement balance
Unpresented cheques and outstanding EFTs	You, not yet the bank	Decrease the bank statement balance
Bank charges, fees, interest charged	The bank, not yet you	Decrease your ledger balance
Interest revenue, direct credits, notes collected by the bank	The bank, not yet you	Increase your ledger balance
Dishonoured cheques <i>customer had insufficient funds</i>	The bank, not yet you	Decrease your ledger balance
Errors	Whoever made them	Adjust whichever side made the error

THE TEMPLATE

Work **two columns at once** and drive them to the same number. That number, not the bank's, is the true cash balance and the figure that goes in the statement of financial position.

START FROM THE BANK STATEMENT BALANCE	START FROM THE CASH AT BANK LEDGER BALANCE
Add outstanding / undeposited receipts	Add notes and accounts collected by the bank, interest revenue, direct credits
Less unpresented cheques and outstanding EFTs	Less bank fees and charges, dishonoured cheques, direct debits
Adjust for errors made by the <i>bank</i>	Adjust for errors made by <i>you</i> in the cash journals

START FROM THE BANK STATEMENT
BALANCE

START FROM THE CASH AT BANK LEDGER BALANCE

= Adjusted balance

= Adjusted balance (*must be identical*)

THE RULE THAT DECIDES EVERY JOURNAL ENTRY

You journalise **only the items on the cash-book side**. Outstanding deposits, unpresented cheques and bank errors get no entry — the bank will catch up by itself. Anything the bank knew and you did not, you must now record.

THE PROCEDURE

You need three documents: the **prior period's bank reconciliation**, the **Cash at Bank ledger account**, and the **bank statement** for the period since the last reconciliation. Then:

- 1 Compare the current bank statement to the previous month's reconciliation and to the current month's cash receipts and cash payments journals, ticking off everything that matches.
- 2 Deal with what is left unticked. Unticked items on the *bank statement* mean the bank knew and you did not — **adjust the cash book** for dishonoured cheques, direct deposits, fees and your own errors. Unticked items in the *cash journals* mean you knew and the bank did not — **list these in the bank reconciliation** as outstanding deposits and unpresented cheques. Unticked items carried over from the opening reconciliation come forward into the current one.
- 3 Total the cash journals and post to the Cash at Bank ledger.
- 4 Complete the reconciliation: outstanding deposits increase the bank figure, unpresented cheques decrease it, and the adjusted bank balance must equal the adjusted Cash at Bank balance.

For internal control purposes the reconciliation should be prepared by an employee who has **no other responsibilities relating to cash** — an application of independent internal verification.

WORKED • NORTHBRIDGE SIGNAGE PTY LTD, 31 MAY 2025

The bank statement shows a **credit** balance of \$22,150; the ledger Cash at Bank shows a **debit** balance of \$22,185. The bank collected \$2,755 on a note on the business's behalf (\$2,600 principal, \$180 interest, less a \$25 collection fee); a \$6,400 deposit banked on 31 May is not yet on the statement; outstanding EFTs total \$4,950; and the statement shows a \$1,340 reversal of a payment from a customer, R. Halloran.

BEFORE YOU START – WHY THE SIGNS LOOK BACKWARDS

Your ledger shows cash as a *debit* because cash is your asset. The bank shows it as a *credit* because from the bank's point of view your deposit is money the bank owes you — their liability. Both describe the same money. Don't let the opposite wording confuse the arithmetic.

BANK SIDE	\$	BOOKS SIDE	\$
Balance per bank statement	22,150	Balance per Cash at Bank	22,185
Add outstanding deposit	6,400	Add note collected, net	2,755
Less outstanding EFTs	(4,950)	Less reversal — R. Halloran	(1,340)
Adjusted balance	23,600	Adjusted balance	23,600

ADJUSTING ENTRIES – 31 MAY 2025

DATE	ACCOUNT	DR	CR
31 May	Cash at Bank	2,755	
	Bank Charges	25	
	Note Receivable		2,600
	Interest Revenue		180
31 May	Accounts Receivable	1,340	
	Cash at Bank		1,340

The first entry needs four lines. The *net* \$2,755 goes into cash because that is what the bank actually deposited (2,600 + 180 – 25), but the entry must still break out the \$25 fee as an expense and the \$180 as interest revenue. The Halloran reversal is a dishonoured cheque: the customer still owes the money, so the debt goes back to Accounts Receivable.

WORKED • KELSO JOINERY PTY LTD, 30 SEPTEMBER 2025 – A RECORDING ERROR IN THE CASH JOURNAL

Cash at Bank \$12,457 Dr; bank statement \$19,480 Cr. Receipts of \$1,205 deposited on 30 September are not yet recorded by the bank. Cheque #418 to a supplier, correctly written and paid at \$1,209, was recorded in the cash payments journal as \$1,290. Unpresented cheques total \$3,640. A \$620 cheque from T. Abasi was returned dishonoured. The bank charged a \$48 account fee. A \$5,000 note receivable was collected by the bank on 22 September plus \$210 interest, less a \$35 collection fee; no interest had been accrued.

BANK SIDE	\$	BOOKS SIDE	\$
Balance per bank statement	19,480	Balance per Cash at Bank	12,457
Add outstanding deposit	1,205	Add error on cheque #418 <i>1,290 - 1,209</i>	81
Less unpresented cheques	(3,640)	Add note collected <i>5,000 + 210 - 35</i>	5,175
		Less dishonoured cheque — T. Abasi	(620)
		Less bank fees	(48)
Adjusted balance	17,045	Adjusted balance	17,045

ADJUSTING ENTRIES – 30 SEPTEMBER 2025			
30 Sep	Cash at Bank	81	
	Accounts Payable <i>correcting the overstated payment</i>		81
30 Sep	Cash at Bank	5,175	
	Bank Charges	35	
	Note Receivable		5,000
	Interest Revenue		210
30 Sep	Accounts Receivable – T. Abasi	620	
	Cash at Bank		620
30 Sep	Bank Charges	48	
	Cash at Bank		48

The error, reasoned out. You wrote \$1,290 in the journal but only \$1,209 actually left the account. You therefore recorded the payment as \$81 bigger than it was, so your cash balance is \$81 *too low*. Add \$81 back. And since the supplier was debited \$81 too much in your books, reduce Accounts Payable by the same \$81.

FOUR WAYS THIS GOES WRONG

- **Getting the direction of an error backwards.** Always ask: did my mistake make cash look too high or too low? If a \$4,310 cheque was recorded as \$4,130, you understated the payment, so cash is *overstated* — deduct \$180. If a \$1,209 cheque was recorded as \$1,290, you overstated the payment, so cash is *understated* — add \$81. Same accounts, opposite direction.
- **Journalising bank-side items.** Never an entry for outstanding deposits or unpresented cheques.
- **Netting a note collection into one line.** The fee is an expense and the interest is revenue; both must appear.
- **Treating a dishonoured cheque as an expense.** It is not — the customer still owes you. Dr Accounts Receivable, Cr Cash at Bank.

Cash management

Cash earns nothing sitting in an account, but running out of it ends the business. Managing it means five things:

1. **Increase the speed of collection of receivables** — get paid faster.
2. **Keep inventory levels low** — stock ties up cash and is exposed to theft and shrinkage.
3. **Do not pay earlier than necessary** — but do take settlement discounts where they are worth more than the delay.
4. **Plan the timing of major expenditures** so they do not collide with lean periods.
5. **Invest idle cash** rather than leaving it unproductive.

Cash is what a business ends up with. Before that, most sales create only a promise to pay — and promises are not always kept.

Accounting for receivables

Selling on credit turns a sale into a promise. Most promises are honoured and some are not, and the business rarely knows in advance which is which. This chapter is about carrying those promises on the balance sheet at a figure that tells the truth about how many will be kept.

The three types of receivable

TYPE	WHAT IT IS
Accounts receivable	Amounts owed to the business by customers <i>on account</i> — for goods sold or services provided on credit. The main focus of this topic.
Notes receivable	Amounts owed to the business for which a <i>formal instrument of credit</i> — a written promissory note — has been issued evidencing the debt. If you lend a supplier \$10,000 and they give you a written promise to repay, that is a note receivable.
Other receivables	Non-trade receivables such as interest receivable, loans and advances.

HOW RECEIVABLES ARE REPORTED

Receivables are classified as current or non-current. Those due within twelve months (or the entity's operating cycle, if longer) sit in the **current assets** section of the balance sheet. The notes to the financial statements show the accounting policy and a breakdown of receivables including face value and any allowance or impairment write-down.

Three accounting issues attach to accounts receivable: **recognising** them (there must be a sale), **valuing** them (what to do about bad debts), and **accelerating cash receipts** from them.

Why bad debts happen, and why you accept them

Customers fail to pay for ordinary reasons — job loss, death, poor record keeping, a dispute with or mistake by the business. If a customer does not pay, the amount owed eventually becomes an expense.

THE COMMERCIAL POINT BEHIND THE ACCOUNTING

The only way to guarantee no bad debts is to be a cash-only business — and that means losing most of your customers. Extending credit is a normal part of trading; the job is not to eliminate bad debts but to *manage* them, by evaluating credit risk before you sell and by collecting well afterwards. The accounting exists to report the resulting losses honestly and in the right period.

The two methods

DIRECT WRITE-OFF

Wait until a specific debt is known to be bad, then expense it.

Dr Bad Debts Expense
Cr Accounts Receivable

Receivables are reported at their gross amount. Simple, but it violates matching — the expense lands in a later period than the sale that caused it — and receivables are overstated until the write-off. It *reduces the usefulness of the financial statements if bad debts are material*, so it is acceptable only where they are not.

ALLOWANCE METHOD

At the end of each period, estimate the total bad debts expected to arise from that period's sales.

Dr Bad Debts Expense
Cr Allowance for Doubtful Debts

Records the estimated expense in the period the related sales were recorded, and reports receivables at the amount of cash actually expected to be collected — their **net realisable value**. Required where bad debts are material.

