| 200/9 |
| --- |
| Original: 1998 |
| Revised: 2002/06 |

# ACCOUNTING

**(Year 11 and 12 D/E200)**

## *Minor Syllabus Changes 2006-2007*

**YEAR 11 AND 12 ACCOUNTING**

These notes have been prepared to assist with the implementation of the minor changes, in 2006, to the Year 11 and 12 Accounting syllabuses. There is a brief summary of the changes included as a preamble to the document.

This set of notes for teachers provides an in-depth knowledge of the changes and in some cases gives additional background information.

The notes on each change to the syllabuses indicate whether they are useful as notes for students as well as teachers. Where additional information is provided, teachers will need to use their professional expertise as to how much information to impart to their students.

**NOTE:**

All assessment support material for both Year 11 and Year 12 Accounting has been reviewed for 2006/2007 to ensure that the current syllabus requirements are reflected.

The 2002-2004 TEE Examinations have also been reviewed. There are now a total of 11 assessment support documents available to teachers of Accounting.

Teachers are advised to remove all support materials dated prior to 2006 from their files and replace with the updated/revised material.

## SUMMARY OF CHANGES TO THE YEAR 11 & 12 ACCOUNTING SYLLABUSES 2006/2007

**Terminology and general changes**

"Profit and Loss Statement" now "**Income Statement"**
"Revenue" now **"Income"** (includes Revenue and Gains)
"Periodic/Physical" inventory method now just **"Periodic"** inventory method
"Net Profit" now just **"Profit"**
"Trading/Merchandising" firm now just **"Merchandising"**
"Proprietorship" or "Owner's Equity" now just **"Equity"**
SAC 3 and SAC 4 have now been supplanted by **The Framework for the Preparation and Presentation of Financial Reports**. Note however that **SAC 1 and SAC 2 still exist.**

| | |
|---|---|
| Accounting principles : | "Historical cost", "Matching" "Revenue recognition" deleted<br>"Income recognition", "Expense recognition", "Asset recognition", "Liability recognition" inserted |

The numbering of various AASBs has changed. However, students are not expected to be able to quote the number when referring to the provisions of a standard (e.g. for the definition of "Cash and cash equivalents""

**Year 11 syllabus specific changes**

| | |
|---|---|
| Farm accounting : | Description of classification of farm income and expenses amended |

**Year 12 syllabus specific changes**

| | |
|---|---|
| Depreciation & disposal : | "Profit on disposal" referred to as **"Gain on disposal"** |
| Cash flow statements : | Now "**Cash flow statements"** not "Statements of cash flow"<br>"Interest paid" now included in "Investing activities" |
| Companies : | "Retained profits" now **"Retained Earnings:**<br>Current year final dividends excluded (not an appropriation of profit nor a liability). Previous year's final dividend, if any, will be included in Retained Earnings account.<br>"Current tax liability" shown as separate current liability<br>Consequently, no "Provisions"<br>"Profit and Loss Statement" replaced by new **"Statement of Changes in Equity"** The Income Statement for companies is not in the syllabus |

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# PROFIT DETERMINATION – YEAR 11

## REASONS FOR THE CALCULATION OF PROFIT AND LOSS

Businesses and other organisations have many and varied goals or objectives. One primary motive for most businesses is the earning of profit. The determination of business profit is therefore considered to be one of the most important functions of accounting.

*Statement of Accounting Concepts 2: Objective of General Purpose Financial Reporting* ("SAC 2") outlines the purpose of financial reporting. According to SAC 2, the main objective of general purpose financial reports is to provide information useful to the users of these reports in making and evaluating decisions on the allocation of scarce resources. It also assists these users to make judgements about the efficiency of operation and accountability of managers.

The main user groups include investors, shareholders, lenders, employees, suppliers (and other trade creditors), customers, government bodies, the public and other users of financial reports who rely on these reports to make decisions about allocating their scarce resources.

SAC 2 also outlines the types of information relevant to users' needs. One of these areas is performance. One way of measuring performance is the level of profits earned through the purchase and use of an entity's net assets in effectively and efficiently achieving its goals. SAC 2 says that calculation of income and expenses is useful in judging the performance of an entity.

SAC 2 outlines the purposes for which user groups require financial information. Resource providers want to know whether the entity is operating profitably. In this way they can determine if the entity is achieving its objectives, is operating efficiently and economically, and using resources as prescribed.

The amount of profit that a business makes is considered by many to be a measure of the financial performance of the business operation. Profit is also used as a measure of credit worthiness and management efficiency. These are important factors in predicting the future earnings from the business. The value of a business, the price of a company's shares and the amount of dividends or drawings are all affected by profits.

Profit is therefore calculated so as to judge the success of an operation, to predict future earnings from an operation and to assist users to make economic decisions.

## PROFIT DETERMINATION – YEAR 11

## CALCULATION OF PROFIT AND LOSS

### (Note: The following is only an outline of the content of this section of the syllabus.)

Income is increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other then those relating to contributions from equity participants. Income consists of both revenues and gains. *Revenues* arise from the ordinary activities of an entity e.g. Sale of goods, fees from services, interest, royalties, dividends. *Gains* are other items meeting the definition of income that may or may not arise in the course of ordinary activities e.g. Gains on disposal of assets.

