THE CPAP STUDY GUIDE TO VCE ACCOUNTING

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5th edition

Adrian Peacock

Edited by Greg Gould

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UNIT 3: FINANCIAL ACCOUNTING FOR A TRADING BUSINESS

This unit focuses on financial accounting for a trading business owned by a sole proprietor, and highlights the role of accounting as an information system. Students use the double entry system of recording financial data and prepare reports using the accrual basis of accounting and the perpetual method of inventory recording.

Students develop their understanding of the accounting processes for recording and reporting and consider the effect of decisions made on the performance of the business. They interpret reports and information presented in a variety of formats and suggest strategies to the owner to improve the performance of the business.

Where appropriate, the accounting procedures developed in each area of study should incorporate the application of the Conceptual Framework, financial indicators to measure business performance, as well as the ethical considerations of business owners when making decisions, including financial, social and environmental.

Area of Study 1: Recording and analysing financial data

In this area of study students focus on identifying and recording financial data for a business. They use double entry accounting to record data and generate accounting information in the form of accounting reports and graphical representations. This information is used to assist the owner in making informed decisions about the operation of the business. Students should also consider strategies to improve the performance of the business, taking into account the ethical considerations relevant to the business owner.

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Outcome 1

On completion of this unit the student should be able to record financial data using a double entry system; explain the role of the General Journal, General Ledger and inventory cards in the recording process; and describe, discuss and analyse various aspects of the accounting system, including ethical considerations.

To achieve this outcome the student will draw on key knowledge and key skills outlined in Area of Study 1.

Key knowledge

- accounting assumptions and qualitative characteristics as applicable
- documents used by a business to record financial transactions
- the accounting elements: assets, liabilities, owner's equity, revenues and expenses
- classification of assets and liabilities into categories of current and non-current
- the effect of transactions on the accounting equation
- characteristics of the General Ledger with T-form accounts for manual recording
- the GST Clearing account
- the General Journal and General Ledger and their use in recording transactions, both manually and using ICT, including:
  - establishment of a double entry system
  - cash payments (GST on settlement discounts excluded)
  - cash receipts (GST on settlement discounts excluded)
  - credit sales of inventory
  - credit purchases of inventory
  - sales returns from accounts receivable
  - purchase returns to accounts payable
  - inventory write-down
  - inventory loss or gain
  - correction of errors
  - inventory used for advertising purposes (GST excluded)
  - drawings of inventory by the owner (GST excluded)
  - contribution of non-current assets at fair value by the owner
- the purpose and use of the pre-adjustment Trial Balance
- inventory cards using the First-In, First-Out (FIFO) and Identified Cost methods for:
  - inventory sold
  - inventory purchased
  - inventory returned
  - drawings of inventory by the owner
  - inventory used for advertising
  - inventory loss or gain

  - inventory write-down
- inventory valuation:
  - product and period costs
  - the lower of cost and net realisable value (NRV)
- internal control procedures to safeguard resources against theft and fraud
- financial indicators: inventory turnover, accounts payable turnover, accounts receivable turnover
- non-financial information available to assist analysis and decision-making in relation to inventory, accounts receivable and accounts payable
- strategies to improve the management of inventory, accounts receivable and accounts payable
- ethical considerations when making business decisions in relation to operating a trading business

Key skills

- use correct accounting terminology
- explain and apply relevant qualitative characteristics and accounting assumptions
- apply theoretical knowledge to simulated situations
- identify and manually record financial data in the General Journal, General Ledger and inventory cards
- use ICT to record financial data in the General Journal, General Ledger and inventory cards and to construct graphical representations
- distinguish between current and non-current assets, and current and non-current liabilities
- explain the purpose of a Trial Balance
- explain and apply appropriate internal control procedures
- analyse the effect of transactions on the accounting equation
- distinguish between product and period costs in relation to inventory valuation
- use ICT, including spreadsheets, to model and analyse the effect of alternative inventory valuation methods and cost assignment methods
- evaluate the effect of alternative inventory valuation methods and cost assignment methods on the accounting equation
- discuss strategies to improve the management of inventory, accounts receivable and accounts payable
- discuss ethical considerations involved in decisions made by owners of trading businesses

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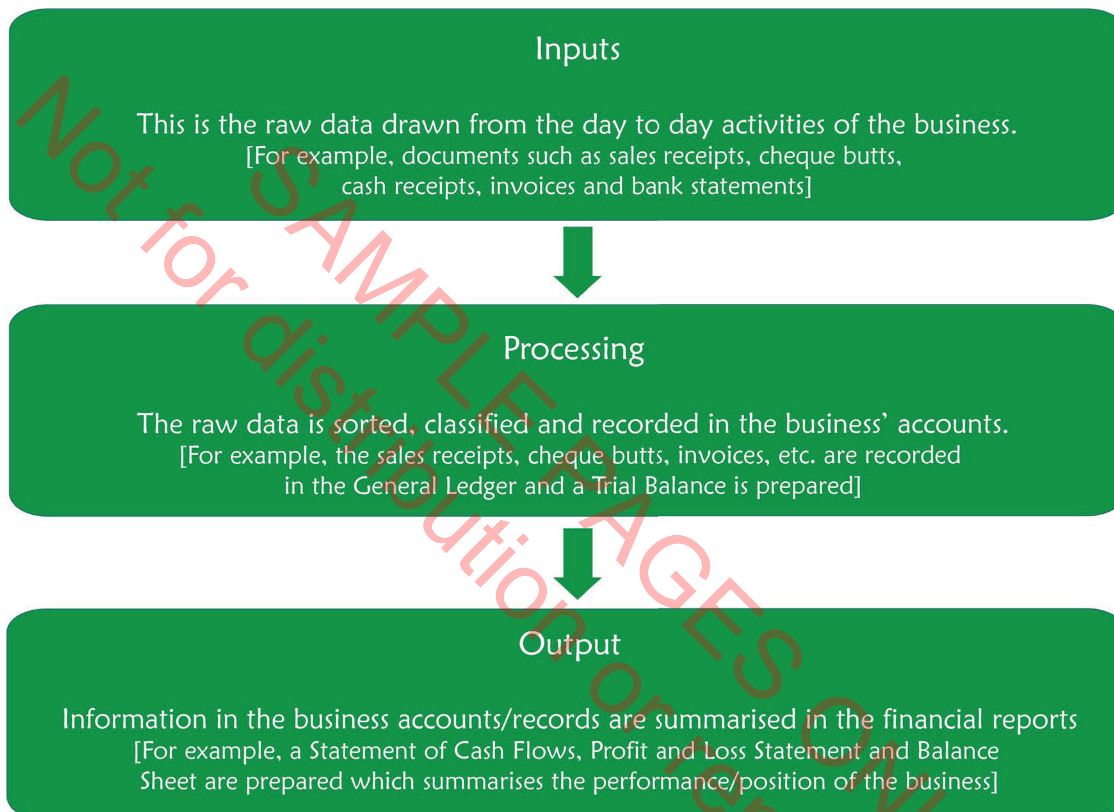
WHAT IS ACCOUNTING?

As noted in the VCE Accounting Study Design, Accounting involves modelling and forecasting financial information, such as sales and profit figures, and using that information to provide advice to stakeholders, such as shareholders and lenders. The modelling, forecasting and advice is conducted or enabled via the process of collecting, recording, reporting, analysing and interpreting financial and non-financial data and accounting information. This information, once communicated to internal stakeholders (e.g. managers) and external stakeholders (e.g. shareholders), is designed to improve both the decision-making and improve performance of the business. It is in this respect that Accounting plays an integral role in the successful operation and management of businesses.

In a nutshell, Accounting is a process involving the recording and reporting of financial information to allow users of this information to make decisions. This process consists of three important stages – Inputs, Processing and Output.



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As outlined on page 4, Unit 3 focuses on financial accounting for a trading business owned by a sole proprietor. It highlights the role of accounting as an information system, where students are taught to use the double entry system of recording financial data, as well as prepare reports using the accrual basis of accounting and the perpetual method of inventory recording.

Over the course of Unit 3, students will record and report financial information and consider the effect of business decisions on the overall performance of the business. Students will be then be required to interpret reports and other information and suggest strategies that are designed to improve the performance of the business.

Area of Study 1 focuses on identifying and recording financial data for a business using double entry accounting to record data and generate accounting information (e.g. accounting reports and graphical representations), while Area of Study 2 focuses on the preparation of financial reports and providing information that can be used as a basis for planning and decision-making by the owner. It will necessarily include an analysis of accounting reports and the interpretation of these reports (and other information) in order to evaluate the performance of the business.

ACCOUNTING ASSUMPTIONS AND QUALITATIVE CHARACTERISTICS

ACCOUNTING ASSUMPTIONS

Accounting assumptions are the basis of the preparation and presentation of financial statements.

Accounting Entity Assumption	The records of assets, liabilities and business activities of the entity are kept completely separate from those of the owner.
Accrual Basis Assumption	Under the accrual basis of accounting, revenue is recognised when it is earned and expenses recognised when they are incurred. Profit for a period is determined by subtracting expenses incurred for a period from revenue earned in that same period.
Going Concern Assumption	Financial reports are prepared on the assumption that the existing entity will continue to operate into the future.
Period Assumption	Reports are prepared for a particular period of time, such as a month or a year, in order to obtain comparability of results.

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QUALITATIVE CHARACTERISTICS

Qualitative characteristics are what makes information in financial statements useful to users.

Relevance	Relevant information is capable of making a difference to the decisions made by users.
Faithful representation	The information reported is complete, free from error and without bias.
Comparability	Comparability enables users to identify and understand similarities and differences in the information about an entity from another period.
Verifiability	The information reported will mean that all users will reach the same conclusion. An event will be faithfully represented when it can be verified by source documents and checked through the auditing process.
Timeliness	Timeliness means having information available to decision-makers in time to be capable of influencing their decisions.
Understandability	The information reported is presented clearly and concisely to be understood by users with reasonable knowledge of business activities.

Exam Tip: A useful way to prepare for assessment tasks and exams is to create study cards for key definitions or concepts. Purchase those white, lined cardboard cards from Officeworks. On one side, write the accounting assumption, qualitative characteristic, type of transaction or name of General Ledger account. On the reverse side, write out the definition, the General Journal entry to record the transaction or the format of the specific General Ledger account. As the year progresses, the number of study vave created will prove useful when preparing for SACs and the exam.

DOCUMENTS USED BY A BUSINESS TO RECORD FINANCIAL TRANSACTIONS

The following types of documents are commonly used by a business as records of financial transactions in VCE Accounting Units 3 and 4:

- Cash Receipt
- Cheque Butt
- Sales Invoice
- Purchase Invoice
- Credit Note
- Memo
- Bank statement
- Statement of account
- Electronic Funds Transfer (EFT) receipt
- Order
- Shipping and order confirmation
- Delivery docket
- Credit card receipt

For accounting data to be recorded it needs to be accurate so that all users will come to the same conclusion.