On the balance sheet, the allowance method presents:

```
Accounts receivable      124,300
- Allowance for doubtful debts    (6,750)
= Net receivables      117,550    the net realisable value
```

The full cycle of entries

ALLOWANCE METHOD – ALL FOUR ENTRIES			
EVENT	ACCOUNT	DR	CR
1 • Estimate, at period end	Bad Debts Expense	X	
	Allowance for Doubtful Debts		X
2 • Write off a specific debt	Allowance for Doubtful Debts	Y	
	Accounts Receivable – <i>named debtor</i>		Y
3a • Recovery – reverse the write-off	Accounts Receivable – <i>named debtor</i>	Z	
	Allowance for Doubtful Debts		Z
3b • Recovery – record the cash	Cash at Bank	Z	
	Accounts Receivable – <i>named debtor</i>		Z

WRITING OFF A DEBT DOES NOT AFFECT PROFIT

Under the allowance method, step 2 has **no effect on profit and no effect on net receivables**. The expense was already recognised at step 1. The asset and the contra-asset both fall by the same amount, so the net figure is unchanged. It is the whole reason this method matches better than direct write-off.

WHY THE RECOVERY TAKES TWO ENTRIES

You could just debit Cash and credit Bad Debts Expense. But the two-step version leaves a proper record in the customer's own account in the subsidiary ledger — it was written off, then reinstated, then paid. Anyone reviewing that customer's credit history can see what happened. Collapsing it into one entry hides it.

Estimating the allowance

	PERCENTAGE OF NET CREDIT SALES	AGEING OF RECEIVABLES
Focus	Income statement — matching the expense to sales	Balance sheet — stating receivables at collectable value
Based on	The historical relationship between net credit sales and bad debts	The age of each debt; older accounts are more likely to go bad
The percentage gives you	The <i>expense</i> for the period, directly	The <i>required closing balance</i> of the allowance
Existing allowance balance	Ignored — the new expense is added on top	Critical — you adjust <i>to</i> the target

WORKED • PERCENTAGE OF NET CREDIT SALES

Rivera Tiling finishes its first year of operations in June 20X1. The owner estimates that 8% of the year's \$58,000 of net credit sales will prove uncollectable.

$$\text{Bad debts expense} = 58,000 \times 8\% = \mathbf{4,640}$$

30 Jun	Bad Debts Expense	4,640
	Allowance for Doubtful Debts	4,640

The percentage is applied to *sales*, and the result *is* the expense. Any pre-existing balance in the allowance is left alone — this method is not trying to set the allowance to a particular level, it is trying to charge this year's sales with this year's expected losses.

WORKED • AGEING OF RECEIVABLES, THE FOUR STEPS

Halcyon Interiors. At 30 June 20X3 accounts receivable are \$124,300 Dr and the Allowance for Doubtful Debts has a credit balance of \$2,180.

- 1 **Classify the debtors into age groups** from the accounting records — current, 1–30 days overdue, 31–60, 61–90, over 90.
- 2 **Apply an expected loss percentage to each band** and total them. This gives the amount the allowance *should* be — the desired closing balance. Say it comes to \$6,750.
- 3 **Compare the desired balance with the actual balance** — \$6,750 required against \$2,180 already there.
- 4 **The difference is the adjusting entry.**

$$\text{Expense} = 6,750 - 2,180 = \mathbf{4,570}$$

30 Jun	Bad Debts Expense	4,570	
	Allowance for Doubtful Debts		4,570

WORKED • THE AGEING ADJUSTMENT IN BOTH DIRECTIONS

An ageing schedule at 31 December indicates \$38,400 of receivables will be uncollectable.

Case 1 — the allowance already has a \$21,600 *credit* balance. It needs to end at \$38,400 credit, so top it up by the shortfall.

$$\text{Expense} = 38,400 - 21,600 = \mathbf{16,800}$$

31 Dec	Bad Debts Expense	16,800	
	Allowance for Doubtful Debts		16,800

Case 2 — the allowance has a \$950 *debit* balance instead. A debit balance in a contra-asset means last year's write-offs exceeded last year's estimate — the allowance was used up and then some. You must fill the \$950 hole *and then* build up to \$38,400.

$$\text{Expense} = 38,400 + 950 = \mathbf{39,350}$$

31 Dec	Bad Debts Expense	39,350	
	Allowance for Doubtful Debts		39,350

Then a write-off. A \$2,410 account is written off on 31 January. Under the allowance method:

31 Jan	Allowance for Doubtful Debts	2,410	
	Accounts Receivable		2,410

Under the *direct write-off* method instead, the same event hits profit in January:

31 Jan	Bad Debts Expense	2,410	
	Accounts Receivable		2,410

Compare those last two. Same event, same amount, completely different effect on the period's profit. That contrast is the argument for the allowance method, and it is worth stating in any written answer on the topic.

THE SINGLE BIGGEST ERROR IN THIS TOPIC

Reading "\$38,400 will be uncollectable" as the expense. Under the ageing method it is the **closing balance of the allowance**. If you are unsure, draw the T-account: opening balance, plus this year's expense, less write-offs, equals required closing balance — then solve for the expense. Get the direction of the opening balance right and the rest follows.

Managing receivables — five steps in order

- 1 Determine to whom to extend credit. Evaluate credit risk before you sell.
- 2 Establish a payment period and communicate it.
- 3 Monitor collections against those terms.
- 4 Evaluate the liquidity of the receivables balance — including deciding which sales should be promoted.

5 Accelerate cash receipts from receivables — settlement discounts, factoring, accepting credit cards.

The order matters, and step 1 is the one people misplace: you cannot set terms, monitor, or accelerate collection of credit you have not yet decided to extend.

Receivables are what a sale leaves behind. The next two chapters go back a step, to the goods that were sold in the first place.

Inventory I – systems, terms and journals

For a retailer, inventory is usually the largest asset on the balance sheet and cost of sales the largest expense on the income statement. How both are recorded therefore shapes almost every figure that matters.

This is also the largest source of journal-entry work in the unit. A business must choose between two systems for tracking inventory, and that single choice changes every entry it writes.

Service versus merchandising businesses

A **service business** provides expertise or actions to customers. A **merchandising (retail) business** buys and resells inventory. The difference drives the accounting:

- A merchandiser's revenue is called **sales revenue**.
- Its expenses split into two categories — **cost of sales** and **operating expenses** — where a service business has operating expenses only.
- It therefore reports a **gross profit** figure, which a service business does not.

$$\text{Sales revenue} - \text{Cost of sales} = \text{Gross profit}$$
$$\text{Gross profit} - \text{Operating expenses} = \text{Profit (or loss)}$$

A merchandiser also has a different **operating cycle** — the average length of time from acquiring inventory through to collecting the cash from selling it. In retail, inventory is one of the most important assets and often a material part of total assets.

Perpetual versus periodic

THE ONE DIFFERENCE EVERYTHING ELSE FOLLOWS FROM

The key difference is **the point at which cost of sales is calculated**. Perpetual calculates it at every sale. Periodic calculates it once, at the end of the period.

	PERPETUAL	PERIODIC
Inventory account	Updated continuously after every purchase, sale and return. The balance is always the current inventory on hand.	Not updated until period end. Throughout the period the balance is still the <i>opening</i> balance.

	PERPETUAL	PERIODIC
Cost of sales	Recorded at each sale, in a second journal entry	Calculated at period end by combining five figures: opening inventory, purchases, purchase returns, freight-in and closing inventory
Purchases are recorded in	The Inventory account directly. There is no Purchases account.	A Purchases account (an expense), with Purchase Returns and Allowances as a contra-expense
What the stocktake is for	To <i>verify</i> the records and identify loss, theft or deterioration	To <i>determine</i> closing inventory in the first place. It cannot detect missing stock — anything gone is assumed sold.
Typical users	Car dealerships, furniture stores; and via barcodes and scanners, supermarkets and department stores	Small businesses — convenience stores, cafés

A WAY TO PICTURE PERIODIC

Imagine an office that buys 30 reams of printer paper. A month later somebody asks how much was used. Nobody logged each ream, so you count what is left: four. You conclude 26 were used. That is the periodic system — opening 30, closing 4, "cost of sales" 26. Notice you cannot tell whether 26 were genuinely used or 22 were used and four walked out of the building. That blind spot is exactly why periodic is weak internal control over inventory.

The terms you must be able to define

TERM	MEANING	WHERE IT LANDS
Freight-in	Cost of transporting goods, charged to the <i>buyer</i>	Added to the cost of inventory; part of cost of sales
Freight-out	Delivery cost incurred by the <i>seller</i>	An operating expense of the seller — a selling / delivery expense
Sales return	The customer returns the goods and receives a refund or credit	Sales Returns and Allowances — a contra-revenue account
Sales allowance	The customer keeps the goods and is granted a price reduction	

TERM	MEANING	WHERE IT LANDS
Purchase return	Goods returned to the supplier	Reduces Inventory (perpetual) or credits Purchase Returns and Allowances (periodic)
Settlement discount	A discount for <i>prompt payment</i> of an account. 2/7, n/30 means 2% off if paid within 7 days, otherwise the full amount is due within 30 days.	Recorded: Discount Received (income) for the buyer, Discount Allowed (contra-revenue) for the seller
Trade discount	A percentage reduction in the <i>list price</i> of the goods sold	Never recorded. The transaction simply goes into the books at the discounted amount

SETTLEMENT VERSUS TRADE DISCOUNT, WITH NUMBERS

Trade discount: the list price is \$12,000 and a 15% trade discount is given. You record a purchase of \$10,200 and that is the end of it. There is no "trade discount" account, because \$10,200 simply *is* the price.

Settlement discount: a buyer owes \$6,000 on terms 2/7, n/30 and pays within seven days, receiving \$120 off. Here the \$6,000 was genuinely the agreed price, and the \$120 is a reward for paying early — a financing matter, so it gets its own account.

FREIGHT-IN VERSUS FREIGHT-OUT

Both are the cost of moving goods, but they sit in different halves of the income statement. Freight-in increases cost of sales, so it *reduces gross profit*. Freight-out is a selling expense below the gross profit line, so gross profit is untouched. A question asking how each is disclosed wants exactly that contrast.

Example: buy stock for \$24,000 and pay \$860 freight-in — the inventory is recorded at \$24,860. Deliver goods to a customer and pay \$410 freight-out — that \$410 is a separate selling expense.