Expenses are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other then those relating to distributions to equity participants. The difference between these two items i.e. income and expenses, is profit or loss.

The determination of profit is based on a number of assumptions (eg accounting entity, accounting period) and principles, (eg income and expense recognition). As a result of the accounting period assumption, profit determination is the process of deducting the expenses incurred during an accounting period from the income recognised in that period. The application of the income recognition principle requires consideration of the probability that the income has occurred and that the income can be measured reliably.

The application of the accounting period assumption, and income recognition principle results in the need for balance day adjustments and reversing entries. Adjusting entries to income and expense items are made before the closing of these accounts.

The calculation of profit and loss, in the general ledger, requires that all income and expense accounts are closed or cleared by transferring their balances to another account. Generally there are two accounts involved – the trading account and profit and loss account. The trading account, which is used by a merchandising firm, is used to determine the value of the gross profit or loss for the period. Gross profit (or loss) is the difference between net sales and cost of goods sold. The profit and loss ledger account is used to calculate profit or loss. Profit is the excess of all income over all expenses. Reversing entries are made in the new accounting period to reverse the effects of certain adjusting entries.

Accounting Standards detail the requirement for disclosure of income and expenses in two financial reports – the income statement and, in the case of reporting entities such as public companies, the statement of changes in equity. Unless there is a direct requirement for income or expenses to be recorded in equity, they are to be shown in the income statement. The income statement is to include income, finance costs, associated profit/loss, tax, gains/losses on disposal. The statement of changes in equity is to show revaluation changes and other specific gains/losses. This is dealt with in the topic "Companies" in the Year 12 syllabus.

***Interesting questions for students to consider:***

1. Outline your understanding of the term 'profit'.
2. Explain the influence of the following accounting concepts on the calculation of profit and loss:
   - accounting entity assumption
   - accounting period assumption
   - income recognition principle
3. Outline the accounting procedures for the calculation of profit and loss.
4. Discuss the classification of expenses by nature and by function.
5. Explain the two recognition criteria that apply expenses and income.

## BALANCE DAY ADJUSTMENTS – YEAR 11

## PREPAID EXPENSES, STOCK OF SUPPLIES (ASSET METHOD), AND INCOME RECEIVED IN ADVANCE OR UNEARNED INCOME (LIABILITY METHOD)

***Illustrative examples:***

## PREPAID EXPENSES AND STOCK OF SUPPLIES (ASSET METHOD ONLY)

### Prepaid Expenses (Asset method)

On 1 March 2005 the business of Monty Traders paid for its annual insurance policy costing $1440. Insurance coverage began on 1 March 2005 and balance day is 30 June. On 28 February 2005 the Prepaid Insurance account showed a debit balance of $880 which represented the cost of the insurance policy from 1 July 2004 to 28 February 2005.

**STEP 1.**
Record the payment as Prepaid Insurance (an asset account) in the Cash Payments Journal.

**Cash Payments Journal (Extract)**

| Date | Particulars | Other | Bank |
|---|---|---|---|
| 1 March 2005 | Prepaid Insurance | $1440 | $1440 |

**STEP 2.**
On balance day calculate how much of the asset has become an expense and what portion remains an asset.

- Expense portion from 1 July 2004 to 28 February 2005 = $880
- Expense portion from 1 March 2005 to 30 June 2005: $1440 x 4/12 = $480
- Total expense for the current year = $1360

The asset portion is: $1440 x 8/12 = $960

**STEP 3.**
On balance day record an adjustment to the Prepaid Insurance account, in the General Journal, to bring to account the Insurance Expense for the year.

**General Journal**

| Date | Particulars | Debit | Credit |
|---|---|---|---|
| 30 June 2005 | Insurance Expense | $1360 | |
| | Prepaid Insurance | | $1360 |
| | Adjusting entry to record portion of insurance consumed. | | |

After the adjusting entry is posted, the accounts appear as follows:

**Prepaid Insurance**

| Date | Particulars | Amount | Date | Particulars | Amount |
|---|---|---|---|---|---|
| 1 July 2004 | Balance b/d | 880 | 30 June 2005 | Insurance Expense | 1360 |
| 1 March 2005 | Cash at Bank | 1440 | | Balance c/d | 960 |
| | | 2320 | | | 2320 |
| 1 July 2005 | Balance b/d | 960 | | | |

**Insurance Expense**

| Date | Particulars | Amount | Date | Particulars | Amount |
|---|---|---|---|---|---|
| 30 June 2005 | Prepaid Insurance | 1360 | 30 June 2005 | Profit and Loss | 1360 |

There is no need for a reversing entry under this method.

## Stock of Supplies (Asset method)

On 1 April 2005 the business of Monty Traders purchased Office Supplies of $800 on credit from Watson Office Suppliers. As at 1 July 2004 the Office Supplies account showed a debit balance of $1000. Balance day is 30 June each year and on 30 June 2005 the cost of office supplies on hand was determined to be $300.