For information to be accurate, verifiability requires that the accounting data needs to be able to be verified by a source document through the auditing process.

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Exam Tip: Students should attempt to avoid common errors made by students in assessment tasks/examinations when attempting to demonstrate an understanding of 'source documents'. For example, it is important to remember that the location of the business name on the source document determines whether the invoice is a Sales Invoice, a Purchase Invoice, or a Credit Note (that requires a purchase return or sales return entry in the General Journal). Further, if the business's name being recorded appears at the top of an invoice, then the details from this invoice relate to a credit sale of inventory. Alternatively, if the business's name being recorded appears in the middle of an invoice, then the details from this invoice relate to a credit purchase of inventory. If, however, the business's name appears towards the top of a credit note, then details from this credit note relate to a sales return of inventory from a customer. In contrast, if the business's name appears towards the middle of a credit note, details from this credit note relate to a purchase return of inventory to a supplier.

Cash Receipt

Caldwell's Chocolates

1 Bucket Street

Wonkerville VIC 3999

CASH RECEIPT

Receipt # 412

Date 24 July 2019

Cash received from Nine Network

of $770

for December's account.

Matilda Caldwell

On 24 July 2019 Nine Network was issued receipt 412 by Caldwell's Chocolates for paying the $770 owing from December 2018.

Cheque Butt

Date	25 July 2019
Pay	Ray White
For	August Rent
$$$	$2 750 incl. GST
Caldwell's Chocolates	
CHQ 218	

On 25 July 2019 Caldwell's Chocolates used cheque 219 to pay Ray White $2 750 including GST for August's rent.

Sales Invoice

Caldwell's Chocolates			
Date: 26/07/19			Tax Invoice: 2884
Charge to: Arthur Slugworth			
Item	**Qty**	**Unit Cost**	**$**
'Classic' Box	8	$40	$320
		GST	$32
		Total Owing	$352
Credit Terms: 2/7, n/30			

On 26 July 2019 Arthur Slugworth purchased 8 boxes of 'Classic' chocolates from Caldwell's Chocolates on credit for $40 plus GST each and was issued invoice 2884.

If Arthur Slugworth pays Caldwell's Chocolates within 7 days of 26 July 2019 he is entitled to a 2 per cent discount. Alternatively, Arthur Slugworth is required to pay Caldwell's Chocolates within 30 days of 26 July 2019.

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Purchase Invoice

On 27 July 2019 Caldwell's Chocolates purchased 10 boxes of 'Standard' chocolates from Donaldson's Dairy on credit for $20 plus GST each and was issued invoice 1442.

If Caldwell's Chocolates pays Donaldson's Dairy within 5 days of 27 July 2019 he is entitled to a 5 per cent discount. Alternatively, Caldwell's Chocolates is required to pay Donaldson's Dairy within 28 days of 27 July 2019.

Donaldson's Dairy			
Date: 27/07/19			Tax Invoice: 1442
Charge to: Caldwell's Chocolates			
Item	**Qty**	**Unit Cost**	**$**
'Standard' Box	10	$20	$200
		GST	$20
		Total Owing	$220
Credit Terms: 5/10, n/28			

Credit Note – Sales Return

Caldwell's Chocolates			
Date: 28/07/19			Credit Note: 13
Credit: Beau Regarde			
Item	**Qty**	**Unit Cost**	**$**
'Sampler' Box	1	$10	$10
		GST	$1
		Total Credit	$11

On 28 July 2019 Beau Regarde returned 1 box of 'Sampler' chocolates to Caldwell's Chocolates. Beau Regarde received a credit of $10 plus GST reducing the amount they owed to Caldwell's Chocolates and was issued credit note 13.

Credit Note – Purchase Return

Ian's Imports			
Date: 29/07/19			Credit Note: 167
Credit: Caldwell's Chocolates			
Item	**Qty**	**Unit Cost**	**$**
'BIG' Collection	15	$30	$450
		GST	$45
		Total Credit	$495

On 29 July 2019 Caldwell's Chocolates returned 15 boxes of 'BIG' collection chocolates to Ian's Imports. Caldwell's Chocolates received a credit of $450 plus GST reducing the amount they owed to Ian's Imports and was issued credit note 167.

Memo

The purpose of a memo being completed is to document any non-cash transactions occurring within a business or transactions involving the owner.

Caldwell's Chocolates	
MEMO # 35	**Date** 31 August 2019
Bee Carson's debt of $550 needs to be written off.	
	Matilda Caldwell

On 31 August 2019 Matilda Caldwell of Caldwell's Chocolates has instructed her accountant to write off Bee Carson's debt of $550.

Bank Statement

A bank statement shows all the cash transactions of a business and their bank. It provides a 'cross-checking' mechanism for the business to compare the actual cash received and cash paid with their own records for accuracy.

CCA BANK
BANK STATEMENT
Caldwell's Chocolates

Date	Particulars	Debit	Credit	Balance
24/07	Cash / Cheques		770	6 430 CR
26/07	Chq 218	2 750		3 680 CR

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Statement of Account

Similarly to the Bank Statement, a Statement of Account shows all the transactions between a supplier and their credit customers. It provides a 'cross-checking' mechanism for the business to compare the actual transactions and balance owing at the end of a month with their own records.

Phillip's Products
88 Main Road
BALWYN VIC 3103

STATEMENT OF ACCOUNT

Account Name: Caldwell's Chocolates
1 Bucket Street
WONKERVILLE VIC 3999

Date: 31 August 2019

Date	Details	Debit	Credit	Balance
01/08	Balance			6 600 DR
04/08	Payment Received		6 468	132 DR
04/08	Discount Allowed		132	Nil
09/08	Invoice 349	10 560		10 560 DR
11/08	Credit Note 17		550	10 010 DR
29/08	Payment Received		2 000	8 010 DR

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Order

An order form is used to request inventory from a supplier.

Caldwell's Chocolates

1 Bucket Street

Wonkerville VIC 3999

ORDER FORM

TO: Donaldson's Dairy **DATE:** 18 July 2019

Inventory Item	Quantity
'Standard' Box	10

Matilda Caldwell

Shipping and Order Confirmation

A shipping and order confirmation form communicates with a customer that their inventory order has been sent and will arrive shortly.

DONALDSON'S DAIRY

SHIPPING CONFIRMATION

Australia Post Tracking Number: 19780316

TO: Donaldson's Dairy **DATE:** 20 July 2019

1 Bucket Street

Wonkerville VIC 3999

The following items have been included in your most recent order and have been dispatched today.

Inventory Item	Quantity
'Standard' Box	10

Donald Donaldson

Delivery Docket

A delivery docket provides a description of the inventory items that have been delivered and acts as evidence that the inventory items were received by the customer.

Exam Tip: Students need to be minful that an Order, Shipping and Order Confirmation and Delivery Docket do not constitute a financial transaction and require no entry in the General Journal.

Credit Card Receipt

A credit card receipt provides evidence of a customer paying the amount owing via use of their credit card facility. The credit card receipt amount can be checked against the bank statement.

CCA Bank

Caldwell's Chocolates

1 Bucket Street

Wonkerville VIC 3999

Customer Copy

DEBIT: XXXX XXXX XXXX XXXX 1930

Date: 29 July 2019

Amount: $132

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Electronic Funds Transfer (EFT) Receipt

An electronic funds transfer receipt provides evidence of funds being deposited directly into a supplier's bank account. The electronic funds transfer receipt amount can be checked against the bank statement.

ELECTRONIC FUNDS TRANSFER RECEIPT NUMBER:	1234567980
Date:	30 July 2019
Amount:	$660
FROM:	Weir Racing
TO:	Caldwell's Chocolates

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Exam Tip: Students should be prepared to complete source documents. For example, in the 2016 VCAA exam required students to complete a memo describing a transaction involving the withdrawal of inventory by the owner for personal use or inventory being donated for Advertising purposes.

ACCOUNTING ELEMENTS

Element	Definition
Asset	An asset is a present economic resource controlled by the entity as a result of past events.
Liability	A liability is a present obligation of the entity to transfer an economic resource as a result of past events.
Owner's Equity	Owner's Equity is the residual interest in the assets of the entity after deducting all its liabilities.
Revenue	Revenue is an increase in assets or decreases in liabilities that result in an increase in owner's equity, other than those relating to contributions from the owner.
Expenses	An expense is a decrease in assets or an increase in liabilities that result in a decrease in owner's equity, other than those relating to distributions to the owner.

Exam Tip: Even though it is recommended that definitions are memorised, it is the application of the specific componenets that is crucial to achieving full marks for questions relating to revenues and expenses .

CLASSIFICATION OF ASSETS AND LIABILITIES

Classification	Definition	Examples
Current Asset	Current assets are reasonably expected to be converted to cash, sold or consumed by a business within 12 months after the end of the reporting period.	Bank Accounts Receivable Inventory Prepaid Expenses Accrued Revenue GST Clearing (Refund)
Non-Current Asset	Non-current assets are expected to be used by the business entity for a number of years.	Equipment Shelving Van
Current Liability	Current liabilities are obligations of the entity that are reasonably expected to be settled within 12 months of the end of the reporting period.	Bank Overdraft Accounts Payable Accrued Expenses Unearned Revenue Loan GST Clearing
Non-Current Liability	Non-current liabilities are obligations of the entity that are not required to be settled within 12 months after the end of the reporting period.	Loan

Exam Tip: The classification of Assets and Liabilities between 'Current' and 'Non-Current' on a business's Balance Sheet satisfies the qualitative characteristic of Understandability.

Through the use of headings and sub-headings, totals and sub-totals, classifying items presents information in a manner that enables users with reasonable knowledge of business activities to understand the report.

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GENERAL LEDGER WITH T-FORM ACCOUNTS

Ledger accounts are accounting records that record all increases and decreases of that item during a reporting period. The group of individual ledger accounts is known as the General Ledger.

Name of Ledger

Date	Cross-reference	Amount	Date	Cross-reference	Amount
	DEBIT SIDE			CREDIT SIDE	

The rules for recording transactions in the General Ledger depend upon which accounting element is represented in each account.

Asset

Date	Cross-reference	Amount	Date	Cross-reference	Amount
	INCREASE			DECREASE	

Liability

Date	Cross-reference	Amount	Date	Cross-reference	Amount
	DECREASE			INCREASE	

Owner's Equity

Date	Cross-reference	Amount	Date	Cross-reference	Amount
	DECREASE			INCREASE	

Revenue

Date	Cross-reference	Amount	Date	Cross-reference	Amount
	DECREASE			INCREASE	

Expense

Date	Cross-reference	Amount	Date	Cross-reference	Amount
	INCREASE			DECREASE	

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Exam Tip: To perform well in the examination, students must know how to record the details from all source documents into each General Ledger account. For example, student responses in the 2017 exam highlighted that some students experienced difficulty posting details from multiple source documents directly into the GST Clearing account.