The journal entries

Perpetual needs **two entries for every sale** — one for the revenue at selling price, one for the cost at cost price. Periodic needs one. That is the whole practical difference.

PERPETUAL SYSTEM			
EVENT	ACCOUNT	DR	CR
Purchase on credit	Inventory	✓	
	Accounts Payable		✓

EVENT	ACCOUNT	DR	CR
Freight-in paid	Inventory <i>or Freight-in</i>	✓	
	Cash at Bank		✓
Purchase return	Accounts Payable	✓	
	Inventory		✓
Payment within discount period	Accounts Payable <i>gross amount owing</i>	✓	
	Discount Received		✓
	Cash at Bank		✓
Sale on credit <i>entry 1 of 2</i>	Accounts Receivable	✓	
	Sales Revenue		✓
<i>entry 2 of 2</i>	Cost of Sales	✓	
	Inventory		✓
Sales return <i>also two entries</i>	Sales Returns and Allowances <i>at selling price</i>	✓	
	Accounts Receivable		✓
	Inventory <i>at cost</i>	✓	
	Cost of Sales		✓
Receipt within discount period	Cash at Bank	✓	
	Discount Allowed	✓	
	Accounts Receivable		✓

PERIODIC SYSTEM – ONLY WHERE IT DIFFERS			
EVENT	ACCOUNT	DR	CR
Purchase on credit	Purchases	✓	
	Accounts Payable		✓
Freight-in paid	Freight-in	✓	
	Cash at Bank		✓
Purchase return	Accounts Payable	✓	
	Purchase Returns and Allowances		✓

EVENT	ACCOUNT	DR	CR
Sale on credit	Accounts Receivable	✓	
	Sales Revenue		✓
— and nothing else. No cost of sales entry. —			

WORKED • BRIGHTWATER SUPPLIES, MARCH – PERPETUAL, THEN THE SAME TRANSACTIONS PERIODIC

(1) 4 March purchased 200 units at \$150 each on credit, 2/10, n/30. (2) 6 March returned 20 units. (3) 12 March paid the supplier. (4) 20 March sold 60 units at \$250 on credit, 2/10, n/30. (5) 26 March the customer returned 8 units and paid for the remaining 52.

PERPETUAL			
4 Mar	Inventory 200×150	30,000	
	Accounts Payable		30,000
6 Mar	Accounts Payable 20×150	3,000	
	Inventory		3,000
12 Mar	Accounts Payable 180×150	27,000	
	Discount Received $27,000 \times 2\%$		540
	Cash at Bank		26,460
20 Mar	Accounts Receivable 60×250	15,000	
	Sales Revenue		15,000
	Cost of Sales 60×150	9,000	
	Inventory		9,000
26 Mar	Sales Returns and Allowances 8×250	2,000	
	Accounts Receivable		2,000
	Inventory 8×150	1,200	
	Cost of Sales		1,200
26 Mar	Cash at Bank	12,740	
	Discount Allowed $13,000 \times 2\%$	260	
	Accounts Receivable $15,000 - 2,000$		13,000

THE SAME FIRST TWO TRANSACTIONS, PERIODIC

4 Mar	Purchases	30,000	
	Accounts Payable		30,000
6 Mar	Accounts Payable	3,000	
	Purchase Returns and Allowances		3,000

Note the sales return under perpetual needs **two** entries: reverse the revenue at \$250 a unit, and put the goods back into inventory at \$150 a unit. The \$100 difference per unit is the gross profit being reversed.

DISCOUNTS ARE CALCULATED ON THE AMOUNT AFTER RETURNS

Buy \$8,400 on 2/10, n/30, then return \$900. You owe \$7,500, and the 2% discount is **\$150 on \$7,500**, not \$168 on \$8,400. Always deduct returns before applying the percentage.

Note also that this unit credits **Discount Received** as income and debits **Discount Allowed** as contra-revenue. Some textbooks instead adjust Inventory and Sales directly. Follow the unit's treatment — it is what this unit's materials use throughout.

Cost of sales under the periodic system

```

Opening inventory
+ Purchases
- Purchase returns and allowances
= Net purchases
+ Freight-in
= Cost of goods purchased

Opening inventory + Cost of goods purchased
= Cost of goods available for sale
- Closing inventory per stocktake
= Cost of sales

```

WORKED • DALTON MENSWEAR, MONTH ENDED 31 AUGUST

Periodic system. A stocktake at 31 August shows \$24,200 on hand. Prepare the income statement through to gross profit.

DALTON MENSWEAR – INCOME STATEMENT (PARTIAL), FOR THE MONTH ENDED 31 AUGUST		\$	\$
Sales		78,000	
Less: Sales returns and allowances		2,400	
Net sales			75,600
Cost of sales			
Inventory, 1 August			26,500
Purchases		41,000	
Less: Purchase returns and allowances		2,900	
Net purchases		38,100	
Add: Freight-in		1,750	
Cost of goods purchased			39,850
Cost of goods available for sale			66,350
Less: Inventory, 31 August			24,200
Cost of sales			42,150
Gross profit			33,450

Advertising expense of \$900 and accounts payable of \$7,300 also appeared in the trial balance and are **deliberately irrelevant** — advertising sits below the gross profit line, and payables are a balance sheet item. Questions of this type always plant a distractor or two.

The classified income statement

Below gross profit, operating expenses are classified into three groups. Knowing which group an item belongs to is the usual test:

SELLING EXPENSES

The cost of making the sale.

Advertising, sales salaries and commissions, delivery expense, freight-out.

ADMINISTRATIVE EXPENSES

The cost of the general, accounting and personnel offices.

Office salaries, rent, insurance, office supplies, depreciation of office equipment.

FINANCIAL EXPENSES

The cost of financing the business.

Interest expense, discount allowed, bank charges.

Interest expense is a *financial* expense, not an administrative one. It is a common slip.

All of this assumed you already knew what a unit of inventory cost. Once identical goods have been bought at different prices through the year, that turns out to be a genuine question.

Inventory II – cost flow and valuation

The previous chapter recorded inventory transactions on the assumption that the cost of each item was known. In practice a business buys identical goods at different prices throughout the year, so when it sells one, it must decide *which* cost to release to cost of sales. That decision is the first half of this chapter. The second is the limit the accounting standards place on what inventory may be carried at once it is sitting in the warehouse.

Step one: decide what you actually own

Before costing anything, establish which goods belong to you at balance date. Two situations cause trouble.

SITUATION	RULE	GOODS IN TRANSIT AT BALANCE DATE BELONG TO
FOB shipping point	Ownership passes when the goods leave the seller's premises	The buyer — include them in the buyer's stocktake
FOB destination	Ownership passes when the goods are delivered	The seller
Consignment	An agent (the consignee) sells goods on behalf of the owner (the consignor) for a commission	The consignor , always — even though the goods sit in the agent's warehouse

WHAT THE STOCKTAKE IS FOR, IN EACH SYSTEM

- **Periodic:** necessary — it is the only way to determine closing inventory and therefore cost of sales.
- **Perpetual:** used to verify the accounting records, and to identify loss, theft or deterioration.

The four cost flow assumptions

Suppose you bought identical units at different prices during the year. When you sell one, which cost do you release to cost of sales? Cost flow assumptions answer that. They are assumptions about the flow of *cost*, not about the physical flow of goods.

1. Cost of goods available for sale = opening inventory + net purchases + freight-in
2. Closing inventory = apply the cost flow assumption
3. Cost of sales = step 1 - step 2

Step 1 and step 3 never change. Only step 2 depends on the method.

A business has the following inventory movements. 29 units are sold during the year; 11 remain at year end.

DATE	EVENT	UNITS	UNIT COST	TOTAL
1 Jan	Opening inventory	8	\$30	\$240
14 Aug	Purchase	20	\$33	\$660
2 Dec	Purchase	12	\$35	\$420
Available for sale		40		\$1,320

Specific identification. Each unit is tracked to its own invoice. Say the 29 sold were 3 from opening inventory, 20 from the August purchase and 6 from the December purchase.

$$\text{Cost of sales} = (3 \times 30) + (20 \times 33) + (6 \times 35) = 90 + 660 + 210 = \mathbf{960}$$

$$\text{Closing inventory} = 1,320 - 960 = \mathbf{360} \quad 5 \text{ units @ } \$30 + 6 \text{ units @ } \$35$$

FIFO. The first units acquired are the first sold, so the units *remaining* are the most recent ones. Work out closing inventory from the *latest* prices.

The 11 units left are the most recently bought, and 12 were purchased on 2 December,
so all 11 are costed at that price.

$$\text{Closing inventory} = 11 \times 35 = \mathbf{385}$$

$$\text{Cost of sales} = 1,320 - 385 = \mathbf{935}$$

Weighted average (periodic). One average cost per unit for the whole period.

Weighted average cost per unit = total cost available ÷ total units available

$$= 1,320 \div 40 = \mathbf{\$33.00}$$

$$\text{Closing inventory} = 11 \times 33.00 = \mathbf{363}$$

$$\text{Cost of sales} = 1,320 - 363 = \mathbf{957}$$

Same goods, same money spent, three different profits. Nothing dishonest has happened — this is why the *consistency* requirement and the disclosure of the valuation basis matter so much.

MOVING AVERAGE – THE PERPETUAL VERSION

Under perpetual, you recalculate the average *every time you buy*, and use the current average for each sale.

Hold 15 units @ \$30 = \$450

Buy 25 units @ \$34 = \$850

New average = $(450 + 850) \div 40 \text{ units} = \mathbf{\$32.50 \text{ per unit}}$

Every sale until the next purchase is costed at \$32.50.