**STEP 1.**
Record the credit purchase of office supplies as an asset, in the General Journal.

**General Journal**

| Date | Particulars | Debit | Credit |
|---|---|---|---|
| 1 April 2005 | Office Supplies<br>Watson Office Suppliers<br>Purchase of office supplies on credit. | $800 | <br>$800 |

**STEP 2.**
On balance day determine the value of unused office supplies i.e. $300, and the cost of office supplies used during the current accounting period i.e. $1500 ($1000 + $800 - $300).

**STEP 3.**
On balance day record an adjustment to the Office Supplies account, in the General Journal, to bring to account the office supplies expense for the year.

**General Journal**

| Date | Particulars | Other | Bank |
|---|---|---|---|
| 30 June 2005 | Office Supplies Expense<br>Office Supplies<br>Adjusting entry to record supplies consumed during the year. | $1500 | <br>$1500 |

After the adjusting entry is posted, the accounts appear as follows:

**Office Supplies**

| Date | Particulars | Amount | Date | Particulars | Amount |
|---|---|---|---|---|---|
| 1 July 2004 | Balance b/d | 1000 | 30 June 2005 | Office Supplies Expense | 1 500 |
| 1 April 2005 | Watson Office Supplies | 800 | | Balance c/d | 300 |
| | | 1 800 | | | 1 800 |
| 1 July 2005 | Balance b/d | 300 | | | |

**Office Supplies Expense**

| Date | Particulars | Amount | Date | Particulars | Amount |
|---|---|---|---|---|---|
| 30 June 2005 | Office Supplies | 1500 | 30 June 2005 | Profit and Loss | 1500 |

There is no necessity for a reversing entry under this method.

## INCOME RECEIVED IN ADVANCE OR UNEARNED INCOME (LIABILITY METHOD)

On 1 May 2005 the business of Monty Traders received a quarterly rent payment of $600 for office space rented out to a client. Previous quarterly payments received were as follows:

| | |
|---|---|
| 1 February 2005 | $600 |
| 1 November 2004 | $600 |
| 1 August 2004 | $540 |

On 1 July 2004 the Rent Received in Advance account showed a credit balance of $180 representing rent received in advance for the month of July 2004.

**STEP 1.**
Record the cash received of $600 for rent, as a liability, in the Cash Receipts Journal.

**Cash Receipts Journal (Extract)**

| Date | Particulars | Other | Bank |
|---|---|---|---|
| 1 May 2005 | Rent Received in Advance | $600 | $600 |

**STEP 2.**
On balance day determine the amount of rent which has been earned during the current accounting period i.e. $2320. This is calculated as:

- 1 July 2004 to 30 April 2005: $180 + 540 + 600 + 600 = $1920
- 1 May 2000 to 30 June 2005: $600 x 2/3 = $400

  Total Rent Income for the year = $2320

**STEP 3.**
On balance day record an adjustment, to the Rent Received in Advance account, in the General Journal, to bring to account the Rent Income for the year.

**General Journal**

| Date | Particulars | Debit | Credit |
|---|---|---|---|
| 30 June 2005 | Rent Received in Advance | $2320 | |
| | Rent Income | | $2320 |
| | Adjusting entry to record rent earned | | |

After the adjusting entry is posted, the accounts appear as follows:

**Rent Received in Advance**

| Date | Particulars | Amount | Date | Particulars | Amount |
|---|---|---|---|---|---|
| 30 June 2005 | Rent Income | 2320 | 1 July 2004 | Balance b/d | 180 |
| | Balance c/d | 200 | 1 Aug. 2004 | Cash at Bank | 540 |
| | | | 1 Nov. 2004 | Cash at Bank | 600 |
| | | | 1 Feb. 2005 | Cash at Bank | 600 |
| | | | 1 May 2005 | Cash at Bank | 600 |
| | | 2520 | | | 2520 |
| | | | 1 July 2005 | Balance b/d | 200 |

**Rent Income**

| Date | Particulars | Amount | Date | Particulars | Amount |
|---|---|---|---|---|---|
| 30 June 2005 | Profit & Loss | 2 320 | 30 June 2005 | Rent Received in Advance | 2 320 |

There is no need for a reversing entry under this method.

## PRESENTATION OF ACCOUNTING REPORTS FOR A MERCHANDISING AND A SERVICE BUSINESS – YEAR 11

## SUGGESTED FORMATS FOR A SOLE TRADER: INCOME STATEMENT

A service provider is more likely to classify expenses by nature, and a manufacturing business is more likely to classify expenses by function. These alternative presentation formats are illustrated here. *Expense groupings can vary.