GENERAL JOURNAL AND GENERAL LEDGER – ESTABLISHMENT OF DOUBLE ENTRY SYSTEM

On 1 January 2019 Matilda Caldwell, the owner of Caldwell's Chocolates, had the following asset and liability balances.

	$	
Accounts Payable	12 800	
Accounts Receivable	16 500	
Bank	9 860	
Equipment	19 200	
GST Clearing	1 073	[credit]
Inventory	14 300	
Loan – MNC Bank	15 000	
Shelving	7 400	

Prepare the General Journal entry required to establish a double entry accounting system.

Exam Tip: Students should remember to label each of the account balances with either an A (for Assets) or L (for Liabilities). Each account balance with an A would be recorded as an debit. Each account balance with an L would be recorded as a credit. Students need to total the value of the Assets and deduct the total value of the Liabilities in order to calculate capital. This ensures the accounting equation balances. It is important that students do not assume that the balance of the Bank will be a debit and the balance of the GST Clearing will be a credit. Even though the business may have a Bank Overdraft, the name of the leder account will remain 'Bank'.

General Journal

Date	Details	Debit	Credit
01/01	Accounts Payable		12 800
	Accounts Receivable	16 500	
	Bank	9 860	
	Equipment	19 200	
	GST Clearing		1 073
	Inventory	14 300	
	Loan – MNC Bank		15 000
	Shelving	7 400	
	Capital		38 387

Post the General Journal entry establishing the double entry accounting system to the General Ledger.

General Ledger

Bank

Date	Cross-reference	Amount	Date	Cross-reference	Amount
01/01	Balance	9 860			

Accounts Receivable

Date	Cross-reference	Amount	Date	Cross-reference	Amount
01/01	Balance	16 500			

Inventory

Date	Cross-reference	Amount	Date	Cross-reference	Amount
01/01	Balance	14 300			

Equipment

Date	Cross-reference	Amount	Date	Cross-reference	Amount
01/01	Balance	19 200			

Shelving

Date	Cross-reference	Amount	Date	Cross-reference	Amount
01/01	Balance	7 400			

Accounts Payable

Date	Cross-reference	Amount	Date	Cross-reference	Amount
			01/01	Balance	12 800

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GST Clearing

Date	Cross-reference	Amount	Date	Cross-reference	Amount
			01/01	Balance	1 073

Loan – MNC Bank

Date	Cross-reference	Amount	Date	Cross-reference	Amount
			01/01	Balance	15 000

Capital

Date	Cross-reference	Amount	Date	Cross-reference	Amount
			01/01	Balance	38 387

APPLICATION EXERCISE 1

Neville Jetta owns and operates Neville's Nursey, a small business selling plants and garden related products. As at 1 February 2019 Neville determined the following account balances for his business.

	$
Accounts Payable	*4 840*
Accounts Receivable	*8 910*
Bank Overdraft	*2 080*
GST Payable	*1 170*
Inventory	*24 000*
Loan – MNC Bank	*18 000*
Office Equipment	*7 200*
Shelving	*11 400*
Van	*34 000*

***Prepare** the General Journal entry required to establish a double entry accounting system.*

General Journal

Date	*Details*	*Debit*	*Credit*

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GENERAL JOURNAL AND GENERAL LEDGER – CONTRIBUTION OF NON-CURRENT ASSETS AT FAIR VALUE

On 3 January 2019 Matilda Caldwell, the owner of Caldwell's Chocolates, contributed her Van to the business for the purposes of deliveries. Matilda originally purchased the Van in 2017 for $35 000 plus GST. Matilda believes the fair value of the Van to be $18 000.

Prepare the General Journal entry required to record this transaction and **post** it to the General Ledger.

General Journal

Date	Details	Debit	Credit
03/01	Van	18 000	
	Capital		18 000

General Ledger (extract)

Van

Date	Cross-reference	Amount	Date	Cross-reference	Amount
03/01	**Capital**	**18 000**			

Capital

Date	Cross-reference	Amount	Date	Cross-reference	Amount
			01/01	Balance	38 387
			03/01	**Van**	**18 000**

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Issues relating to the use of fair values

Fair value is the price that would be received to sell an asset in an orderly transaction between market participants at the measurement date.

Exam Tip: In the examination, it would be reasonably expected that students can discuss, making specific reference to qualitative characteristics, whether non-cash assets contributed to the business by the owner should be recorded at their fair value or its original cost.

As outlined above, the fair value of a non-cash asset contributed to a business by an owner is the price that would be received to sell an asset in an orderly transaction between market participants at the measurement date. The problem with assigning a fair value to a non-cash asset is that no two assets are exactly the same in terms of age and condition. Therefore, the use of a fair value is ultimately an estimated value reached by an owner.

The qualitative characteristic of relevance supports the use of fair values. Relevance outlines that information is relevant when it is capable of making a difference to the decisions made by users. Fair values are more relevant than an asset's original cost as it provides an estimate of the future economic benefits the asset is expected to provide the business from the date it is contributed by the owner.

However, the qualitative characteristics of verifiability and faithful representation do not support the use of fair values. Verifiability outlines that the information reported will mean that all users will reach the same conclusion. No two individuals will agree with the estimated value of an asset. An event will be faithfully represented when it can be verified by keeping source documents and checked through the auditing process. The use of fair values is that it is subject to the bias of the owner and can't be checked with reference to a source document.

GENERAL JOURNAL AND GENERAL LEDGER – CREDIT PURCHASES OF INVENTORY

On 6 January 2019 Caldwell's Chocolates purchased inventory from Donaldson's Dairy for $9 350 including GST (Invoice 1088). Donaldson's Dairy's credit terms are 2/7, n/30.

Prepare the General Journal entry required to record this transaction and **post** it to the General Ledger.

General Journal

Date	Details	Debit	Credit
06/01	Inventory	8 500	
	GST Clearing	850	
	Accounts Payable		9 350

General Ledger (extract)

Inventory

Date	Cross-reference	Amount	Date	Cross-reference	Amount
01/01	Balance	14 300			
06/01	**Accounts Payable**	**8 500**			

GST Clearing

Date	Cross-reference	Amount	Date	Cross-reference	Amount
06/01	**Accounts Payable**	**850**	01/01	Balance	1 073

Accounts Payable

Date	Cross-reference	Amount	Date	Cross-reference	Amount
			01/01	Balance	12 800
			06/01	**Inventory / GST Clearing**	**9 350**

EFFECT OF TRANSACTION ON ACCOUNTING EQUATION

Element	Items Increased / Decreased	Overall Effect	Amount
Assets	Inventory	Increase	$8 500
Liabilities	Accounts Payable ↑ by $9 350 / GST Clearing ↓ by $850	Increase	$8 500
Owner's Equity		No Effect	$0

EXPLANATION

As a result of the transaction on 6 January 2019, Assets (Inventory) would increase by $8 500, Liabilities would increase **overall** by $8 500 as Accounts Payable would increase by $9 350 but GST Clearing would decrease by $850, and there would be no effect on Owner's Equity.

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GENERAL JOURNAL AND GENERAL LEDGER – PURCHASE RETURNS TO ACCOUNTS PAYABLE

On 9 January 2019 Caldwell's Chocolates returned inventory to Donaldson's Dairy and received a credit of $550 including GST (Credit Note 14).

Prepare the General Journal entry required to record this transaction and **post** it to the General Ledger.

General Journal

Date	Details	Debit	Credit
09/01	Accounts Payable	550	
	Inventory		500
	GST Clearing		50

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General Ledger (extract)

Accounts Payable

Date	Cross-reference	Amount	Date	Cross-reference	Amount
09/01	**Inventory / GST Clearing**	**550**	01/01	Balance	12 800
			06/01	Inventory / GST Clearing	9 350

Inventory

Date	Cross-reference	Amount	Date	Cross-reference	Amount
01/01	Balance	14 300	**09/01**	**Accounts Payable**	**500**
06/01	Accounts Payable	8 500			

GST Clearing

Date	Cross-reference	Amount	Date	Cross-reference	Amount
06/01	Accounts Payable	850	01/01	Balance	1 073
			09/01	**Accounts Payable**	**50**

EFFECT OF TRANSACTION ON ACCOUNTING EQUATION

Element	Items Increased / Decreased	Overall Effect	Amount
Assets	Inventory	Decrease	$500
Liabilities	Accounts Payable ↓ by $550 / GST Clearing ↑ by $50	Decrease	$500
Owner's Equity		No Effect	$0

EXPLANATION

As a result of the transaction on 9 January 2019, Assets (Inventory) would decrease increase by $500, Liabilities would decrease **overall** by $500 as Accounts Payable would decrease by $550 but GST Clearing would increase by $50, and there would be no effect on Owner's Equity.

GENERAL JOURNAL AND GENERAL LEDGER – CASH PAYMENTS

On 12 January 2019 Caldwell's Chocolates used cheque 347 to pay Donaldson's Dairy the outstanding amount.

Prepare the General Journal entry required to record this transaction and **post** it to the General Ledger.

General Journal

Date	Details	Debit	Credit
12/01	Accounts Payable	8 800	
	Bank		8 624
	Discount Revenue		176

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Exam Tip: During reading time of the examination or a SAC time, it is important to make a mental note of dates and any reference to credit terms. For example, in relation to the current exercise, on 6 January 2019 Caldwell's Chocolates purchased inventory on credit. The supplier's credit terms were 2/7, n/30. A payment was then made on 12 January 2019. Therefore, Caldwell's Chocolates were entitled to a 2 per cent discount off the net amount owing. A complication to this event is that there was a purchase return of inventory on 9 January 2019. This reduced the amount Caldwell's Chocolates owed their supplier. It is this net amount owing that is the basis for the calculation of the discount, not the amount owing from the original credit purchase of inventory. [($9 350 - $550) x 0.02 = $176]

General Ledger (extract)

Accounts Payable

Date	Cross-reference	Amount	Date	Cross-reference	Amount
09/01	Inventory / GST Clearing	550	01/01	Balance	12 800
12/01	**Bank / Discount Revenue**	**8 800**	06/01	Inventory / GST Clearing	9 350

Bank

Date	Cross-reference	Amount	Date	Cross-reference	Amount
01/01	Balance	9 860	**12/01**	**Accounts Payable**	**8 624**

Discount Revenue

Date	Cross-reference	Amount	Date	Cross-reference	Amount
			12/01	**Accounts Payable**	**176**

EFFECT OF TRANSACTION ON ACCOUNTING EQUATION

Element	Items Increased / Decreased	Overall Effect	Amount
Assets	Bank	Decrease	$8 624
Liabilities	Accounts Payable	Decrease	$8 800
Owner's Equity	Net Profit (Discount Revenue)	Increase	$176

EXPLANATION

As a result of the transaction on 12 January 2019, Assets (Bank) would decrease by $8 624, Liabilities (Accounts Payable) would decrease by $8 800 and Owner's Equity (Net Profit) would increase by $176.