Comparing the methods

METHOD	ASSUMPTION	ADVANTAGE	DRAWBACK
Specific identification	Each unit is identified with a specific invoice price	Consistent with the actual physical movement of the inventory	Offers room for <i>manipulating profit</i> — management can choose which unit to "sell"
FIFO	The cost of the first units acquired is the cost of the first units sold	Closing inventory reflects current prices; does not permit manipulation of profit	In times of inflation, releases the oldest and cheapest costs, giving the highest gross profit
LIFO	The cost of the last units acquired is the cost of the first units sold	Matches current cost against current revenue	Not permitted under AASB 102. Balance sheet values become outdated; profit can be manipulated. In inflation, gives the lowest gross profit
Weighted / moving average	An average cost applies to all units	Identical items are assigned identical values; smooths out profit and inventory values	The reported cost corresponds to no actual transaction

An entity should choose based on a range of factors; specific identification is ideal where it is practical. **LIFO is not allowed under the accounting standards.** Note also that LIFO cannot sensibly be run under a perpetual system — you cannot cost a sale using the price of items you have not purchased yet.

THE CHAIN TO RUN IN ANY COMPARISON

Higher closing inventory → lower cost of sales → higher gross profit and higher profit → higher total assets. Lower closing inventory does the reverse. Every comparison-of-methods question is answered by running that chain.

The corollary about errors: a misstatement of closing inventory misstates profit in the same direction this year, and in the *opposite* direction next year — because this year's closing inventory is next year's opening inventory. Over two years the errors cancel out; in either single year the profit is wrong.

PERIODIC VERSUS PERPETUAL, UNDER THE SAME METHOD

- **Specific identification and FIFO** give the *same* cost of sales and closing inventory under both systems.
- **Average cost** gives *different* results — weighted average computes one average for the whole period; moving average recomputes after each purchase.

Lower of cost and net realisable value

AASB 102 INVENTORIES

Inventories must be valued at the **lower of cost and net realisable value**, applied item by item.

Net realisable value is the estimated selling price in the ordinary course of business, less the estimated costs of completion and the estimated costs necessary to make the sale.

This is conservatism in operation: write inventory *down* when it will not recover its cost, but never *up* in anticipation of a profit not yet earned. If stock costing \$14,500 can now only be sold for \$9,200 net of selling costs, it is carried at \$9,200 and the \$5,300 loss is recognised now.

Presentation: AASB 102 requires suitable subclassifications relevant to the entity's activities, and the **valuation basis must be disclosed for each class of inventories**.

Consistency

The same methods and procedures must be used from period to period. Otherwise horizontal analysis is meaningless — you could not tell whether a change in gross profit came from trading or from switching cost flow assumption. This connects directly to **comparability** in Week 2 and to the **alternative accounting methods** limitation in Week 10.

One further element rides along with almost every purchase and sale made in Australia, and every entry so far has quietly left it out.

GST

Every journal entry in this book so far has ignored GST. It is time to put it back.

GST is a **value-added tax**: the tax is levied on the value added by a business at each stage of the production and distribution chain. It is collected by entities that are **registered for GST**, when they make **taxable supplies** in the course of their enterprise.

THE TWO CALCULATIONS

10% of the GST-exclusive price — use when you are given the price before tax.

1/11th of the GST-inclusive price — use when you are given the total the customer paid.

On \$1,000 exclusive: GST is \$100, total \$1,100. On \$1,100 inclusive: GST is \$100, sale \$1,000.

WHY 1/11 AND NOT 10%

If the sale is 100 and the GST is 10, the total is 110. The GST is 10 out of 110 of the total — that is 1/11, not 1/10. Taking 10% of a GST-inclusive figure always gives the wrong answer, and it is a classic slip.

GST COLLECTED

GST charged on your sales, held on behalf of the ATO and remitted to it.

A liability. Normal balance: credit.

GST PAID

GST paid on your purchases, recoverable from the ATO as an *input tax credit*.

An asset. Normal balance: debit.

GST IN THE JOURNALS – PERPETUAL SYSTEM

EVENT	ACCOUNT	DR	CR
Credit purchase \$1,100 incl. GST	Inventory <i>ex-GST</i>	1,000	
	GST Paid	100	
	Accounts Payable <i>the full amount owed</i>		1,100
Credit sale \$2,200 incl. GST	Accounts Receivable	2,200	
	Sales Revenue <i>ex-GST</i>		2,000
	GST Collected		200

EVENT	ACCOUNT	DR	CR
Remit to the ATO on the BAS	GST Collected	200	
	GST Paid		100
	Cash at Bank <i>the net amount</i>		100

Under a **periodic** system the same logic applies, with Purchases and Purchase Returns in place of Inventory:

PERIODIC, WITH GST			
Purchase 260 units @ \$40 + GST	Purchases 260×40	10,400	
	GST Paid	1,040	
	Accounts Payable		11,440
Freight-in \$310 + GST	Freight-in	310	
	GST Paid	31	
	Cash at Bank		341
Return 60 units @ \$40	Accounts Payable	2,640	
	Purchase Returns and Allowances		2,400
	GST Paid <i>the credit is reversed too</i>		240

GST NEVER TOUCHES REVENUE OR EXPENSE

Sales Revenue is always the **GST-exclusive** amount. The asset or expense is always the **GST-exclusive** amount. Only Accounts Receivable, Accounts Payable and Cash carry the GST-inclusive figure, because that is what actually changes hands. If GST has crept into your Sales or Inventory figure, the mark is gone.

Note too that when goods are returned, the GST on them is reversed as well — the return entry is for the GST-inclusive amount, split across the two accounts.

The three categories of supply

CATEGORY	GST ON YOUR SALE?	INPUT TAX CREDIT ON YOUR INPUTS?	EXAMPLES
Taxable supply	Yes — 10%	Yes	Most goods and services
GST-free supply	No	Yes	Basic (unprocessed) food; health goods and services; educational materials and services; childcare services; goods exported from Australia; transport services to or from Australia; supplies by inwards duty-free shops; supplies of a going concern
Input taxed supply	No	No	Financial supplies such as making loans, dealing in money and issuing securities; supply of residential (not commercial) premises for residential rent; the sale or long-term lease (generally at least 50 years) of <i>existing</i> residential premises — not new ones

THE DISTINCTION WORTH HOLDING ONTO

GST-free and input taxed *both* mean no GST is charged on the sale. The difference is what happens to the GST you paid on your inputs: a **GST-free** supplier still claims it back, while an **input taxed** supplier absorbs it as a cost. That is why the two categories are not interchangeable.

INPUT TAX CREDITS

GST paid by a business on its purchases is credited back by the ATO as an **input tax credit**. A business is entitled to a credit for its **creditable acquisitions** — a thing is acquired for a "creditable purpose" if it is acquired in carrying on the taxpayer's enterprise. Generally the credit equals the GST-inclusive price $\times$ 1/11. There is no credit where the acquisition relates to GST-free or input taxed supplies, and a **credit cannot be claimed unless the taxpayer holds a complying tax invoice**.

WORKED • THE NET AMOUNT REMITTED TO THE ATO

Priya runs a bicycle shop and is registered for GST. She buys a bicycle from a wholesaler for \$1,320 GST-inclusive and receives a complying tax invoice. She then sells it to a customer for \$2,860 GST-inclusive.

GST paid on the purchase = $1,320 \times 1/11 = \$120$ *claimed as an input tax credit*

GST collected on the sale = $2,860 \times 1/11 = \$260$ *remitted to the ATO*

Net GST = $260 - 120 = \$140$ **remitted**

Priya pays tax on the \$1,400 of value she added, not on the whole \$2,600 sale price. That is what "value-added tax" means, and it is why the chain does not tax the same value twice.

When a GST-registered business lodges its **Business Activity Statement (BAS)**, this net amount is what is calculated and paid.

That completes the operating cycle – buy, sell, collect, remit. What remains on the balance sheet are the assets a business holds for years rather than months.

PART THREE

Assets, liabilities and equity

Beyond the operating cycle sit the things a business keeps for years and the claims against them. These two chapters cover what the balance sheet is mostly made of: long-lived assets on one side, and the debt and ownership that funded them on the other.

Accounting for non-current assets

The assets in the last few chapters turned over within months. This chapter deals with the ones that stay: the land, buildings, vehicles and machinery a business uses for years. Because they are consumed slowly, their cost has to be spread across the periods that benefit — and because the spreading rests on estimates, two honest businesses can report very different numbers for identical assets.

Three skills sit in the topic and they are usually tested together: calculating depreciation under more than one method, journalising a disposal, and discussing what a difference in depreciation policy does to comparability.

What property, plant and equipment is

AASB 116 DEFINITION

PPE assets are **tangible items, with a specific use within the entity, that are expected to be used during more than one period** — that is, they are non-current in nature.

Property includes land and buildings. *Plant and equipment* includes cash registers, computers, office furniture, factory machinery and motor vehicles. Intangible assets are also non-current assets, but this unit focuses on tangible PPE.

Initial recognition — what goes into cost

PPE is recorded at **cost**: all expenditures necessary to acquire the asset and make it ready for its intended use. That sweeps in the purchase price plus delivery, installation, testing and stamp duty. It does *not* include the costs of running the asset once it is ready — registration and insurance are expenses, not part of cost.

Depreciation

WHAT DEPRECIATION IS — AND IS NOT

Under AASB 116, the economic benefits derived from an asset must be recognised on a **systematic basis over the asset's useful life**. This is recognised as depreciation expense in the income statement.

Depreciation is a **cost allocation process, not a valuation process**. It does not reduce the asset to market value, and it is not a fund being set aside for replacement. Carrying amount is simply cost less what has been allocated so far.

Land does not depreciate — it has an indefinite useful life.

TERM	MEANING
Cost (c)	All expenditures necessary to acquire the asset and make it ready for intended use
Useful life (n)	An estimate of expected life, based on intended use, need for repair, vulnerability to obsolescence and legal life
Residual value (r)	An estimate of the asset's value at the end of its useful life
Depreciable cost	Cost – residual value
Accumulated depreciation	The total amount of the asset's cost charged to depreciation expense since acquisition. A contra-asset, normal balance credit.
Carrying amount <i>book value</i>	Cost – accumulated depreciation

The entry is the same every period, whatever the method:

Period end	Depreciation Expense	✓
	Accumulated Depreciation – <i>named asset</i>	✓

THE THREE METHODS

Straight-line = (Cost – Residual) ÷ Useful life in years = (c – r) ÷ n

The same expense every year. Use when benefits are consumed evenly.