**Service Business**
**Income Statement**
**For the period ended …**

| ***INCOME*** | **$** | **$** | **$** |
|---|---|---|---|
| Fees | XXX | | |
| Interest | XXX | | |
| Rent | XXX | XXX | |
| | | | |
| **ADD OTHER INCOME** | | | |
| Discount received | XXX | XXX | XXX |
| | | | |
| **LESS EXPENSES** | | | |
| | | | |
| **Depreciation** | | | |
| Depreciation of fixtures and fittings | (XXX) | | |
| Depreciation of delivery vehicles | (XXX) | (XXX) | |
| | | | |
| **Transport costs** | | | |
| Delivery | (XXX) | | |
| Packaging | (XXX) | (XXX) | |
| | | | |
| **Finance costs** | | | |
| Interest | (XXX) | | |
| Doubtful debts | (XXX) | (XXX) | |
| | | | |
| **Employee costs** | | | |
| Commissions | (XXX) | | |
| Salaries of office staff | (XXX) | | |
| Wages of delivery staff | (XXX) | (XXX) | |
| | | | |
| **Other expenses** | | | |
| Rent | (XXX) | (XXX) | (XXX) |
| | | | |
| ***PROFIT (LOSS) FOR THE PERIOD*** | | | ***XXX*** |

**Note**: This is a suggested format only, other relevant formats are acceptable.

.

**Merchandising/Trading Business**
**Income Statement**
**For the period ended …**

| *INCOME* | | | |
|---|---|---|---|
| **INCOME** | **$** | **$** | **$** |
| Sales (net of returns $XX) | | | XXX |
| **LESS COST OF SALES** | | | |
| Opening Inventory | XXX | | |
| Purchases (net of returns $XX) | XXX | | |
| Other purchasing expenses (e.g. freight inwards) | XXX | | |
| Less Closing Inventory | | XXX | XXX |
| *GROSS PROFIT (LOSS)* | | | XXX |
| | | | |
| **ADD OTHER INCOME** | | | |
| Discount received (rent, interest) | | XXX | XXX |
| | | | |
| **LESS EXPENSES** | | | |
| | | | |
| **Selling and Distribution Expenses** | | | |
| Advertising | (XXX) | | |
| Delivery | (XXX) | | |
| Depreciation of delivery vehicles | (XXX) | | |
| Commissions | (XXX) | | |
| Wages of delivery staff | (XXX) | (XXX) | |
| | | | |
| **General and Administration Expenses** | | | |
| Depreciation of fixtures and fittings | (XXX) | | |
| Rent | (XXX) | | |
| Salaries of office staff | (XXX) | | |
| Office supplies | (XXX) | | |
| Rent | (XXX) | (XXX) | |
| | | | |
| **Financial Expenses** | | | |
| Interest | (XXX) | | |
| Doubtful debts | (XXX) | (XXX) | (XXX) |
| | | | |
| ***PROFIT FOR THE PERIOD*** | | | ***XXX*** |

**Note**: This is a suggested format only, other relevant formats are acceptable.

## CONCEPTS, PRINCIPLES AND PRACTICES – YEAR 11

## THE ROLE OF THE ACCOUNTANT

The traditional role of the accountant and accounting has been the keeper of records and the preparer of financial statements associated with the economic and financial activities of an enterprise. The role has changed significantly over time. Today, the accountant and accounting are the primary sources of financial information for an enterprise. The focus is concerned with communicating economic information to groups of individuals and organisations who need to make informed financial decisions. These groups are referred to as the users of financial information. They include the owners of the enterprise, organisations who may lend or have lent money to the enterprise, suppliers of goods and services, employees and unions, regulatory agencies such as the Australian Securities and Investments Commission and the Taxation Office, and other political and social interest groups. The breadth of information required by user groups is significant and requires the accountant to possess a variety of skills.

It is the accountant who brings together a mass of apparently unrelated economic events into the form of financial statements. In a large enterprise, the financial statements may summarise several million transactions onto a few pages in an annual report. The statements disclose measures of risk and return (profit) to owners, and the nature and value of the resources owned and used by the enterprise. The focus of financial statements is to assist the user group to make informed judgements and decisions. The information must be relevant for some decision the user is to make and it must assist in selecting between alternate courses of actions. If the information is irrelevant or unreliable the damage to the decision-making process may be significant.

A primary user of financial information is the owner. Generally an owner's decisions are concerned with whether to continue or to expand investment in an enterprise. The owner must decide how much profit to withdraw and how much profit to provide for future expenditure. The owners must also be aware of liquidity, solvency and claims by others on the financial resources of the enterprise. The accountant therefore has a role in providing such information.

In enterprises that are companies, where the owners' needs are represented by directors, shareholders need to know if the directors are acting in the shareholders' best interests. They need information to assist in the evaluation of the accountability and the performance of directors and managers. The information helps to evaluate whether to buy, sell or maintain existing levels of investment in the company.

Long-term and short-term suppliers of credit and finance must decide whether to continue to supply financial support. They must decide whether loans or amounts outstanding will be repaid. Therefore they must have financial information that permits them to assess if future returns will be adequate to meet repayment schedules and whether the enterprise will remain financially sound.

The information needs of these groups require the provision of financial reports. These may include the Balance Sheet, the Income Statement, the Statement of Changes in Equity and a Cash Flow Statement. As many of these decisions are related to events that will occur in the future, there is significant focus on information based on valuation and not only historical events. The skills of accountants are therefore broad-based and utilised in many areas.