Exam Tip: It is crucial for students to identify the effect of transactions on the accounting equation. The 2017 VCAA Northern Hemisphere exam required students to complete a table to demonstrate how a transaction effected the accounting equation, and a number of students performed poorly. Importantly, not only can students be asked to demonstrate their knowledge of how transactions effect the accounting equation (via the completion of a table), they also need to be able to explain how the accounting equation is effected. The most important aspect of this approach is to explain the overall effect on an accounting element when multiple items effects an accounting element.

How does a discount for prompt payment satisfy the definition of revenue?

When a business pays a supplier within the credit terms and is entitled to a discount, the discount satisfies the definition of revenue as it decreases liabilities that results in an increase in owner's equity, other than that relating to contributions from the owner.

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Exam Tip: A reminder that not all of the definition of revenue is required to be included in a response. In terms of the response above, it is incorrect for students to include any reference to assets increasing.

Examples of Other Cash Payments

During January 2019 Caldwell's Chocolates also made the following payments.

13/01 Ian's Imports were paid $1 650 with cheque 348 for the amount owing from a credit purchase of Inventory in December 2018.

15/01 Monthly loan repayment to MNC Bank of $750 made with cheque 349. Each repayment includes $250 of interest.

18/01 Inventory of $2 200 including GST purchased from Bradbury's with cheque 350.

21/01 The Australian Taxation Office was sent cheque 351 for the GST owing of $1 073 from December 2018.

27/01 Cheque 352 for $1 250 was used by Matilda for personal use.

29/01 Advertising for $440 including GST was paid for with cheque 353.

31/01 Additional Shelving costing $3 300 plus GST purchased from Sidney Norman with cheque 354.

Prepare the General Journal entries required to record these transactions and **post** them to the General Ledger.

Exam Tip: It is very important not to confuse the words 'plus GST' and 'including GST'. When the transaction is described as 'plus GST', 10 per cent of the item is added in order to calculate the GST amount and the total of the payment. In contrast, when the transaction is described as 'including GST', the total amount of the payment needs to be divided by 11 inorder to calculate the GST amount.

General Journal

Date	Details	Debit	Credit
13/01	Accounts Payable	1 650	
	Bank		1 650
15/01	Loan – MNC Bank	500	
	Interest Expense	250	
	Bank		750
18/01	Inventory	2 000	
	GST Clearing	200	
	Bank		2 200
21/01	GST Clearing	1 073	
	Bank		1 073
27/01	Drawings	1 250	
	Bank		1 250
29/01	Advertising	400	
	GST Clearing	40	
	Bank		440
31/01	Shelving	3 300	
	GST Clearing	330	
	Bank		3 630

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General Ledger (extract)

Bank

Date	Cross-reference	Amount	Date	Cross-reference	Amount
01/01	Balance	9 860	12/01	Accounts Payable	8 624
			13/01	**Accounts Payable**	**1 650**
			15/01	**Loan – MNC Bank/Interest Expense**	**750**
			18/01	**Inventory / GST Clearing**	**2 200**
			21/01	**GST Clearing**	**1 073**
			27/01	**Drawings**	**1 250**
			29/01	**Advertising / GST Clearing**	**440**
			31/01	**Shelving / GST Clearing**	**3 630**

Inventory

Date	Cross-reference	Amount	Date	Cross-reference	Amount
01/01	Balance	14 300	09/01	Accounts Payable	500
06/01	Accounts Payable	8 500			
18/01	**Bank**	**2 000**			

Shelving

Date	Cross-reference	Amount	Date	Cross-reference	Amount
01/01	Balance	7 400			
31/01	**Bank**	**2 000**			

Accounts Payable

Date	Cross-reference	Amount	Date	Cross-reference	Amount
09/01	Inventory / GST Clearing	550	01/01	Balance	12 800
12/01	Bank / Discount Revenue	8 800	06/01	Inventory / GST Clearing	9 350
13/01	**Bank**	**1 650**			

GST Clearing

Date	Cross-reference	Amount	Date	Cross-reference	Amount
06/01	Accounts Payable	850	01/01	Balance	1 073
18/01	**Bank**	**200**	09/01	Accounts Payable	50
21/01	**Bank**	**1 073**			
29/01	**Bank**	**40**			
31/01	**Bank**	**330**			

Loan – MNC Bank

Date	Cross-reference	Amount	Date	Cross-reference	Amount
15/01	**Bank**	**500**	01/01	Balance	15 000

Drawings

Date	Cross-reference	Amount	Date	Cross-reference	Amount
27/01	**Bank**	**1 250**			

Advertising

Date	Cross-reference	Amount	Date	Cross-reference	Amount
29/01	**Bank**	**400**			

Interest Expense

Date	Cross-reference	Amount	Date	Cross-reference	Amount
15/01	**Bank**	**250**			

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PERCENTAGE MARK-UP

A mark-up is a percentage of the cost price that is added to the cost price to determine a selling price.

Exam Tip: When given a cost price (excluding GST) and a mark-up percentage you need to multiply in order to calculate the selling price (excluding GST).

Cost Price (excluding GST)	Mark-Up	Action [1 + % mark-up]	Selling Price (excluding GST)
$100	50%	x 1.5	$150
$100	100%	x 2	$200
$100	150%	x 2.5	$250
$100	200%	x 3	$300

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Exam Tip: When given a selling price (excluding GST) and a mark-up percentage you need to divide in order to calculate the cost price (excluding GST).

Selling Price (excluding GST)	Mark-Up	Action [1 + % mark-up]	Cost Price (excluding GST)
$150	50%	/ 1.5	$100
$200	100%	/ 2	$100
$250	150%	/ 2.5	$100
$300	200%	/ 3	$100

GENERAL JOURNAL AND GENERAL LEDGER – CREDIT SALES OF INVENTORY

On 11 January 2019 Draper Hotels purchased inventory from Caldwell's Chocolates for $4 950 including GST (Invoice 316). These items cost Caldwell's Chocolates $1 980 including GST. Caldwell's Chocolates' credit terms are 2/7, n/30.

Prepare the General Journal entry required to record this transaction and post it to the General Ledger.

General Journal

Date	Details	Debit	Credit
11/01	Accounts Receivable	4 950	
	Credit Sales		4 500
	GST Clearing		450
	Cost of Sales	1 800	
	Inventory		1 800

Exam Tip: In examinations, it is common for students to misread transactions of this nature. The word 'including' will often cause students some angst. Always remember that when recording the cost price allocated for the item of inventory sold, GST is ignored or removed from the GST inclusive cost.

General Ledger (extract)

Accounts Receivable

Date	Cross-reference	Amount	Date	Cross-reference	Amount
01/01	Balance	16 500			
11/01	**Credit Sales / GST Clearing**	**4 950**			

Credit Sales

Date	Cross-reference	Amount	Date	Cross-reference	Amount
			11/01	**Accounts Receivable**	**4 500**

GST Clearing

Date	Cross-reference	Amount	Date	Cross-reference	Amount
06/01	Accounts Payable	850	01/01	Balance	1 073
18/01	Bank	200	09/01	Accounts Payable	50
21/01	Bank	1 073	**11/01**	**Accounts Receivable**	**450**
29/01	Bank	40			
31/01	Bank	330			

Cost of Sales

Date	Cross-reference	Amount	Date	Cross-reference	Amount
11/01	**Inventory**	**1 800**			

Inventory

Date	Cross-reference	Amount	Date	Cross-reference	Amount
01/01	Balance	14 300	09/01	Accounts Payable	500
06/01	Accounts Payable	8 500	**11/01**	**Cost of Sales**	**1 800**
18/01	Bank	2 000			

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EFFECT OF TRANSACTION ON ACCOUNTING EQUATION

Element	Items Increased / Decreased	Overall Effect	Amount
Assets	Accounts Receivable ↑ by $4 950 / Inventory ↓ by $1 800	Increase	$3 150
Liabilities	GST Clearing	Increase	$450
Owner's Equity	Net Profit (Credit Sales ↑ by $4 500 / Cost of Sales ↑ $1 800)	Increase	$2 700

EXPLANATION

As a result of the transaction on 11 January 2019, Assets would increase **overall** by $3 150 as Accounts Receivable would increase by $4 950 but Inventory would decrease by $1 800. Liabilities (GST Clearing) would increase by $450. Owner's Equity (Capital) would increase **overall** by $2 700 as Credit Sales would increase by $4 500 as would Cost of Sales by $1 800.

GENERAL JOURNAL AND GENERAL LEDGER – SALES RETURNS FROM ACCOUNTS RECEIVABLE

On 13 January 2019 Draper Hotels returned inventory to Caldwell's Chocolates and received a credit of $550 including GST (Credit Note 6). These items originally had a cost price of $200.

Prepare the General Journal entry required to record this transaction and **post** it to the General Ledger.

General Journal

Date	Details	Debit	Credit
13/01	Sales Returns	500	
	GST Clearing	50	
	Accounts Receivable		550
	Inventory	200	
	Cost of Sales		200

General Ledger (extract)

Sales Returns

Date	Cross-reference	Amount	Date	Cross-reference	Amount
13/01	**Accounts Receivable**	**500**			

GST Clearing

Date	Cross-reference	Amount	Date	Cross-reference	Amount
06/01	Accounts Payable	850	01/01	Balance	1 073
13/01	**Accounts Receivable**	**50**	09/01	Accounts Payable	50
18/01	Bank	200	11/01	Accounts Receivable	450
21/01	Bank	1 073			
29/01	Bank	40			
31/01	Bank	330			

Accounts Receivable

Date	Cross-reference	Amount	Date	Cross-reference	Amount
01/01	Balance	16 500	**13/01**	**Sales Returns / GST Clearing**	**550**
11/01	Credit Sales / GST Clearing	4 950			

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Inventory

Date	Cross-reference	Amount	Date	Cross-reference	Amount
01/01	Balance	14 300	09/01	Accounts Payable	500
06/01	Accounts Payable	8 500	11/01	Cost of Sales	1 800
13/01	**Cost of Sales**	**200**			
18/01	Bank	2 000			

Cost of Sales

Date	Cross-reference	Amount	Date	Cross-reference	Amount
11/01	Inventory	1 800	**13/01**	**Inventory**	**200**

EFFECT OF TRANSACTION ON ACCOUNTING EQUATION

Element	Items Increased / Decreased	Overall Effect	Amount
Assets	Inventory ↑ by $200 / Accounts Receivable ↓ by $550	Decrease	$350
Liabilities	GST Clearing	Decrease	$50
Owner's Equity	Net Profit (Sales Returns ↑ by $500 / Cost of Sales ↓ $200)	Decrease	$300

EXPLANATION

As a result of the transaction on 13 January 2019, Assets would decrease **overall** by $350 as Inventory would increase by $200 but Accounts Receivable would decrease by $550. Liabilities (GST Clearing) would decrease by $50. Owner's Equity (Capital) would decrease **overall** by $300 as Sales Returns would increase by $500 but Cost of Sales would decrease by $200.