Diminishing balance = Carrying amount at start of year × Rate

A decreasing expense. Use when more benefit is consumed early in the asset's life.

Where the rate is not given: Rate = [1 – (residual ÷ cost)^{1/n}] × 100

Units of production = (Cost – Residual) ÷ Total expected units × Units this period

Use when useful life is best expressed as output rather than time.

WORKED • ONE REFRIGERATED VAN, THREE METHODS

Hartley Produce buys a refrigerated van. Cost \$86,000; expected residual value \$6,000; estimated useful life 5 years or 200,000 kilometres.

Straight-line

$$\text{Annual depreciation} = (86,000 - 6,000) \div 5 = \text{\$16,000 every year}$$

Diminishing balance. The rate is not given, so derive it:

$$\begin{aligned}\text{Rate} &= [1 - (6,000 \div 86,000)^{1/5}] \times 100 \\ &= (1 - 0.587) \times 100 = \textbf{41\% (approximately)}\end{aligned}$$

$$\text{Year 1} = 86,000 \times 41\% = 35,260 \quad \text{carrying amount now 50,740}$$

$$\text{Year 2} = 50,740 \times 41\% = 20,803 \quad \text{carrying amount now 29,937}$$

$$\text{Year 3} = 29,937 \times 41\% = 12,274 \quad \text{and so on, approaching but never below residual}$$

Units of production. Suppose the van travels 34,000 km this year.

$$\text{Depreciation per unit} = (86,000 - 6,000) \div 200,000 \text{ km} = \textbf{\$0.40 per km}$$

$$\text{This year's expense} = 0.40 \times 34,000 = \textbf{\$13,600}$$

Same van, same total cost over its life — but a very different expense in any single year, and therefore a different reported profit. That is the whole basis of the comparability discussion below.

RESIDUAL VALUE BEHAVES DIFFERENTLY UNDER DIMINISHING BALANCE

Straight-line and units of production **deduct residual value first**, then spread what is left.

Diminishing balance applies the rate to the **carrying amount**, and residual value is *not* deducted before you multiply. You simply stop depreciating once carrying amount reaches residual value. In year one, carrying amount equals cost — so a \$65,000 machine at 25% has \$16,250 of accumulated depreciation after its first full year, regardless of a \$5,000 residual.

Mixing these up is the most common error in this topic.

WORKED • TWO MACHINES, ACCUMULATED DEPRECIATION AT 31 DECEMBER 2025

Machine A — acquired 1 April 2024 by Ardent Plastics, cost \$92,000, residual \$8,000, 6 years, straight-line.

$$\text{Annual charge} = (92,000 - 8,000) \div 6 = 14,000$$

$$2024 \text{ April to December is 9 months} = 14,000 \times 9/12 = 10,500$$

$$2025 \text{ a full year} = 14,000$$

$$\text{Accumulated depreciation} = 10,500 + 14,000 = 24,500$$

Machine B — acquired 1 January 2025, cost \$65,000, residual \$5,000, diminishing balance at 25%.

$$2025 \text{ first year, so carrying amount} = \text{cost} = 65,000 \times 25\% = 16,250$$

$$\text{Accumulated depreciation} = 16,250$$

The part-year apportionment on Machine A is the hard part. Count months from the date of acquisition, not from the start of the year. And note the residual is used for Machine A but not for Machine B.

Subsequent expenditure

Once you own the asset, further spending on it is either expensed now or added to the asset. The test is whether it merely *maintains* the asset or genuinely *improves* it.

REVENUE EXPENDITURE — ORDINARY REPAIRS

Expenses incurred in **maintaining** the operating efficiency of the asset. Expensed immediately in the operating statement.

Dr Repairs Expense

Cr Cash at Bank

Servicing the truck, replacing worn tyres.

CAPITAL EXPENDITURE — ADDITIONS AND IMPROVEMENTS

Costs incurred to **increase** the capacity or operating efficiency of the asset, or extend its life. Capitalised and depreciated over the asset's remaining useful life.

Dr Asset e.g. Delivery Truck

Cr Cash at Bank

Fitting a refrigeration unit that lets the truck carry new products.

Disposal of PPE

An asset can leave the business three ways: **sale** (sold to another party), **scrapping** (discarded, usually for nothing), or **exchange** (traded in on a new asset).

THREE STEPS, IN THIS ORDER, EVERY TIME

1. Bring depreciation up to date to the date of disposal. This is a part-year charge apportioned by months, and it is the step people skip.
2. Remove the asset from the books — both its cost and its accumulated depreciation.
3. Record the proceeds and the resulting gain or loss.

Gain or loss = proceeds – carrying amount at the date of disposal. Proceeds above carrying amount is a gain (credit, reported as income); below is a loss (debit, reported as an expense).

WHY GAINS AND LOSSES ON DISPOSAL EXIST AT ALL

Useful life and residual value are *estimates* made years earlier. When the asset finally goes, reality rarely matches the estimate. A gain means you under-estimated what it would be worth — you depreciated too fast. A loss means the opposite. The gain or loss is really a correction of past depreciation, recognised all at once at the end.

THE THREE DISPOSAL SHAPES			
TYPE	ACCOUNT	DR	CR
Sale <i>at a gain</i>	Cash at Bank <i>proceeds</i>	✓	
	Accumulated Depreciation	✓	
	Asset <i>at original cost</i>		✓
	Gain on Disposal		✓
Scrapping <i>no proceeds</i>	Accumulated Depreciation	✓	
	Loss on Disposal <i>the remaining carrying amount</i>	✓	
	Asset		✓
Exchange <i>trade-in</i>	Accumulated Depreciation <i>on the old asset</i>	✓	
	New Asset	✓	
	Old Asset <i>at cost</i>		✓
	Gain on Disposal <i>if any</i>		✓

If an asset is **fully depreciated** and scrapped, carrying amount is nil, so there is no gain or loss — you simply remove both the cost and the matching accumulated depreciation.

Straight-line throughout; depreciation has been recorded to 31 December 2024; ignore GST.

1 January — scrapped a press. Bought 1 January 2013 for \$96,000, 12-year life, no residual. It is exactly twelve years old, so it is fully depreciated: carrying amount nil, no gain or loss, and no step-one entry needed.

1 Jan	Accumulated Depreciation — Machinery	96,000	
	Machinery		96,000

31 May — sold a lathe for \$14,500. Bought 1 January 2021 for \$75,000, 5-year life, no residual, so \$15,000 a year. Four full years to 31 December 2024 gives \$60,000. Now catch up five months of 2025.

Step 1 $75,000 \div 5 \times 5/12 = 6,250$

Accumulated depreciation at disposal = $60,000 + 6,250 = 66,250$

Carrying amount = $75,000 - 66,250 = 8,750$

Gain = $14,500 - 8,750 = 5,750$

31 May	Depreciation Expense $75,000 \div 5 \times 5/12$	6,250	
	Accumulated Depreciation — Lathe		6,250
31 May	Cash at Bank	14,500	
	Accumulated Depreciation — Lathe	66,250	
	Lathe		75,000
	Gain on Disposal		5,750

31 December — discarded a delivery van. Bought 1 October 2018 for \$28,000, 8-year life, \$1,600 residual.

Annual charge = $(28,000 - 1,600) \div 8 = 3,300$

To 31 Dec 2024 *6 years 3 months* = 20,625

2025 *full year* = 3,300

Accumulated depreciation at disposal *7 years 3 months* = 23,925

Carrying amount = $28,000 - 23,925 = 4,075$

Proceeds nil, so loss = **4,075**

31 Dec	Depreciation Expense $(28,000 - 1,600) \div 8$	3,300
	Accumulated Depreciation – Motor Vehicle	3,300
31 Dec	Accumulated Depreciation – Motor Vehicle	23,925
	Loss on Disposal	4,075
	Motor Vehicle	28,000

The \$1,600 residual was an estimate that discarding the van did not realise. The whole \$4,075 carrying amount is therefore a loss.

The comparability discussion

A standard discussion question runs like this. Calder Ltd depreciates its PPE assets over a 30-year life, whereas Marchetti Ltd depreciates its PPE assets over a 40-year life. Discuss the implications this has for comparing the results of the two entities.

HOW TO ANSWER IT, IN FOUR MOVES

1. By selecting a longer estimated useful life, Marchetti spreads the same cost over more periods. Its annual depreciation expense is *lower* and its reported profit is *higher*.
2. Calder's shorter useful life produces *higher* depreciation expense each period and *lower* reported profit.
3. Marchetti will therefore *appear* to be the better performer, even if the two businesses are economically identical. The effect reaches the balance sheet too: slower depreciation leaves higher carrying amounts for PPE and higher total assets, which depresses Marchetti's asset turnover and complicates any comparison of return on assets.
4. The difference arises from an accounting-policy choice, not from a difference in underlying performance. Useful life is an estimate requiring professional judgement. This illustrates two limitations of financial statement analysis — reliance on *estimates*, and the availability of *alternative accounting methods*. A meaningful comparison would require restating one entity onto the other's assumed life.

Move 4 is what separates a complete answer from a superficial one. Always name the limitation.

Assets have to be paid for. The other side of the balance sheet – who funded all this, and what they are owed – is the subject of the next chapter.

Accounting for liabilities and equity

Everything a business controls was funded by somebody: lenders, owners, or profits the business kept rather than paid out. This chapter covers both. The first half deals with obligations owed to outsiders, including the awkward ones whose amount or timing nobody yet knows. The second deals with the residual claim belonging to the owners themselves.

What a liability is

A liability is a **present obligation to an external party**, which must have **resulted from a past event**, and which is expected to result in a **future outflow of resources embodying economic benefits**. All three elements are needed.

It is recognised when it is probable that the outflow will occur and the amount can be measured reliably — or, in the current framework's language, when recognition gives relevant and faithfully represented information.

CURRENT VERSUS NON-CURRENT

A **current liability** is an obligation that can reasonably be expected to be paid within one year, or within the operating cycle if that is longer. Everything else is **non-current**. Liabilities are presented in the statement of financial position **in order of liquidity**.