Accountants occupy positions in many sectors of industry and commerce, in government administration from local to federal level, the armed forces, law enforcement and the arts. Accountants also play an important role in the community at large, providing financial skills in voluntary work for charities, school and community organisations.

The accountant may be employed in public practice, providing general and specialist accounting services, strategic business planning, cost and management accounting, stockbroking, auditing, treasury, taxation planning and advice, management of information systems, mergers, acquisitions and corporate takeovers, foreign exchange and international currency arrangements, insurance and management consulting.

There are three organisations in Australia which represent accountants and are referred to as the Professional Accounting Bodies. There is CPA Australia, the Institute of Chartered Accountants in Australia (ICAA), and the National Institute of Accountants (NIA).

There is no legal or statutory requirement in Australia to register to be called an accountant. Anyone can claim to be an accountant. To distinguish between those who are appropriately qualified to be called accountants and others who call themselves accountants, it is necessary to examine their professional qualifications. Members of the professional bodies are recognised as professional accountants, just as doctors or lawyers are recognised as professionals. It is necessary to be a member of CPA Australia or ICAA if an accountant is to practise as a principal in public practice, an auditor or a liquidator.

In general, members of the CPA Australia and the ICAA work in similar fields. The majority of CPAs work in public accounting firms, government, industry and commerce. The majority of ICAA members are employed in chartered accounting firms and commerce. There are many members of both professional bodies employed in academia.

Many individuals aspire to membership of the professional associations as it provides recognition of scholastic accomplishment and importance in society. To be rewarded with this status it is necessary to accept significant responsibilities towards society. These responsibilities are supported and reinforced by the professional organisations which require the maintenance of knowledge and expertise appropriate to the profession. In addition to technical expertise, it is an obligation for a member of the professional bodies to act with integrity, whether dealing with a client or the general public. Clients are entitled to receive complete honesty and discretion from their accountant. They do not expect the accountant to disclose confidential information or provide poor and inadequate advice. These expectations are formally addressed in the Code of Professional Conduct.

The professional bodies have established codes of professional ethical conduct with which members must comply or face disciplinary action. The codes prescribe good conduct between the accountant, clients and other members of the profession and the general public. A breach could result in disciplinary proceedings being brought against the member responsible, which could result in a fine or expulsion from the professional body.

The professional bodies assist in maintaining professional standards by:

- requiring continuing education for all members
- organising professional development activities to assist in continuing education
- providing support services such as newsletters, journals, libraries, seminars and materials to keep members up to date
- providing technical and financial support to government and regulating agencies
- liaising with international accounting organisations
- providing quality assurance programs for members
- maintaining and enforcing codes of ethical conduct.

The CPA Australia and the ICAA have a minimum entry requirement for aspiring members. A member must have a three-year university degree with a core of accounting knowledge. All recognised degrees must be accredited by the professional body. The programs and courses in the approved universities are reviewed at least every five years. Each professional body has an extensive post graduate program for aspiring members to complete. This is the CPA Program for CPA Australia and the Professional Year Program for the ICAA. There is also a requirement for an extensive period of practical experience before full membership is given.

The NIA requires members to complete a TAFE qualification and then the Graduate Certificate of Professional Accounting. Programs for all three professional bodies are offered throughout Australia and South-East Asia.

There are many differences in the three post-graduate programmes required by the professional bodies. The programs align closely with the professional expectations of each organisation. It is therefore important for aspiring accountants and members of the public to be aware of these expectations and seek membership of, or employ an accountant from, the organisation that best meets their aspirations and objectives.

The professional bodies also play a role in the regulation of accounting information in Australia. They do so:

- ♣ if appointed, as a member of the Financial Reporting Council (FRC) or Australian Accounting Standards Board (AASB);
- ♣ if appointed to a committee, or advisory group established by the FRC;
- ♣ if appointed to a committee, advisory panel or consultative group established by the AASB;
- ♣ by means of one of their members being engaged as staff of, or consultant to, the AASB;
- ♣ being involved in the process of setting Accounting Standards;
- ♣ by engaging in general public debate on issues relating to Accounting Standards.

Members of CPA Australia and ICAA must comply with Accounting Standards. It is mandatory for all members who prepare financial statements to prepare those statements applying the standards set out in the Accounting Standards. Furthermore, they must take all reasonable steps to ensure that Accounting Standards are consistently applied. However, compliance with the Conceptual Framework is voluntary. Failure to comply with mandatory requirements represents a breach of the ethics of the professional bodies.

***Interesting questions for students to consider:***

1. How is the role of an accountant different to that of a bookkeeper?
2. What are some of the ethical implications that arise from being the chief financial officer of a publicly owned business or company?

## CONCEPTS, PRINCIPLES AND PRACTICES – YEAR 11 AND 12

## QUALITATIVE CHARACTERISTICS

The qualitative characteristics of financial information are those attributes which the information should have in order for it to be useful for economic decision-making, which is the main objective of general purpose financial reporting. It forms an integral part of the conceptual framework.