GENERAL JOURNAL AND GENERAL LEDGER – CASH RECEIPTS

On 17 January 2019 Caldwell's Chocolates issued Draper Hotels receipt 583 when they paid their outstanding amount.

General Journal

Date	Details	Debit	Credit
17/01	Bank	4 312	
	Discount Expense	88	
	Accounts Receivable		4 400

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General Ledger (extract)

Bank

Date	Cross-reference	Amount	Date	Cross-reference	Amount
01/01	Balance	9 860	12/01	Accounts Payable	8 624
17/01	**Accounts Receivable**	**4 312**	13/01	Accounts Payable	1 650
			15/01	Loan – MNC Bank / Interest Expense	750
			18/01	Inventory / GST Clearing	2 200
			21/01	GST Clearing	1 073
			27/01	Drawings	1 250
			29/01	Advertising / GST Clearing	440
			31/01	Shelving / GST Clearing	3 630

Discount Expense

Date	Cross-reference	Amount	Date	Cross-reference	Amount
17/01	**Accounts Receivable**	**88**			

Accounts Receivable

Date	Cross-reference	Amount	Date	Cross-reference	Amount
01/01	Balance	16 500	13/01	Sales Returns / GST Clearing	550
11/01	Credit Sales / GST Clearing	4 950	**17/01**	**Bank / Discount Expense**	**4 400**

EFFECT OF TRANSACTION ON ACCOUNTING EQUATION

Element	Items Increased / Decreased	Overall Effect	Amount
Assets	Bank ↑ by $4 312 / Accounts Receivable ↓ by $4 400	Decrease	$88
Liabilities		No Effect	$0
Owner's Equity	Net Profit (Discount Expense)	Decrease	$88

EXPLANATION

As a result of the transaction on 17 January 2019, Assets would decrease **overall** by $88 as Bank would increase by $4 312 but Accounts Receivable would decrease by $4 400. There would be no effect on Liabilities and Owner's Equity (Net Profit) would decrease by $88.

How does a discount for prompt payment satisfy the definition of expense?

When a customer pays within the credit terms and is entitled to a discount, the discount satisfies the definition of an expense as it decreases assets that results in a decrease in owner's equity, other than that relating to distributions to the owner.

Examples of Other Cash Receipts

During January 2019 Caldwell's Chocolates also had the following receipts.

18/01 Matilda decided to deposit $5 000 into her business' bank account.

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21/01 Sale made to Kevin Heffernan of $990 including GST (Receipt 585). The inventory items sold were marked up by 50%.

27/01 Chloe Smith was issued receipt 586 when she paid $2 200. This amount related to a Credit Sale recorded in December 2018.

29/01 Cash Sale of $380 plus GST (Receipt 587) made to George Ryder. The cost of sales for these items were $190.

Prepare the General Journal entries required to record these transactions and **post** them to the General Ledger.

General Journal

Date	Details	Debit	Credit
18/01	Bank	5 000	
	Capital		5 000
21/01	Bank	990	
	Cash Sales		900
	GST Clearing		90
	Cost of Sales	600	
	Inventory		600
27/01	Bank	2 200	
	Accounts Receivable		2 200
29/01	Bank	418	
	Cash Sales		380
	GST Clearing		38
	Cost of Sales	190	
	Inventory		190

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General Ledger (extract)

Bank

Date	Cross-reference	Amount	Date	Cross-reference	Amount
17/01	Accounts Receivable	4 312	13/01	Accounts Payable	1 650
18/01	**Capital**	**5 000**	15/01	Loan – MNC Bank/Interest Expense	750
21/01	**Cash Sales / GST Clearing**	**990**	18/01	Inventory / GST Clearing	2 200
27/01	**Accounts Receivable**	**2 200**	21/01	GST Clearing	1 073
29/01	**Cash Sales / GST Clearing**	**418**	27/01	Drawings	1 250
			29/01	Advertising / GST Clearing	440
			31/01	Shelving / GST Clearing	3 630

Accounts Receivable

Date	Cross-reference	Amount	Date	Cross-reference	Amount
01/01	Balance	16 500	13/01	Sales Returns / GST Clearing	550
11/01	Credit Sales / GST Clearing	4 950	17/01	Bank / Discount Expense	4 400
			27/01	**Bank**	**2 200**

Inventory

Date	Cross-reference	Amount	Date	Cross-reference	Amount
01/01	Balance	14 300	09/01	Accounts Payable	500
06/01	Accounts Payable	8 500	11/01	Cost of Sales	1 800
13/01	Cost of Sales	200	**21/01**	**Cost of Sales**	**600**
18/01	Bank	2 000	**29/01**	**Cost of Sales**	**190**

GST Clearing

Date	Cross-reference	Amount	Date	Cross-reference	Amount
06/01	Accounts Payable	850	01/01	Balance	1 073
13/01	Accounts Receivable	50	09/01	Accounts Payable	50
18/01	Bank	200	11/01	Accounts Receivable	450
21/01	Bank	1 073	**21/01**	**Bank**	**90**
29/01	Bank	40	**29/01**	**Bank**	**38**
31/01	Bank	330			

Capital

Date	Cross-reference	Amount	Date	Cross-reference	Amount
			01/01	Balance	38 387
			03/01	Van	18 000
			18/01	**Bank**	**5 000**

Cash Sales

Date	Cross-reference	Amount	Date	Cross-reference	Amount
			21/01	**Bank**	**900**
			29/01	**Bank**	**380**

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Cost of Sales

Date	Cross-reference	Amount	Date	Cross-reference	Amount
11/01	Inventory	1 800	13/01	Inventory	200
21/01	**Inventory**	**600**			
29/01	**Inventory**	**190**			

GST CLEARING ACCOUNT

Below is the GST Clearing account from the General Ledger of Caldwell's Chocolates for the month ending 31 January 2019.

GST Clearing

Date	Cross-reference	Amount	Date	Cross-reference	Amount
06/01	Accounts Payable	850	01/01	Balance	1 073
13/01	Accounts Receivable	50	09/01	Accounts Payable	50
18/01	Bank	200	11/01	Accounts Receivable	450
21/01	Bank	1 073	21/01	Bank	90
29/01	Bank	40	29/01	Bank	38
31/01	Bank	330			rep

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Why did the GST Clearing account have a credit balance on 1 January 2019?

Caldwell's Chocolates had a credit balance in their GST Clearing account on 1 January 2019 as the amount of GST collected from Cash Sales and the GST charged on Credit Sales was greater than the amount of GST paid on cash payments of expenses and purchases of assets and the GST incurred on credit purchases of assets in period ended 31 December 2018.

How would the GST Clearing account be classified on the Balance Sheet as at 1 January 2019?

As the GST Clearing account had a credit balance on 1 January 2019, the account would be classified as a Current Liability as this amount represents a present obligation of Caldwell's Chocolates to transfer of an economic resource as a result of past events within 12 months of the end of the reporting period.

Why would a GST Clearing account have a debit balance?

A business will have a debit balance at the start of the reporting period as the amount of GST collected from Cash Sales and the GST charged on Credit Sales was less than the amount of GST paid on cash payments of expenses and purchases of assets and the GST incurred on credit purchases of assets during the previous period.

This may have occurred due to a large purchase of stock that remained unsold at the end of the period or the purchase of a non-current asset.

How would a GST Clearing account with a debit balance be classified on the Balance Sheet?

A GST Clearing account with a debit balance would be classified as a Current Asset as this amount represents a present economic resource controlled by the entity as a result of past events where the GST refund is reasonably expected to be received within 12 months after the end of the reporting period.

FOOTING A LEDGER ACCOUNT

At this stage of your accounting life, General Ledger accounts for Revenues, Expenses, Capital and Drawings can be informally 'footed'.

'Footing' involves simply calculating what the balance of the ledger account is and circling the balance for inclusion in the Trial Balance on the date the Trial Balance is being prepared.

Cash Sales

Date	Cross-reference	Amount	Date	Cross-reference	Amount
			21/01	Bank	900
			29/01	Bank	380
					1 280

Cost of Sales

Date	Cross-reference	Amount	Date	Cross-reference	Amount
11/01	Inventory	1 800	13/01	Inventory	200
21/01	Inventory	600			
29/01	Inventory	190			
		2 390			

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GENERAL JOURNAL AND GENERAL LEDGER - CORRECTION OF ERRORS

Believe it or not, accountants are not perfect! Sometimes, an accountant may prepare an incorrect General Journal entry or post a General Journal entry to the wrong account in the General Ledger.

One of these errors may be identified on balance day and require a correcting entry to ensure that the accounting reports are more accurate. This will require students to transfer an amount **out** of the incorrect account and post it **into** the correct account.

To illustrate, in the November 2017 VCAA examination, students were told that a payment for Wages of $280 was incorrectly recorded as a payment for Drawings.

The correcting entry would appear as follows:

General Journal

Date	Details	Debit	Credit
30/06	Wages	280	
	Drawings		280

The effect of this correcting entry is that the $280 is taken **out** of the Drawings account and posts it **into** the Wages account in the General Ledger.

Exam Tip: Due to a business not being able to deduct any GST paid on transactions of a personal nature from their GST liability, correcting entries appear rarely on exams. In the eight exams conducted under the previous VCAA Study Design, a correcting entry was assessed three times.

Exam Tip: Accounting is all about opposites! If cost prices are falling, under FIFO, Cost of Sales would be higher and Profit will be lower in the Income Statement. On the Balance Sheet, both the value of Inventory and Owner's Equity will be lower.

INVENTORY VALUATION

The purchases of Inventory examples introduced in the Inventory cards provided the cost price of Inventory to be recorded in the In column. However, the cost price of an Inventory item may not necessarily just be the unit price charged by the supplier.

Cost of Inventory

The cost of inventory shall comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventory to their present location and condition.

However, just because a cost is incurred in bringing the Inventory to its present location and condition does not necessarily mean that it will be included in the cost price of an Inventory item.

Exam Tip: The VCE Accounting course requires students to distinguish between product and period costs in relation to inventory valuation. Students are often presented with an Invoice relating to a purchase of inventory and determine the cost price of inventory by choosing which costs are product costs and which costs are period costs.

Product Costs

A product cost is a cost incurred in getting the inventory into a condition or location ready for sale and can be directly allocated to each individual unit on a logical basis. Apart from the inventory unit price charged by the supplier, examples of product costs include modifications, import duties, protective packaging and cartage inwards or freight inwards.

Exam Tip: Even though Cartage Inwards or Freight Inwards are costs incurred in getting the Inventory into a location ready for sale, when multiple lines of inventory are delivered, the delivery cost cant be directly allocated to each individual unit of inventory and would be treated as a period cost.

A product cost is included in the unit cost of an Inventory item, is recorded in the In column of the Inventory card and debited to the Inventory General Ledger account.

A product cost is only reported in the Income Statement under the heading of Cost of Goods Sold as Cost of Sales in the period when the item of Inventory is sold.