COMMON CURRENT LIABILITIES

- Accounts payable
- GST Collected
- Notes payable
- Revenue received in advance
- Payroll and payroll deductions payable
- Warranty provision
- Dividends payable

COMMON NON-CURRENT LIABILITIES

- Bank loans
- Long-term notes
- Mortgage payable
- Debentures payable

Notes payable and interest

Notes payable record obligations in the form of **written notes**. They usually require the borrower to pay interest — a borrowing or finance cost — are transferable, are issued for varying periods, and are frequently used to meet short-term financing needs.

$$\text{Interest} = \text{Principal} \times \text{Annual rate} \times \text{Time expressed in years}$$

Camden Freight borrows \$120,000 on 1 September by signing a \$120,000, 6%, one-year note payable. Adjusting entries are made only at 31 December.

1 Sep	Cash at Bank	120,000	
	Note Payable		120,000
31 Dec	Interest Expense $120,000 \times 6\% \times 4/12$	2,400	
	Interest Payable		2,400

Two details matter. The credit is **Interest Payable**, not Note Payable and not Cash — the interest is accrued, not yet paid. And the $\times 4/12$ must be shown: only four of the twelve months have elapsed by 31 December.

Payroll and payroll deductions

Employers deduct amounts from employees' wages and salaries where those amounts must be paid to other parties — **PAYG withholding tax, superannuation, trade union fees and health insurance**. Until they are remitted, each is a separate liability. These are classified as current liabilities because they must be paid in the short term.

June wages of \$148,000, to be paid in July. Deductions: private health fund \$8,200, PAYG withheld \$33,600, superannuation \$12,900, union fees \$1,850.

30 Jun	Salaries and Wages Expense <i>gross</i>	148,000	
	Private Health Fund Payable		8,200
	PAYG Withheld Tax Payable		33,600
	Superannuation Payable		12,900
	Union Fees Payable		1,850
	Salaries and Wages Payable <i>the balancing figure</i>		91,450

The method: debit the **gross** figure as the expense, credit every deduction to its own payable, and let net pay fall out as the balance. $148,000 - 8,200 - 33,600 - 12,900 - 1,850 = 91,450$.

Note: in real Australian practice superannuation is usually an employer on-cost rather than an employee deduction. This unit's materials treat it as a deduction, so follow the question as written.

Provisions and contingent liabilities

	PROVISION	CONTINGENT LIABILITY
What it is	A liability for which the <i>amount or timing</i> of the future sacrifice is uncertain — but it <i>can</i> be reliably estimated	A possible obligation arising from a past event, where the amount is so uncertain it cannot be measured reliably, <i>or</i> it does not satisfy the probability criterion, <i>or</i> it depends on an uncertain future event outside the entity's control
Recognised in the accounts?	Yes — on the face of the statement of financial position	No
Disclosed?	Yes	Yes — in the notes to the financial statements
Examples	Warranty provision, long service leave, annual leave	An unresolved legal action; a guarantee of another party's debt

The standard example is a **warranty** — an obligation of the supplier of goods or services to the purchaser that the product will be functional for a stated period. There is significant uncertainty in measuring the future sacrifice, because it is *conditional on the customer making a claim* and the cost *depends on the nature of the fault*. But past experience makes it estimable, so it is a provision, not a contingent liability.

RECORDING A WARRANTY PROVISION		
Period end	Warranty Expense	✓
	Provision for Warranty	✓
When a claim is settled	Provision for Warranty	✓
	Cash at Bank / Inventory	✓

Notice the shape is identical to the allowance method for bad debts: estimate and expense first, then draw down the provision as actual claims arrive.

BOTH HALVES MATTER

"Contingent liabilities are **not recognised** in the accounts because they are neither probable nor able to be measured reliably; however, they **must be disclosed in the notes to the financial statements**." Both halves. Saying only "not recognised" loses the disclosure mark — and disclosure is the whole point of the concept.

Non-current liabilities and debt financing

A **debenture** is a note subject to a *secured charge* over the issuer's assets. An **unsecured note** carries no such security. Debentures are redeemed when repaid by the issuing company, and may be redeemed *before* maturity to reduce interest cost and remove debt from the statement of financial position — in which case the company eliminates the carrying amount, records the cash paid, and recognises any gain or loss on redemption.

Note: the unit materials mark the journal entry for redemption *before* maturity as outside the assessable content. Understand the concept; the entry itself is not something to worry about.

ADVANTAGES OF DEBT FINANCING

- **Shareholder control is not affected** — noteholders have no voting rights, so existing owners keep full control.
- **Tax savings result** — interest is deductible for tax purposes; dividends on shares are not.
- **Earnings per share may be higher** — interest reduces profit, but no additional shares are issued, so the profit is divided among fewer shares.

DISADVANTAGES OF DEBT FINANCING

- The company is **locked into fixed payments** that must be made in good times and bad.
- Interest must be paid on a periodic basis regardless of performance.
- The **principal must be repaid at maturity**.
- A company with fluctuating earnings and weak cash flow may struggle to meet interest in periods of low earnings.

Equity

Equity is the **residual interest of the owners in the assets of the entity after deducting liabilities**. Assets – liabilities = net assets = equity.

ENTITY TYPE	OWNED BY	SEPARATE ACCOUNTING ENTITY?	SEPARATE LEGAL ENTITY?
Sole proprietorship	One person	Yes	No
Partnership	Two or more partners	Yes	No
Company	Shareholders	Yes	Yes — with limited liability and protection for owners

THE THREE CATEGORIES OF COMPANY EQUITY

- **Share capital** — contributed equity. Ordinary or preference shares.
- **Retained earnings** — accumulated profits that have not been distributed to shareholders as dividends.
- **Reserves** — general reserve, asset revaluation reserve, foreign currency translation reserve and others. The nature and purpose of each must be disclosed.

Most reserves of Australian companies are classified as *revenue reserves* and can be distributed as dividends. Management may transfer retained earnings to a reserve account to **signal that it has no intention of distributing that amount in the near future**.

SHAREHOLDER RIGHTS

Ordinary shares carry three major ownership rights:

1. To **vote** in the election of the board of directors at annual general meetings, and on actions requiring shareholder approval.
2. To **share in company profits** through receipt of dividends.
3. To **share in assets on liquidation**, in proportion to holdings. This is a *residual claim* — owners are paid with whatever assets remain after all other claims are met.

Preference shares have priority over ordinary shares with respect to both dividends and claims at liquidation. Where a company has only one class of shares, they are called ordinary shares.

Share issues

A company usually receives cash in exchange for issuing shares. It must decide how many shares, how they are to be issued, and at what price.

- **Private placement** — shares are issued to certain private investors by invitation.
- **Public issue** — requires a **prospectus** inviting public applications. The prospectus reports on the company's financial position, performance and plans, and contains reports from independent parties.

WORKED • AN INSTALMENT SHARE ISSUE

Keel Marine Ltd invites the public to subscribe for 40,000 ordinary shares at \$2.00 per share — \$80,000 in total. The terms: \$1.00 per share payable on **application** by 31 March 2025; directors make the **allotment** on 1 April 2025; \$0.60 per share payable on allotment by 30 April 2025; the remaining \$0.40 per share to be **called** at a later date.

31 Mar	Cash Trust 40,000 × \$1.00 received with applications	40,000
	Application	40,000
1 Apr	Application shares allotted	40,000
	Share Capital	40,000
	Cash at Bank	40,000
	Cash Trust transferred out of trust on allotment	40,000
30 Apr	Cash at Bank 40,000 × \$0.60 allotment money	24,000
	Share Capital	24,000

The remaining \$0.40 per share, \$16,000, is uncalled capital. It is part of the issue but not yet demanded, so it is neither cash nor paid-up share capital.

Dividends

A **dividend** is a distribution of profit by a company to its shareholders on a *pro rata* basis. The directors determine whether a dividend is payable and fix the amount, the payment time and the payment method. Dividends may take the form of **cash**, **property** or **shares**. Public companies often pay two a year — an **interim** dividend during the year and a **final** dividend determined at year end.

WHEN A COMPANY MAY PAY A CASH DIVIDEND – THREE CONDITIONS

1. Assets exceed liabilities by more than the amount of the dividend proposed.
2. It is fair and reasonable to shareholders as a whole.
3. It does not materially prejudice the company's ability to pay its creditors.

On the **declaration date** the board formally declares the dividend and announces it to shareholders. Australian accounting standards require companies to recognise the decrease in retained earnings and the increase in the liability *Dividends Payable* if the dividend is declared **before the end of the reporting period**.

Declaration	Retained Earnings <i>or Dividends Declared</i>	✓
	Dividends Payable <i>a current liability</i>	✓
Payment	Dividends Payable	✓
	Cash at Bank	✓

SHARE DIVIDENDS

A **share dividend** is a pro rata distribution of the company's *own shares* to shareholders. **Total equity does not change** — retained earnings or general reserve decreases and share capital increases by the same amount. It is a transfer within equity, not a payment out of it.

What it signals: this amount of retained earnings is *not* going to be available to shareholders as a cash dividend.

Presenting equity

The equity section of a company's statement of financial position shows **share capital** (contributed equity, both paid and any outstanding amount), **retained earnings**, and **reserves**.

Retained earnings, opening balance
+ Profit for the period
- Dividends declared
- Transfers to reserves
= **Retained earnings, closing balance**

The **statement of changes in equity** reflects the net changes in every equity account for the period, and must show for each account a reconciliation between opening and closing balances.

That completes the financial statements. The remaining question is what a reader is supposed to do with them.

PART FOUR

Analysis and other structures

The last two chapters step back. One asks what the finished statements actually tell a reader; the other looks at what changes when a business is owned by partners rather than shareholders.

Financial statement analysis

The previous chapters built a set of financial statements. This one reads them. A reader confronted with a balance sheet and an income statement needs to turn a page of raw dollars into a judgement — is this business liquid, is it solvent, is it profitable, and compared with what?

The arithmetic here is the easiest in the unit; the interpretation is where the difficulty lies. **Being able to say what a ratio means for a particular business matters more than being able to compute it**, and the chapter is weighted accordingly.