**SAC 1 (1990) - Definition of the Reporting Entity**
This Statement of Accounting Concept defines those entities which are reporting entities. It states that an entity is a reporting entity if it is reasonable to expect the existence of users of financial reports who are dependent upon them for information which will be useful for making and evaluating decisions about the allocation of scarce resources.

**SAC 2 (1990) - Objectives of General Purpose Financial Reporting**
This Statement focuses on the objective of general purpose financial reports (GPFR) in order to make them useful for dependent users. Two main objectives are specified:
1. General purpose financial reports should provide information useful to users for making and evaluating decisions about the allocation of scarce resources.
2. GPFRs should provide information in a manner which assists in discharging the accountability of management.

**The Framework for the Preparation and Presentation of Financial Statements (2005)** ("The Framework") has now replaced SAC 3 and SAC 4. The Framework addresses the following concepts:
- The objective of financial reports
- Qualitative characteristics that make accounting information useful
- The definition, recognition and measurement of the elements of financial statements
- Concepts of capital and capital maintenance.

Paragraph AUS14.1 of The Framework links these objectives to SAC 2.

Qualitative characteristics are as follows:

### Understandability

Information should be readily understandable by users, assuming they have a reasonable knowledge of business and economic structures. Complex information should not be excluded from the financial reports though.

***Interesting questions for students to consider:***

1. How much information explaining depreciation methods should be included in the notes to financial reports?
2. What is 'reasonable knowledge of business and economic structures'? Give examples.

### Relevance

Information is relevant when it influences the economic decisions of users by helping them evaluate events or to confirm or correct their evaluations of the situation. Users should be able to both predict and confirm. The relevance of information is also affected by its nature and **materiality**. Information is material if its omission or misstatement could influence the decisions of users. Materiality is dependent upon the size and/or nature of the item. AASB 1031 defines materiality and explains its importance in making decisions about the preparation and presentation of financial reports.

***Interesting questions for students to consider:***

1. As a potential investor, which two pieces of information would be most relevant to your decision to hold or sell shares in a company?
2. Would an omission of $10 000 from reported income be material? Under what circumstances?

## Reliability

Information is reliable when it is free from material error and bias and can be depended upon by users to represent items faithfully. To be reliable, information must **faithfully represent** the transactions or events it purports to represent. Inherent difficulties can result in a less than faithful representation. Information must also be presented in accordance with its **substance** reporting economic reality and not merely legal form. To be reliable, the information must be **neutral** and free from bias. The report preparers must also exercise **prudence** by exercising a degree of caution when making judgements and estimates. To be reliable, the information must also be **complete** and without material omissions.

***Interesting questions for students to consider:***

1. Purchase price is the most reliable information available about assets, but is it necessarily relevant?
2. If an entity transfers the ownership of an asset under one legal contract, but then signs another contract giving the entity exclusive rights to use that asset, has a sale taken place?

## Comparability

Users must be able to compare the financial reports of an entity through time in order to be able to identify trends. They also need to be able to compare different entities in order to be able to evaluate their relative financial position, financial performance, and cash flow. Users must be informed of the accounting policies employed in the preparation of the report and any changes in those policies. The need for comparability should not be confused with keeping records uniform over time.

***Interesting questions for students to consider:***

1. Is it possible to compare the financial position of two companies if one measures assets using market values and the other company uses original purchase price? If not, why not?
2. Why must changes in accounting policies be reported? Give examples.

## CONCEPTS, PRINCIPLES AND PRACTICES – YEAR 11 AND 12

## DEFINITION OF ASSETS, LIABILITIES, INCOME, EXPENSE AND EQUITY

The Framework for the Preparation and Presentation of Financial Statements ("The Framework") offers definitions of core accounting terms such as assets, liabilities, income and expense.

The purpose of the Framework is to assist with the preparation and presentation of financial reports for external users. Where there is a conflict between an Australian Accounting Standard and the Framework, the requirements of the Standard prevail.

The Framework places emphasis on determining the existence of assets and liabilities, with income, equity and expenses being defined in terms of changes in assets and liabilities. Presented below are the current Framework definitions, with detailed discussion of their characteristics.

### Assets

An Asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.

There are three essential characteristics of an asset:

1. An asset must have *future economic benefits*[*]. Hence, any items which have merely sentimental benefits e.g. various trinkets, or spiritual benefits, are not assets for accounting purposes. These economic benefits must be expected to flow to the entity in a future period or periods, for an asset to exist. In a sense, a block of land (or any piece of plant and equipment) is not an asset, but only the future benefits provided by the land constitute the asset.
2. An asset must be *controlled* by the entity. Note that this means that the asset does not have to be owned. Control[**] relates to the capacity of the entity to *regulate the access of others* to the benefit of the asset.
3. The event giving rise to the control must have occurred. Hence, future economic benefits which are not *currently* controlled by the entity are not assets. A past event or transaction must have occurred.