Period Costs

A period cost is a cost incurred in getting the inventory into a condition or location ready for sale but cannot be directly allocated to each individual unit as there is no logical basis to do so. Examples of period costs include insurance on delivery and cartage inwards or freight inwards when multiple lines of inventory are delivered.

A period cost is not included in the unit cost of an Inventory item, but rather debited to its own General Ledger account and reported separately in the Income Statement under the heading of Cost of Goods Sold in the period the expense is incurred.

Exam Tip: When an additional Inventory cost is treated as a product cost instead of a period cost, Profit will be higher as Cost of Good Sold will be lower when not all of the Inventory items are sold. As accounting is all about opposites, when an additional Inventory cost is treated as a period cost instead of a prodcut cost, Profit will be lower as Cost of Goods Sold will be higher. Even though these are good explanations, students need to go a step further and explain why Profit would be higher or lower. Cost of Goods Sold would be lower and Profit higher under product costing as it is only when the unit of Inventory is sold that the additional Inventory cost is reported as Cost of Sales under the heading of Cost of Goods Sold. Whereas, under period costing, Cost of Goods Sold would higher and Profit lower as the entire additional inventory cost is included in the Income Statement in the period it is incurred, regardless of the number of Inventory items actually sold.

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Beyoncé's Bikes

Beyoncé Knowles owns and operates Beyoncé's Bikes, a small business selling children's bikes and bike related accessories.

The following document was found in the offices of Beyoncé's Bikes.

CARTER'S			
Date: 25/06/19			Tax Invoice: 2884
Charge to: Beyoncé's Bikes			
Item	**Qty**	**Unit Cost**	**$**
'Ivy' Bike (Frame only, no tyres)	15	360	5 400
'Rumi' Bike (Frame only, no tyres)	20	420	8 400
'Brooklyn' Custom Tyres (Pairs)	35	80	2 800
'Tribeca' Helmet	8	55	440
Freight Inwards			210
			17 250
			GST 1 725
			Total Owing 18 975

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a. With reference to Invoice 2884, explain the difference between a product cost and a period cost.

Both product costs and period costs are costs incurred in getting inventory into a condition or location ready for sale. A product cost, such as the 'Brooklyn' custom tyres, can be directly allocated to each bike on a logical basis of $80. Whereas a period cost, such as the freight inwards, can't be directly allocated to each unit of inventory delivered on a logical basis as multiple lines of inventory were delivered on 25 June 2019.

> **Exam Tip:** When presented with a question about determining the cost price of a unit of inventory by applying product costing, there will generally be one additional cost which can be diriectly allocated to the unit of inventory on a logical basis and therefore treated as a product cost. It is recommended that when justifying an additional cost as a product cost, students should state that it is a 'product cost' and include the per unit cost . Similiarly, there will generally be one additional cost which is unable to be directly allocated to the unit of inventory on a logical basis and therefore treated as a period cost.

b. Explain the effect on profit in June 2019 if Beyoncé's Bikes uses product costing instead of period costing.

If Beyonce's Bikes uses product costing instead of period costing, Cost of Goods Sold would be lower and Profit would be higher when not all of the items purchased have been sold. Product costing includes these additional costs in the unit cost of Inventory on the Balance Sheet. It is only when the unit of Inventory is sold that the product cost is reported in the Income Statement under the heading of Cost of Goods Sold as Cost of Sales. Whereas, under period costing, these additional costs are reported in the Income Statement under the heading of Cost of Goods Sold in the period the expense was incurred, regardless of the quantity of units sold.

> **Exam Tip:** Students need to be mindful when answering an effect on profit question that month in the question (June 2019) is the same as the month on the invoice. When this is the case, students can use a prepared response as these questions are common. However, if the month in the question is the month after the month on the invoice, the opposite response is required.

Benge's Boutique Bedding

The following document was found in the offices of Benge's Boutique Bedding relating to its recent purchase of bed frames from Lithuania.

WAISLITZ

Date: 28/06/19 Tax Invoice: 1978

Charge to: Benge's Boutique Bedding

Item	Qty	Unit Cost	$
'Cozzo' Bed Frame	8	180	1 440
'Franco' Bed Frame Junior	14	90	1 260
'Franco' Bed Frame Adult	10	170	1 700
			4 400
Import Duties (5% on cost)			220
Cartage Inwards			860
			5 480
		GST (10%)	548
		Total Owing	6 028

Terms 2/7,n/30

a. Using product costing, record the details from Invoice 1978 in the Journals provided. A narration is not required.

General Journal

Date	Details	Debit	Credit
28/06	Inventory	4 620	
	Cartage Inwards	860	
	GST Clearing	548	
	Accounts Payable		6 028

b. Explain the effect on profit in July 2017 if Benge's Boutique Bedding uses period costing instead of product costing.

If Benge's Boutique uses period costing instead of product costing, Profit in **July** would be higher and Cost of Goods Sold would be lower. Period costing requires the import duties to be expensed in the period in which they are incurred (June) regardless of the number of frames sold. As these import duties have already been expensed in the Income Statement in June, when the frames are sold in July, the Cost of Goods Sold would only report the cost price of the frames that have been sold. Therefore, Cost of Goods Sold will be lower and profit will be higher in July.

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APPLICATION EXERCISE 7

Padma's Pots

The following document was found in the offices of Padma's Pots.

CREATIVE CLAYS			
Date: 29/06/19			Tax Invoice: 2461
Charge to: Padma's Pots			
Item	**Qty**	**Unit Cost**	**$**
Ceramic Capsule	15	30	450
Pine Planter	20	40	800
Tunisia Tub	25	60	1 500
			2 750
Packaging	60	3	180
Cartage Inwards			70
			3 000
		GST (10%)	300
		Total Owing	3 300
Terms: 2/7, n/30			

a. *Using product costing, record Invoice 2461 into the General Journal.*

A narration is **not** *required.*

General Journal

Date	Details	Debit	Credit

b. *Explain the effect on the Balance Sheet if Padma's Pots uses period costing instead of product costing if all the items are no sold.*

Explanation

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Lower of Cost and Net Realisable Value (NRV)

Inventory is recorded in the General Journal and the Inventory Card at its cost.

However, Inventory can be reported on the Balance Sheet at the lower of cost and net realisable value.

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

Exam Tip: The VCE Accounting course describes the estimated costs necessary to make the sale as marketing, selling and distribution costs. When calculating the net realisable value of an item of inventory, students need to read the question carefully to note the quantity of promotional or marketing items included as incentives for customers. For example, one free shirt compared with two free shirts will impact on the calculation of an inventory's net realisable value.

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Stephens' Suits

Martin Stephens owns and operates a men's fashion store called Stephens' Suits.

A physical inventory count confirmed that Stephens' Suits had 7 'S Club' suits on hand as at 30 June 2019.

Even though each of these suits cost Stephens' Suits $480 plus GST, Martin has decided to reduce their selling price from $990 including GST to $495 including GST (memo 147).

Martin has decided that a free tie will be given away with each 'S Club' suit sold. These ties cost Stephens' Suits $22 including GST each.

The net realisable value of a 'S Club' suit will be the reduced estimated selling price (excluding GST) of $450 ***less*** the $20 tie given to the customer when a suit is purchased – being **$430**.

Value on Inventory Card	Net Realisable Value	Difference
$480	$430	$50

Exam Tip: Some students confuse the topics of product costing and the calculation of the net realisable value. Product costing adds additional costs incurred in getting an inventory item into a condition or location ready for sale when it can be directly allocated on a logical basis. Whereas, the calculation of a unit of inventory's net realisable value incvolves subtracting any additional costs necessary to make the sale.

A comparison shows that the Net Realisable Value is $50 less than the $480 value recorded on the Inventory Card.

Therefore, according to the qualitative characteristic of faithful representation, an adjustment to the value of Inventory to be reported on the Balance Sheet as at 30 June 2019 is required to ensure that the financial statements represent real economic events and that the information reported is complete, free from error and without bias. As the business realises that they will not be able to sell a particular line or unit of inventory for more than its cost price, the value of inventory reported on the Balance Sheet would be overstated and not complete.

Likewise, the qualitative characteristic of relevance requires that information capable of making a difference to the decisions made by users is to be included in financial statements. As the business realises that they will not be able to sell a particular line or unit of inventory for more than its cost price, an Inventory Write Down expense adjustment is required to represent the loss that had occurred in the current period so that profit will not be overstated.

Exam Tip: Students are required to confirm the quantity of inventory on hand via a physical inventory count before applying the lower of cost and net realisable value rule. This is crucial when students are presented with both the quantity appearing on the inventory card and the actual quantity as per the physical inventory count. A coomon error occurs when students are required to calculate the value of the Inventory Write Down or record an adjustment in the General Journal. Students may calculate the net realisable value correctly, but apply this value to the quantity as per the inventory card rather than the quantity as per the inventory count.

Recording Inventory Write Down

A general journal entry is required on 30 June 2019 in relation to the 'S Club' suit as the net realisable value has fallen below the cost price appearing on the inventory card. The $50 difference is multiplied by the quantity of 'S Club' suits on hand confirmed by the physical inventory count.

General Journal

Date	Details	Debit	Credit
30/06	Inventory Write Down	350	
	Inventory		350
	7 'S Club' suits written down to NRV (Memo 147).		

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Exam Tip: The narration in the above General Journal entry includes the quantity of inventory items, the type of inventory item and the source document. If a reason for the inventory's net realisable value falling below its cost price is provided in the question, it should be included in the narration. Reasons include damage, out of fashion or season or has been superseded by a new model.

ITEM: 'S Club' Suit **Cost method:** First In, First Out Method
SUPPLIER: Renmark

		IN			OUT			BALANCE		
Date	Document	Quantity	Cost	Total	Quantity	Cost	Total	Quantity	Cost	Total
01/06	Balance							9	480	4 320
04/06	Rec. 1341				1	480	480	8	480	3 840
30/06	Memo 146				1	480	480	7	480	3 360
30/06	**Memo 147**				**7**	**50**	**350**	**7**	**430**	**3 010**

EFFECT OF TRANSACTION ON ACCOUNTING EQUATION

Element	Items Increased / Decreased	Overall Effect	Amount
Assets	Inventory	Decrease	$350
Liabilities		No Effect	$0
Owner's Equity	Net Profit (Inventory Write Down)	Decrease	$350

Exam Tip: When asked to explain the effect of an Inventory Write Down on an Accounting report, students are reminded of the 'two-fold' effect of transactions. For example, the effect of an Inventory Write Down on the Balance Sheet not only decreases the value of Assets (Inventory) but it also decreases the value of Owner's Equity (Profit). Alternatively, the effect of an Inventory Write Down on an Income Statement increases Inventory Write Down expense but laso decreases Profit.