Why analyse at all

- General purpose financial reports are the main source of financial data for external users, and investors — the major user group — base their economic decisions on them.
- Information expressed in monetary terms is of **limited use on its own; comparison is key**. Knowing a company made \$2 million tells you almost nothing until you know against what.
- Analysis reveals **relationships** between financial statement items and **trends** in the data.
- It enables **assessment of past performance**, which is the basis for forecasting future performance.

Three bases of comparison

INTRA-ENTITY

Comparisons within a single entity, over time.

Detects changes in financial relationships and trends.

INTER-ENTITY

Comparisons against other entities.

Indicates competitive position.

INDUSTRY AVERAGE

Comparisons against entities in the same industry.

Determines position relative to peers.

Three techniques

HORIZONTAL ANALYSIS

Evaluates a series of financial data **over a period of time**. One year is selected as the base year, and increases or decreases from it are expressed in both dollar amounts and percentages. Percentages remove the effect of size, so the relative magnitude of the change is revealed.

$$\text{Change \%} = (\text{Current year amount} - \text{Base year amount}) \div \text{Base year amount} \times 100$$

Trend (percentage) analysis is horizontal analysis extended over three or more years to assess growth prospects. Each year is expressed as an index against the base year:

$$\text{Index \%} = \text{Current year amount} \div \text{Base year amount} \times 100$$

$$\text{Revenue 2020 base} = 1,000,000 \div 1,000,000 \times 100 = \mathbf{100\%}$$

$$\text{Revenue 2021} = 1,050,000 \div 1,000,000 \times 100 = \mathbf{105\%}$$

VERTICAL ANALYSIS

Evaluates financial statement data by expressing each item as a **percentage of a base amount** within the same statement — each expense as a percentage of net sales, each asset as a percentage of total assets. This indicates relative magnitude, makes companies of very different sizes comparable, and can be tracked over time to reveal patterns of change.

RATIO ANALYSIS

Expresses the relationship between two or more dollar amounts as a ratio or percentage. Three families: **liquidity**, **solvency** and **profitability**.

Liquidity ratios

Measure the **short-term** ability of an entity to pay its debts as they fall due and meet unexpected needs for cash. Important to bankers, suppliers and other short-term creditors deciding whether to lend or extend credit. Liquidity is determined by the relationship between current assets and current liabilities — the **working capital** of the business.

RATIO	FORMULA	UNIT	WHAT IT TELLS YOU
Current ratio	Current assets ÷ Current liabilities	:1	Ability to cover short-term liabilities with all current assets. Above 1 means more current assets than current liabilities. Includes inventory and prepayments, which may not convert to cash quickly.
Quick ratio <i>acid test</i>	(Cash + Marketable securities + Net receivables) ÷ Current liabilities	:1	A more stringent measure — excludes inventory and prepaid assets because they are the least liquid current assets. Above 1 is a stronger signal than the current ratio.
Receivables turnover	Net credit sales ÷ Average net trade receivables	times	How many times receivables are converted into cash during the period; the effectiveness of credit and collection policies. <i>Higher</i> = collecting efficiently. <i>Lower</i> = struggling to collect, possible cash flow problems.

RATIO	FORMULA	UNIT	WHAT IT TELLS YOU
Average collection period	$365 \div \text{Receivables turnover}$	days	The same thing expressed in days. <i>Shorter</i> is generally better for cash flow. <i>Longer</i> suggests collection inefficiency or customer creditworthiness problems. Compare it against the stated credit terms.
Inventory turnover	$\text{Cost of sales} \div \text{Average inventory}$	times	How many times inventory is sold and replaced; the effectiveness of inventory management. <i>Higher</i> = strong sales and efficient management. <i>Lower</i> = overstocking or slow-moving stock tying up cash.
Average days in inventory	$365 \div \text{Inventory turnover}$	days	How long stock sits before it sells. <i>Longer</i> may signal overstocking or weak demand.

Solvency ratios

Measure the ability of an entity to **survive over a long period** and meet its long-term obligations.

RATIO	FORMULA	UNIT	WHAT IT TELLS YOU
Debt to total assets	$\text{Total liabilities} \div \text{Total assets}$	%	The percentage of total assets funded by creditors — the degree of leverage. <i>Higher</i> = more debt-financed, higher financial leverage and higher risk, more vulnerable to downturns and interest rate movements. <i>Lower</i> = more equity-financed, lower risk.
Times interest earned <i>interest coverage</i>	$\text{Profit before interest and tax (EBIT)} \div \text{Interest expense}$	times	Ability to meet interest payments out of operating profit. <i>Higher</i> = comfortable cover, low default risk. <i>Below 1</i> means the company is not generating enough income to cover its interest at all — a serious solvency warning.

CHECK THIS ONE AGAINST YOUR OWN NOTES

Debt to total assets is **liabilities over assets**. It appears inverted in at least one widely circulated set of ACCG1001 notes. If your answer comes out above 1 for an ordinary trading company, you have flipped it.

Profitability ratios

Measure the profit or operating success of an entity for a given period. The size of an entity's profit affects its **ability to obtain debt and equity financing**, its **liquidity position** and its **ability to grow**. Profitability is often regarded as the ultimate test of management's operating effectiveness.

RATIO	FORMULA	UNIT	WHAT IT TELLS YOU
Profit margin	$\text{Profit} \div \text{Net sales}$	%	Cents of profit per dollar of sales. High-volume firms such as supermarkets generally have low margins; low-volume firms such as white goods retailers have higher ones.
Gross profit rate	$\text{Gross profit} \div \text{Net sales}$	%	Ability to maintain a selling price above cost. The ratio declines as an industry becomes more competitive.
Asset turnover	$\text{Net sales} \div \text{Average total assets}$	times	Sales generated per dollar of assets. Varies enormously between industries.
Return on assets	$\text{Profit} \div \text{Average total assets}$	%	Overall profitability with respect to the investment in assets — how efficiently management uses the asset base.
Return on ordinary shareholders' equity	$(\text{Profit} - \text{Preference dividends}) \div \text{Average ordinary shareholders' equity}$	%	Earnings per dollar invested by the owners.
Operating expenses to sales	$\text{Operating expenses} \div \text{Net sales}$	%	The cost incurred to support each dollar of sales.

THE IDENTITY WORTH QUOTING

Return on assets = Profit margin × Asset turnover.

A business can reach the same return by selling a lot at thin margins or a little at fat ones. This one line answers any question of the form "is a higher margin always better?"

Sales revenue \$912,000, of which 40% is credit sales. Gross profit ratio 45%. Operating expenses \$286,000. Receivables \$48,600 (2025) and \$44,200 (2024). Inventory \$61,500 and \$58,900. Cash \$9,200 and \$18,400. Customers are given 30-day terms.

A – RECEIVABLES TURNOVER AND AVERAGE COLLECTION PERIOD

$$\text{Net credit sales} = 912,000 \times 40\% = 364,800$$

$$\text{Average receivables} = (48,600 + 44,200) \div 2 = 46,400$$

$$\text{Receivables turnover} = 364,800 \div 46,400 = \mathbf{7.86 \text{ times}}$$

$$\text{Average collection period} = 365 \div 7.86 = \mathbf{46.44 \text{ days}}$$

B – INVENTORY TURNOVER

The gross profit ratio is 45%, so cost of sales must be the other 55% of net sales.

$$\text{Cost of sales} = 912,000 \times 55\% = 501,600$$

$$\text{Average inventory} = (61,500 + 58,900) \div 2 = 60,200$$

$$\text{Inventory turnover} = 501,600 \div 60,200 = \mathbf{8.33 \text{ times}}$$

D – PROFIT MARGIN

$$\text{Gross profit} = 912,000 \times 45\% = 410,400$$

$$\text{Profit} = 410,400 - 286,000 = 124,400$$

$$\text{Profit margin} = 124,400 \div 912,000 = \mathbf{13.64\%}$$

C – WHY RECEIVABLES TURNOVER MATTERS, AND THIS COMPANY'S POSITION

Receivables relate to both short-term liquidity and operating efficiency. A large receivables balance is only an advantage if it can be converted to cash with relative ease. A business that collects quickly has good liquidity and does not tie up funds in unproductive assets. A high turnover suggests effective credit-granting and collection activities; granting credit to poor credit risks and making ineffective collection efforts produces a low ratio.

Here, turnover of 7.86 times means collection takes 46.44 days on average, against credit terms of 30 days. That is 16.44 days — more than half as long again as the terms allow — which is a genuine concern rather than a rounding issue.

The effect on the rest of the balance sheet is through cash: the closing balance has halved, falling from \$18,400 to \$9,200, while receivables have grown. Cash the business has earned is sitting in customers' hands instead of its own. Tightening the credit terms offered, or pursuing collection harder, would lift the cash balance and improve the ability to meet currently maturing debts.

E – IS A LARGER PROFIT MARGIN ALWAYS BETTER?

No. Although profit margin is a good indicator of operating performance, a larger margin is not necessarily better, because a high margin may require a large investment and come with low sales volume — while a high sales volume can compensate for a low margin.

For example, a supermarket might earn a 4% margin on \$5,000,000 of sales, which is \$200,000, while a jeweller earns a 20% margin on \$400,000, which is \$80,000. The lower margin is by far the better business. Margin must be read alongside asset turnover, which is exactly why $\text{return on assets} = \text{profit margin} \times \text{asset turnover}$.

FOUR HABITS WORTH BUILDING

- Use **average** balances wherever a ratio pairs an income-statement figure with a balance-sheet figure — both turnovers and both returns. Income is earned across the year; a balance exists at one instant.
- Use **net credit sales** for receivables turnover, not total sales. If the question says 30% credit, apply the 30%.
- State the **unit**: times, days, or per cent. A bare number can be marked wrong.
- Every "analyse" or "discuss" part wants three things: what the ratio means in general, what *this* number says about *this* business against a stated benchmark, and a consequence or recommendation.

Working capital management

Working capital = current assets – current liabilities. An entity must have sufficient working capital to meet its short-term operating costs and short-term debt obligations.

THE POINT MOST STUDENTS MISS

More working capital is not simply better. **Excess working capital is undesirable**, because those funds could be invested in other assets generating a higher return. Cash sitting idle and inventory sitting unsold both earn nothing. The goal is *sufficient*, not *maximum*.