The concept of an asset as a collection of future benefits controlled by an entity means that the following features are *not* essential to the existence of an asset:

- Legal ownership
- Physical existence
- A purchase cost
- Legally enforceable control

***Interesting questions for students to consider:***

1. Do "research and development costs" qualify as assets?
2. Do "advertising costs" qualify as assets?

### Liabilities

A Liability is a present obligation of the entity resulting from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

There are three essential characteristics of a liability:

1. There must exist a *present* obligation. An obligation is a duty or responsibility to act or perform in a certain way. A present obligation means that the entity has little or no choice over whether or

[*] Future economic benefits: Bundles of future services or value to the entity to sell or to use.
[**] Control: Able to secure an item to prevent, deny or restrict access by others.

not to meet the obligation. Most liabilities would be legally enforceable obligations, but other types of obligations may also qualify e.g. equitable obligations.
2. The obligation must involve a sacrifice of economic benefits in the *future*. Settlement of such a sacrifice could be either on demand, on a specified date, or on the happening of a specified event.
3. As with assets, there must exist a *past transaction* or other past event. This event, called the obligating event, gives rise to the present obligation.

***Interesting questions for students to consider:***

1. Does an entity have a liability for warranties given as a result of a sales contract with a customer?
2. Does an entity have a liability for payment of inventory purchased under a contract prior to the goods being delivered?
3. Does a provision for possible losses of inventory constitute a liability?

## Equity

Equity is the residual interest in the assets of the entity after deducting all its liabilities.

Equity, in itself, has no separate existence. It is merely the residual after deducting total liabilities from total assets. Thus the amount at which equity is shown in the balance sheet is dependent on the measurement of assets and liabilities.

The accounting equation is aptly written as:
**Assets minus Liabilities equals Equity.**

## Income

Income is increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.

Note that the definition of income is dependent on the definitions of assets, liabilities, and equity. For income to exist, there must be an increase in an asset, or a reduction in a liability, which is accompanied by an increase in equity. Contributions by equity participants are the only exclusion from this definition. Hence all of the characteristics of assets and liabilities are important in determining the existence of income. The definition is very wide in that it does not appear to require any earning process to have occurred before income comes into existence. However, in most cases, income will have been earned.

***Interesting questions for students to consider:***

1. Is a gift of money given to an entity by an outside party included in the entity's income?
2. Do subscriptions received by the entity in advance of the publication of a magazine constitute income at the time the money is received ?

## Expenses

Expenses are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.

Note that the definition of expenses is dependent on the definitions of assets, liabilities, and equity. For an expense to exist, there must be a decrease in an asset, or an increase in a liability, which is accompanied by a decrease in equity. Distributions to equity participants e.g. dividends, are the only exclusion from this definition. As with income, the definition is very wide in that there is no need for income to have arisen prior to any expense coming into existence.

***Interesting questions for students to consider:***

1. Is depreciation an expense? How would you treat costs incurred for the maintenance of a motor vehicle?
2. Is there any expense arising when an entity provides warranties on merchandise sold under a contract with a customer?

**Note:** In some instances there is no unequivocal answer to the suggested questions in this document. Rather, it is important to analyse and evaluate the question using the essential characteristics of the element.

## Distinction between an asset and an expense

The distinction between an asset and expense is of particular importance to the preparation of financial reports.

Assets and expenses are both recognised as major elements of financial reports, and their definitions are outlined above. The essential characteristics and criteria for recognition for assets and expenses, form a basis within which these two elements can be compared.

An asset is a resource offering *future economic benefits*. For example, a building is an asset because it provides economic benefits in future accounting periods. Inventory held at the end of a period is an asset because it can generate economic benefits in the future. The benefits may come about either from the use or the sale of the asset. Cash is an asset because it represents future economic benefits in the form of purchasing power. Assets will enable an entity to meet its objective of providing a service or product to its customers or clients.

An expense, however, is an economic benefit that has been *consumed or lost* during the accounting period. An expense may be:

- The consumption of an asset e.g. depreciation or losses through destruction of property in a fire. In many cases the acquisition and consumption of the asset occurs during the same financial period. Examples are the use of power supplies and insurance of property.
- An outflow of an asset e.g. cash paid for wages.
- An increase in liabilities e.g. electricity payable at the end of the accounting period.

Assets are characterised by the fact that the entity will have *control* over the benefits embodied in those assets. This is not the case with expenses. The entity should be able to regulate the access of external parties to the benefits of the asset. Control of the asset does not necessarily imply that the entity has legal ownership of that asset. In the case of both assets and expenses they are characterised by the fact that they both arise from past transactions or other past events.

An essential characteristic of expenses is that they should result in a decrease in equity via a change in assets or liabilities. On the other hand, the acquisition of an asset will normally result in an overall increase in equity. Expenses will then be recognised as the benefits of these assets are consumed, lost or sold.

Assets and expenses can also be distinguished based on their *recognition*. Assets are recognised when it is probable that the future economic benefits embodied in them will eventuate and there is a cost which can be measured reliably. An expense is recognised in the income statement when a decrease in future economic benefits related to a decrease in an asset or an increase of a liability, has arisen and can be measured reliably.