Reporting Inventory Write Down

Stephen's Suits
Income Statement (extract)
for the month ending 30 June 2019

	$	$
Revenues		
Cash Sales	8 090	
Credit Sales	3 460	
Less: Sales Returns	480	11 070
Less: Cost of Goods Sold		
Cartage Inwards	310	
Cost of Sales	4 170	4 480
Gross Profit		6 590
Less: Inventory Loss	690	
Less: Inventory Write Down	**350**	1 040
Adjusted Gross Profit		5 550

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Sandy's Sofas

Sandy Olson owns and operates Sandy's Sofas, a small business selling a wide range of home furniture including couches, dining packages and display cases.

The Inventory card for the 'Frenchie' sofa as at 30 June 2019 appears as follows.

ITEM: 'Frenchie' Sofa **Cost method:** First In, First Out Method
SUPPLIER: Sustain

		IN			OUT			BALANCE		
Date	Document	Quantity	Cost	Total	Quantity	Cost	Total	Quantity	Cost	Total
30/06	Balance							1	1 050	1 050
								2	1 085	2 170

Additional Information:

Sandy has decided to reduce the selling price of the 'Frenchie' sofa from $2 310 including GST to $990 including GST (Memo 208).

As an incentive for her staff, Sandy will give the employee who sells a 'Frenchie' sofa a $50 bonus payment.

Sandy will also provide free home delivery for each 'Frenchie' sofa sold. Each of these deliveries cost Sandy's Sofas $80 plus GST.

a. Calculate the Net Realisable Value of one 'Frenchie' sofa.

Estimated Selling Price	$900
Less: Bonus Payment	$50
Less: Delivery Fee	$80
	$770

b. Update the 'Frenchie' sofa Inventory card as a result of the additional information.

ITEM: 'Frenchie' Sofa | **Cost method:** First In, First Out Method
SUPPLIER: Sustain

		IN			OUT			BALANCE		
Date	Document	Quantity	Cost	Total	Quantity	Cost	Total	Quantity	Cost	Total
30/06	Balance							1	1 050	1 050
								2	1 085	2 170
30/06	**Memo 208**				**1**	**280**	**280**			
					2	**315**	**630**	**3**	**770**	**2 310**

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APPLICATION EXERCISE 8

Oliver's Ovens

Oliver Clayton owns and operates Oliver's Ovens, a small business that uses the perpetual method of inventory recording and the First In, First Out (FIFO) method of assigning cost are used.

The Inventory card for the 'Wainer' Oven appears as follows.

***ITEM:** 'Wainer' Oven* | ***Cost method:** First In, First Out Method*
***SUPPLIER:** Whitehorse*

		IN			*OUT*			*BALANCE*		
Date	*Document*	*Quantity*	*Cost*	*Total*	*Quantity*	*Cost*	*Total*	*Quantity*	*Cost*	*Total*
30/06	*Balance*							*1*	*860*	
								5	*780*	*4 760*

Oliver decided to reduce the selling price of the 6 'Wainer' ovens on hand from $2 365 including GST to $770 including GST (Memo 197). In order to sell the remaining ovens, Oliver will give each customer who buys a 'Wainer' oven a free cookbook. The cookbook cost Oliver's Ovens $44 including GST.

a. Prepare the General Journal entry required on 30 June 2019 relating to the 'Wainer' oven.

*A narration **is** required.*

3 marks

General Journal

Date	*Details*	*Debit*	*Credit*

b. Explain how the valuation of the 'Wainer' oven effects the Income Statement and the Balance Sheet.

4 marks

Explanation

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Analysis of Business Performance

The most obvious way to assess a business' trading performance for a period would be to look at the profit (or loss) reported in the Income Statement. As will be introduced In Outcome 2 of Unit 3, an Income Statement will report the revenues earned and expenses incurred for a period. In pure dollar terms, this will enable users of the Income Statement to see if the business' profit was higher or lower than the previous period.

Alternatively, the Cash Flow Statement, also introduced in Outcome 2 of Unit 3, reports a summary of all cash inflows and cash outflows for a period. This will enable users to assess the sources and uses of the business' cash.

However, a thorough analysis of business performance examines changes and trends involving a combination of both financial and non-financial indicators.

The VCE Accounting Study Design provides twelve financial indicators students can use to measure business performance in relation to profitability, liquidity and stability.

Profitability compares the profit the business makes to a base figure such as sales, capital or assets and is generally expressed as a percentage.

Liquidity measures the ability of a business to meet its short-term debts as they fall due.

Stability measures the ability of a business to meet its debts and continue its operations in the long term.

Exam Tip: It is crucial that students know these definitions of profitability, liquidity and stability and incorporate them in their responses. For example, Outcome 1 of Unit 3 will focus on how three financial indicators will effect the liquidity of a business. In formulating a response, students will need to explain whether the trend in the financial indicator(s) in a question will make it easier or more difficult for the business to meet their shor term debts as they fall due., i.e. the liquidity of the business.

The analysis of a business' performance generally involves comparing the result of the current period to one of four **benchmarks**:

1. Previous period
2. Budget
3. Industry average
4. Alternative investments

The purpose of a benchmark is to provide a point of comparison when reviewing business performance.

Exam Tip: Students need to know these four benchmarks. However, the alternative investment benchmark is only used to assess the Return on Owner's Investment profitability indicator. That leaves the first three benchmarks from the above list. A common examination question is to ask students to state one other benchmark a business owner can use to assess the profitability or liquidity of the business. A common error students make when answering this question is that they 'group' together the 12 financial indicators into either profitability or iquidity and provide one of the 12 financial indicators not used in the question. The other error students make is that they ignore the word 'other' in the question and provide the same benchmark that has already been provided in the question. For example, a question that provides the results of a financial indicator for 2019, 2018 and 2017 can only have two acceptable answers - either budget or industry average.

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The three non-financial indicators of Unit 3 Outcome 1 are the Inventory Turnover, the Accounts Receivable Turnover and the Accounts Payable Turnover.

Exam Tip: Students are required to explain how the trends in the Inventory Turnover, the Accounts Receivable Turnover and the Accounts Payable Turnover will either, positively or negatively, effect primarily the liquidity, and sometimes the profitability, of a business.

INVENTORY TURNOVER

The Inventory Turnover measures the average number of days it takes for a business to sell its inventory.

The Inventory Turnover formula is as follows:

$$\frac{\text{Average Inventory}}{\text{Cost of Goods Sold}} \times 365$$

The Inventory Turnover is expressed as 'number of days' with changes being described as faster or slower. Generally, the fewer number of days the more favourable for the business as, by selling inventory faster, it will assist it earn profit and convert the inventory into cash. Alternatively, an increase in the number of days is generally unfavourable for the business as, by selling inventory slower, it limits its ability to earn profit and convert the inventory into cash.

Exam Tip: There have been no marks allocated in exams for students to calculate any of the financial indicators. However, students should be familiar with each of the twelve financial indicators in order to provide explanations as to why the indicators have changed. When commenting on these three turnover financial indicators, students need to use the words faster, slower, favourable and unfavourable.

Impact on Liquidity

Liquidity measures the ability of a business to meet its short-term debts as they fall due.

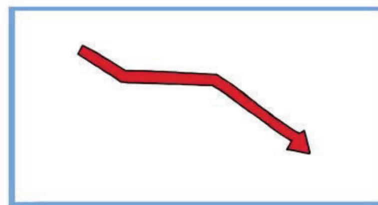
If the inventory turnover is faster (reduction in the number of days) it is favourable for the liquidity of the business as it is selling its inventory faster. By converting the inventory to cash faster it makes it easier for the business to meet its short-term debts as they fall due.

Alternatively, if the inventory turnover is slower (increase in the number of days) it is unfavourable for the liquidity of the business as it is taking longer to sell. By converting the inventory to cash slower it makes it more difficult for the business to meet its short-term debts as they fall due.

Impact on Profitability

Profitability compares the profit the business makes to a base figure such as sales, capital or assets and is generally expressed as a percentage.

If the inventory turnover is faster (reduction in the number of days) it is generally favourable for the profitability of the business as it is selling its inventory faster. By increasing the quantity of units of inventory sold, the business would report an increase in Sales and probably an increase in profit and therefore profitability.



"What if we don't change anything at all ... and something magical just happens."

However, a faster inventory turnover may not necessarily be favourable for the profitability of the business. Due to a reduction in its mark-up percentage, the cheaper selling prices result in less profit being made for each unit of inventory sold. As less profit is being made for each unit of inventory sold, the profit, and possibility the profitability of the business, would be worse. Another strategy that could have been adopted to improve the inventory turnover is to reduce the quantity and value of inventory on hand by buying inventory in smaller quantities more frequently. However, the business exposes itself to potentially running out of inventory and losing potential sales, and incurring higher transportation expenses which would negatively affect both profit and profitability.

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Exam Tip: The above explanation of the impact of a faster inventory turnover on the profitability of a business is a good example of a 'discuss' style question. When students are asked to 'discuss' the trend of a financial indicator on either the liquidity or profitability of a business, an explanation requires students to address both the potential positive and negative impacts.

Alternatively, if the inventory turnover is slower (increase in the number of days) it is unfavourable for the profitability of the business as it is taking longer to sell. If the quantity of units sold has decreased, the business would report a decrease in Sales probably a decrease in profit and therefore profitability. An additional potential negative impact of a slower inventory turnover would be that inventory is remaining in the business longer. The longer the inventory remains in the business, the more likely it is to be obsolete and the business recording an inventory write-down.

However, a slower inventory turnover may not necessarily be unfavourable for the profitability of the business. Due to an increase in its mark-up percentage, the higher selling prices result in more profit being made for each unit of inventory sold. As more profit is being made for each unit of inventory sold, the profit, and possibility the profitability of the business, could be better. Another strategy that could have contributed to the worse inventory turnover was to increase the quantity and value of inventory on hand by buying inventory in larger quantities less often. The reason why the business decided to buy inventory in larger quantities maybe due to a cheaper unit cost. Not only would transportation expenses reduce, but in the event that selling prices remained constant, the business would be making more profit from each unit of inventory sold.

Exam Tip: Strategies to improve financial indicators are a key part of the VCE Accounting course. Not only do students need to know multiple strategies to improve each of the twelve financial indicators, they need to be able to justify why the strategies chosen will improve the indicator.

Strategies to Improve the Management of Inventory

- employ strategies to increase sales, like advertising, changing selling prices (changing the mark up), or changing the inventory mix

- decreasing the level of inventory on hand by ordering less, ordering smaller amounts more frequently, replacing slow moving inventory lines

- reducing the selling price of slow-moving items

- relocating inventory within the store to highlight particular goods

A justification for these strategies is to ultimately sell more inventory faster or to reduce the quantity and value of inventory to mathematically improve the inventory turnover.

ACCOUNTS RECEIVABLE TURNOVER

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The Accounts Receivable Turnover measures the average number of days it takes for a business to collect outstanding debt balances from credit customers.