Working capital management involves monitoring cash flow, current assets and current liabilities through ratio analysis. Three ratios are commonly used: the **current ratio**, the **collection ratio** (average collection period) and the **inventory turnover ratio**. This is named explicitly in the unit's learning outcomes, so be ready to define it and name those ratios.

Limitations of financial statement analysis

LIMITATION	WHY IT BITES
Estimates	Financial statements contain estimates — allowance for doubtful debts, depreciation expense, warranty costs. If the estimates are inaccurate, every ratio and percentage derived from them is inaccurate too.
Cost	Many items are carried at historic cost, which does not account for price-level changes. A building bought in 1990 sits at 1990 dollars.
Alternative accounting methods	Different accounting policies are permitted for similar activities — three depreciation methods, several inventory cost flow assumptions — so two entities' figures may not be comparable.
Atypical data	End-of-period data may not represent normal business conditions. A retailer's 30 June inventory says nothing about its December peak.
Diversification	Diversification within an entity limits usefulness, because consolidated ratios average away real differences between segments. Segment data provides more relevant and comparable information.

One assumption has run quietly through every chapter: that the business is a company, owned by shareholders. A great many are not.

Accounting for partnerships

Every entity in this book so far has been treated as a company, with share capital, retained earnings and shareholders. A great many Australian businesses — professional practices above all — are partnerships instead. Most of the accounting is unchanged: the same journals, the same statements, the same standards. What changes is the equity section, the way profit is divided, and the extent of the owners' personal exposure.

DEFINITION, FROM THE PARTNERSHIP ACT

A partnership is the relationship that subsists between persons carrying on a business in common with a view to profit.

Three necessary attributes:

1. A written or verbal **agreement** between two or more legally competent persons or entities to carry on a business.
2. Operated **with a view to earning a profit**.
3. Members must be **co-owners** of the business.

Characteristics

CHARACTERISTIC	WHAT IT MEANS
Mutual agency	Each partner acts as an <i>agent</i> — each has authority to act on behalf of the partnership and bind it in the ordinary course of business.
Unlimited liability	Each partner is responsible for the debts of the business. There is <i>no limit</i> , and personal assets can be taken.
Limited life	Admission, withdrawal, death or bankruptcy of a partner ends the existing partnership.
Co-ownership of property	Partnership assets are owned jointly by the partners.
Entity status	A separate <i>accounting</i> entity but not a separate <i>legal</i> entity, and not a separate taxpayer — partners are taxed individually on their share.

MUTUAL AGENCY PLUS UNLIMITED LIABILITY

Read those two together and you see why choosing partners matters so much. Any partner can commit the firm to a contract in the ordinary course of business, and every partner is then personally liable for it without limit. You are exposed to your partners' judgement with your own house on the line. This is the practical reason companies, with their separate legal personality and limited liability, largely displaced partnerships for anything sizeable.

ADVANTAGES

- **Pooling of resources** and the multiple skills of individual partners
- **Ease of formation** — simple and inexpensive to set up and dissolve
- **Subject to little regulation** compared with a company
- **Ease of decision making** — there is no board of directors
- There may be **tax advantages**, since the partnership is not taxed as an entity

DISADVANTAGES

- **Mutual agency** — you are bound by your partners' acts
- **Unlimited liability** for the debts of the business
- **Relationships among partners may be fragile**, and disputes over management or profit share are common
- Limited life and instability on any change in membership

The partnership agreement

Written or verbal. It should cover: the **partnership name and location**; the **nature of the business**; each partner's **name, investment and duties**; the **sharing of profits and losses**; **withdrawals (drawings)**; **dispute resolution**; **admission and withdrawal of partners**; and **partnership liquidation**.

Where the agreement is silent, the Partnership Act's default rules apply — which is the practical reason for putting it in writing.

Formation

THE ONE THING TO REMEMBER ABOUT FORMATION

Assets and liabilities contributed by partners are recorded in the partnership's books at **fair value** at the date of contribution — not at the contributing partner's carrying amount, and not at original cost.

THE GENERAL SHAPE

Assets <i>at fair value</i>	✓
Liabilities assumed	✓
Partner A, Capital <i>the net contribution</i>	✓

So if Okonkwo and Petrakis form a partnership with Okonkwo contributing \$95,000 cash and Petrakis \$60,000:

Cash at Bank	95,000	
Okonkwo, Capital	<i>initial investment by Okonkwo</i>	95,000
Cash at Bank	60,000	
Petrakis, Capital		60,000

The two accounting methods

Before allocating profit, you need to know which of two systems the partnership uses, because it changes which account gets credited.

	METHOD 1 – CAPITAL ACCOUNTS FLUCTUATING CAPITAL	METHOD 2 – FIXED CAPITAL PLUS RETAINED EARNINGS
Capital account records	Investments, drawings, and shares of profit or loss – so the balance fluctuates	Investments only (and withdrawals of capital) – so the balance is fixed
Second account per partner	None	A <i>retained earnings</i> account, for drawings and profit shares
Drawings account is closed to	Capital	Retained earnings
Profit distribution is credited to	Capital	Retained earnings

In both methods, the **Drawings** account is debited during the year with withdrawals of assets or personal expenses, and closed out at year end.

Allocating profits and losses

The allocation should consider each partner's **services performed**, **capital invested** and **business risk assumed**. Three common methods:

PARTNERS' SALARIES AND INTEREST ARE NOT EXPENSES

A partner's "salary" and interest on capital are **allocations of profit, not expenses of the partnership**. They do not reduce the profit figure; they determine how that profit is divided among the partners. It follows from the fact that partners are owners, not employees.

METHOD 1 • FIXED RATIO

Okonkwo and Petrakis agree to share profits and losses 3:2 respectively. At 30 June the profit was \$85,000.

$$\text{Okonkwo} = 85,000 \times 3/5 = \mathbf{51,000}$$

$$\text{Petrakis} = 85,000 \times 2/5 = \mathbf{34,000}$$

First transfer the profit out of the P&L Summary into a Profit Distribution account:

Profit or Loss Summary	85,000
Profit Distribution <i>transfer of profit to the distribution account</i>	85,000

Then allocate it, and here the two accounting methods diverge:

UNDER METHOD 1 – CAPITAL ACCOUNTS

Profit Distribution	85,000
Okonkwo, Capital	51,000
Petrakis, Capital	34,000

UNDER METHOD 2 – FIXED CAPITAL AND RETAINED EARNINGS

Profit Distribution	85,000
Okonkwo, Retained Earnings	51,000
Petrakis, Retained Earnings	34,000

METHOD 2 • RATIO BASED ON CAPITAL BALANCES

Okonkwo has capital of \$175,000 and Petrakis \$105,000. Profit at 30 June is \$85,000.

$$\text{Total capital} = 175,000 + 105,000 = 280,000$$

$$\text{Okonkwo} = 175,000 \div 280,000 \times 85,000 = \mathbf{53,125}$$

$$\text{Petrakis} = 105,000 \div 280,000 \times 85,000 = \mathbf{31,875}$$

$$\text{Check: } 53,125 + 31,875 = 85,000 \checkmark$$

Always check that the allocations sum back to the total profit. Rounding can leave you a dollar out, and the check catches it.

METHOD 3 • FIXED RATIO AFTER ALLOWING FOR INTEREST AND SALARY – THE FOUR STEPS

Okonkwo contributed \$175,000 and Petrakis \$105,000. They agree that each partner receives **interest of 8% on initial capital**; Okonkwo receives a **salary allowance of \$24,000** and Petrakis \$16,000 per year; and any **residual is shared equally**. The partnership's annual profit is \$85,000.

1 Interest on capital.

Okonkwo = $175,000 \times 8\% = \$14,000$ · Petrakis = $105,000 \times 8\% = \$8,400$ · Total \$22,400

2 Salaries to partners.

Okonkwo = \$24,000 · Petrakis = \$16,000 · Total \$40,000

3 Add interest and salary for each partner.

Okonkwo = $14,000 + 24,000 = \$38,000$ · Petrakis = $8,400 + 16,000 = \$24,400$ · Total \$62,400

4 Residual profit, shared in the agreed ratio.

Residual = $85,000 - 62,400 = \$22,600$, split equally = \$11,300 each

	OKONKWO	PETRAKIS	TOTAL
Interest on capital	14,000	8,400	22,400
Salary allowance	24,000	16,000	40,000
Share of residual profit	11,300	11,300	22,600
Total allocation	49,300	35,700	85,000

Work it in that order and lay it out as a table like this one — it makes the arithmetic checkable and shows the marker each step.

IF THE RESIDUAL IS NEGATIVE

Nothing changes. If interest and salaries total more than the profit, the residual is a *negative* number and is shared in the same ratio, reducing each partner's allocation. Partners still get their interest and salary allowances; the shortfall is simply borne between them. Do not stop and assume you have made an error.

Drawings and interest on drawings

During the year, a withdrawal of assets or payment of a personal expense is debited to the partner's Drawings account:

Partner A, Drawings	✓
Cash at Bank <i>cash drawings by partner</i>	✓

At year end the Drawings account is closed — to Capital under Method 1, or to Retained Earnings under Method 2:

Method 1	Partner A, Capital	✓
	Partner A, Drawings <i>closing entry for partner's drawings</i>	✓
Method 2	Partner A, Retained Earnings	✓
	Partner A, Drawings	✓

Where the agreement charges **interest on drawings**, the partner is charged and the amount goes back into the pool for distribution:

Method 1	Partner A, Capital	✓
	Profit Distribution <i>charging interest on drawings</i>	✓
Method 2	Partner A, Retained Earnings	✓
	Profit Distribution	✓

THE EFFECT OF INTEREST ON DRAWINGS

Interest on drawings **increases the profit available for distribution** to the partners. It is not income from outside the partnership — it is a transfer *between* partners, discouraging one partner from drawing more than their share and compensating the others when they do.

And that is the unit. The through-line, if there is one, is the idea the very first chapter opened with: accounting exists so that people who commit resources to a business — owners, lenders, employees, the public — can find out what was done with them. Every rule in the eleven chapters since is an attempt to make that account honest, comparable and timely.