The Accounts Receivable Turnover formula is as follows:

$$\frac{\text{Average Accounts Receivable}}{\text{Net Credit Sales (plus GST)}} \times 365$$

The Accounts Receivable Turnover is expressed as 'number of days' with changes being described as faster or slower. Generally, the fewer number of days the more favourable for the business as, by collecting outstanding debt balances from credit customers faster, the business has access to the cash faster. Alternatively, an increase in the number of days is generally unfavourable for the business as, by taking longer to collect outstanding debt balances from credit customers slower, it increases the likelihood of the debt becoming irrecoverable.

Exam Tip: When it comes to assessing the trend in the Accounts Receivable Turnover, a comparison needs to be made to the credit terms. Generally, when the number of days is fewer (faster) it is beneficial for the liquidity. Alternatively, when the number of days is more (slower) it is worse for the liquidity of the business. Even if the number of days is fewer, if the number of days still remains outside the credit terms, even if the trend is favourable, the outcome remains unfavourable.

Strategies to Improve the Management of Accounts Receivable

- offer a discount / increase the discounts offered
- sending reminders to credit customers / monthly statements
- threatening not to provide credit in the future
- employing a debt collector
- taking legal action to recover the outstanding amount

The justification of using these strategies is to provide the credit customer with an incentive to pay their amount owing promptly or to remind the credit customer to pay their amount owing.

Exam Tip: The identification of the credit terms during reading time is crucial. Students asked to suggest a new strategy to improve the management of outstanding Accounts Receivable balances, a common suggestion is to offer a discount. However, if the business already offers a discount for prompt payment, a correct suggestion would be to increase the discount offerred.

However, offering or increasing the discount offered would negatively the profitability of the business. Any increase in discount expense would decrease net profit. Similarly, sending reminders to credit customers, employing a debt collector or taking legal action comes at a cost. Not only is this a timely process, but the costs associated with employing additional staff or initiating legal proceedings need to be measured against the amount being recovered.

ACCOUNTS PAYABLE TURNOVER

The Accounts Payable Turnover measures the average number of days it takes for a business to repay their outstanding Accounts Payable balances.

The Accounts Payable Turnover formula is as follows:

$$\frac{\text{Average Accounts Payable}}{\text{Net Credit Purchases (plus GST)}} \times 365$$

The Accounts Payable Turnover is expressed as 'number of days' with changes being described as faster or slower.

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The trend in the Accounts Payable Turnover is another example of accounting being all about opposites, especially when compared to the interpretation of the Accounts Receivable Turnover.

As long as the credit terms offered by a supplier are not exceeded, the more number of days (slower) it takes to repay an outstanding Accounts Payable balance the better it is for the liquidity of the business. When a payment made to a supplier is delayed, but not beyond the credit terms offered, cash is within the business for a longer period of time, making it easier for the business to meet its **other** short-term debts as they fall due.

A consequence of exceeding the credit terms of a supplier is having the ability to purchase inventory on credit removed. This will have a negative impact on liquidity as the business will be required to purchase inventory using cash. This will result in significant amounts of cash leaving the business making it difficult for the business to meet **other** short-term debts as they fall due.

Alternatively, the fewer the number of days (faster) it takes to repay an outstanding Accounts Payable balance the worse it is for the liquidity of the business. When a payment is made to a supplier well within the credit terms offered, cash is leaving the business before it is necessary, making it more difficult for the business to meet its **other** short-term debts as they fall due.

Strategies to Improve the Management of Accounts Payable

Strategies to improve the management of accounts payable is to either pay the amount owing on, or as close to the due date as possible. Alternatively, if a business' liquidity permits, pay within the credit terms offered to be entitled to a discount for prompt payment.

Exam Tip: A common examination question involves either a visual representation or a table of results of the Inventory Turnover, Accounts Receivable Turnover and the Accounts Payable Turnover. Not surprisingly, students are asked to explain the effect on the liquidity of the business when the Inventory Turnover and Accounts Receivable Turnover are slower, yet the Accounts Payable Turnover is faster. Trends to look for include whether the Accounts Receivable Turnover still exceeds the credit terms and whether the Accounts Payable Turnover is faster, but not fast enough to be entitled to a discount.

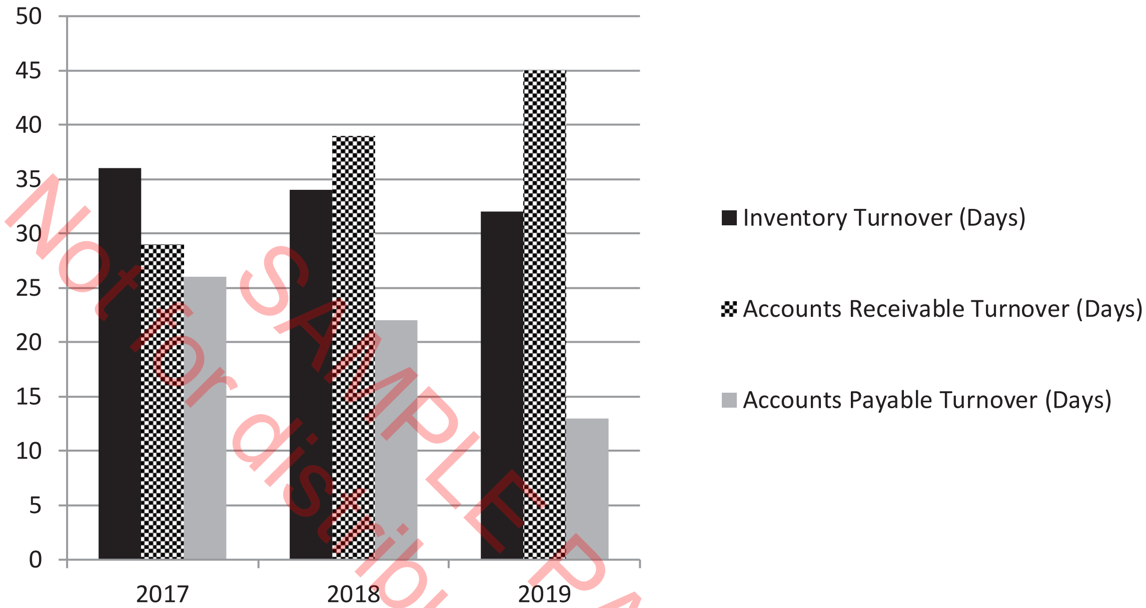
APPLICATION EXERCISE 9

Holly's Hats

Holly's Hats requires its Account Receivable customers to pay within 30 days of sale and offers a 2 per cent discount if they pay within 7 days.

Holly's Hats has negotiated with their supplier credit terms of 21 days and receives a 2 per cent discount if they are paid within 7 days.

The accountant of Holly's Hats has presented the following trends.



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Discuss whether the liquidity of Holly's Hats has improved or worsened between 2017 and 2019.

Explanation

YOU BE THE ASSESSOR: UNIT 3 AREA OF STUDY 1

In this section, you are required to assess the responses presented for each of the questions. You should award the responses a score and justify your decision. Once complete, compare your assessment to that of the author provided at the CPAP website http://www.commpap.com/page90.html

Question 1 (2017 VCAA June Exam Question 4)

A2 Imports has provided the following partially completed Inventory Card for the Tech television.

Inventory card

ITEM: Tech television										**Cost method:** First In, First Out
		IN			**OUT**			**BALANCE**		
Date	Document	Quantity	Cost	Total	Quantity	Cost	Total	Quantity	Cost	Total
01/05	Balance							10	500	5 000
05/05	Inv. 234	10	550	5 500				10	500	
								10	550	10 550

Additional information

6 May	Credit sale of eight Tech televisions to a local school for $800 each plus GST (Invoice 430)
12 May	Credit purchase of seven Tech televisions at a cost of $475 each plus GST and customs duty of $350 plus GST on this invoice (Invoice 644)
17 May	Owner withdrew one Tech television and one Ace television from the business (Memo 33)
19 May	Provided three Tech televisions to a local hospital in exchange for advertising in their newsletter (Memo 34)
24 May	Customer returned one faulty Tech television to the business (Credit Note 56)

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SAMPLE ANSWER A

Record the additional information in the Inventory Card provided. **5 marks**

ITEM: Tech television										**Cost method:** First In, First Out
		IN			**OUT**			**BALANCE**		
Date	Document	Quantity	Cost	Total	Quantity	Cost	Total	Quantity	Cost	Total
01/05	**Balance**							**10**	**500**	**5 000**
05/05	**Inv. 234**	**10**	**550**	**5 500**				**10**	**500**	
								10	**550**	**10 550**
06/05					8	500	4 000	2	500	
								10	550	6 550
12/05	Inv. 644	7	475	3 325				2	500	
								10	550	
								7	475	9 875
17/05	Memo 33				1	500	500	1	500	
								10	550	
								7	475	9 375
19/05	Memo 34				1	500	500	8	550	
					2	550	1 100	7	475	7 725
24/05	C/N 56	1	500	500				1	500	
								8	550	
								7	475	8 225

Justification____

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SAMPLE ANSWER B

Record the additional information in the Inventory Card provided. **5 marks**

ITEM: Tech television **Cost method:** First In, First Out

		IN			OUT			BALANCE		
Date	Document	Quantity	Cost	Total	Quantity	Cost	Total	Quantity	Cost	Total
01/05	**Balance**							**10**	**500**	**5 000**
05/05	**Inv. 234**	**10**	**550**	**5 500**				**10**	**500**	
								10	**550**	**10 550**
06/05	Inv. 430				8	500	4 000	2	500	
								10	550	6 550
12/05	Inv. 644	7	525	3 675				2	500	
								10	550	
								7	525	10 175
17/05	Memo 33				1	500	500	1	500	
								10	550	
								7	525	9 675
19/05	Memo 34				1	500		8	550	
					2	550	1 600	7	525	8 075
24/05	C/N 56	1	550	550				9	550	
								7	525	8 625

Justification____

A physical stocktake was conducted on 31 May and there were 15 Tech televisions on hand (Memo 35).

Prepare the General Journal entry required to record Memo 35.

A narration is required. **3 marks**

SAMPLE ANSWER A

General Journal

Date	Details	Debit	Credit
31/05	Inventory Loss	475	
	Inventory		475

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Justification____

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SAMPLE ANSWER B
General Journal

Date	Details	Debit	Credit
31/05	Inventory Loss	550	
	Inventory		550
	Inventory loss of 1 'Tech TV' per inventory count (Memo 35)		

Justification____

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A new model of the Tech television, called Tech2, was released during May 2017.

The owner provided the following information about the existing televisions in stock on 31 May 2017.

Model	Estimated selling price	Delivery to customers
Tech television	$400	$40

Complete the table provided to show the effect that the release of the new Tech2 television will have on the Balance Sheet. **2 marks**

SAMPLE A

	Increase / Decrease / No Effect	Amount
Assets	Decrease	$2 465
Liabilities	No Effect	$0
Owner's Equity	Decrease	$2 465

Justification____

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