The distinction between assets and expenses is important in clarifying whether some expenditure is to be treated as an asset or an expense. Certain expenditures are assets because they give rise to future economic benefits which will be available for more than one accounting period. Examples are installation costs because they ensure that an asset is suitable for its intended use, and improvements or additions because they increase or add to the lifetime benefits to be obtained from an asset. Other expenditures are expenses because the item benefits only the current accounting period i.e. they are

consumed or used up in the current accounting period. Examples are wages, supplies used, delivery expenses, telephone charges and cost of sales.

***Interesting questions for students to consider:***

1. If an entity acquires computer equipment which has an expected life of ten years but may become technically obsolete within six months of the date of acquisition how should the purchase be recorded in the accounting records?
2. When will the cost of an item of inventory become an expense? Why?

**Suggested References:**

Several sources can be consulted in relation to the Framework. The following are helpful suggestions:

- See the Framework document itself, contained in the *Accounting Handbook*.
- Several textbooks can be of use e.g:
  - ✈ Hoggett, Edwards, and Medlin, *Accounting in Australia* or *Financial Accounting in Australia*, Brisbane: John Wiley, latest edition.
  - ✈ Martin, *An Introduction to Accounting*, latest edition, McGraw-Hill.
  - ✈ Henderson and Peirson, *Issues in Financial Accounting*, latest edition, Longman Cheshire.
  - ✈ Peirson and Ramsay, *Financial Accounting: An Introduction*, Longman Australia, latest edition.

## CONCEPTS, PRINCIPLES AND PRACTICES – YEARS 11 AND 12

## INCOME RECOGNITION

Income is defined in the Framework for the Preparation and Presentation of Financial Statements ("The Framework"). as increases in economic benefits during the accounting period in the form of inflows or other enhancements of assets or reductions of liabilities that result in increases in equity, other than those relating to contributions from equity participants.

The Framework's definition includes two broad categories of income:

- Revenue arising in the ordinary course of business: e.g. Sales, fees, interest, dividends, royalties, rent. Requirements for revenue are detailed in AASB 118 (see below).
- Gains meeting the definition of income which may or may not arise in the ordinary course of business: e.g. Gains arising on the disposal of non-current assets.

Professional judgement is required to distinguish between revenues and gains, and to decide if the inflow of economic benefits is due to ordinary activities.

The Framework states that income is recognised in the income statement when an increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably. For most businesses the majority of income will result from the provision of goods or services during the accounting period. There will be little uncertainty that the income has occurred, as the firm will either have received the cash or have an enforceable claim against an external party.

AASB 118 Revenue, specifies the conditions that must be satisfied for the recognition of revenue from:

- Sale of Goods
- Rendering of Services
- Interest, Royalties and Dividends.

Revenue arising from the *sale of goods* must be recognised when, and only when, all the following conditions have been satisfied:

- The entity has transferred to the buyer the significant risks and rewards of ownership
- The entity does not retain ownership or effective control over the goods
- The amount of revenue can be measured reliably
- It is probable that future economic benefits will flow to the entity
- Costs incurred in respect to the sale can be measured reliably

For the *rendering of services,* where the outcome of a contract to provide services can be estimated reliably, revenue arising from the contract is recognised by reference to the stage of completion of the contract. The outcome of the contract can only be estimated reliably when all the following conditions have been satisfied:

- The revenue amount can be measured reliably
- It is probable that future economic benefits will flow to the entity
- The stage of completion of the transaction can be measured reliably
- Costs incurred to date and costs to complete the transaction can be measured reliably

If the outcome of the contract cannot be reliably measured then revenue is only recognised to the extent that costs incurred are recoverable.

Revenue arising from *interest, royalties or dividends* must be recognised in accordance with the details below, when, and only when, all the following conditions have been satisfied:

- It is probable that economic benefits will flow to the entity
- The amount of the revenue can be measured reliably

Interest and Royalties are recognised on an accrual basis. Dividends are recognised when the shareholder's right to receive payment is established.

***Questions for students:***

1. Outline your understanding of the term 'future economic benefits'.
2. Is a donation revenue and should it be recognised?
3. Discuss the difference between a bad debt and a doubtful debt.
4. Explain the difference in revenue recognition for interim and final dividends, where the company's Constitution allows payment immediately after declaration.

## ASSET RECOGNITION

The Framework provides the following:

An asset is recognised in the balance sheet when it is probable that the future economic benefits will flow to the entity and the asset has a cost or value that can be measured reliably.

An asset is not recognised in the balance sheet when expenditure has been incurred for which it is considered improbable that economic benefits will flow to the entity beyond the current accounting period. Instead, such a transaction results in the recognition of an expense in the income statement.

## LIABILITY RECOGNITION

A liability is recognised in the balance sheet when it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably.

## EXPENSE RECOGNITION

Expenses are recognised in the income statement when a decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen that can be measured reliably. This means, in effect, that recognition of expenses occurs simultaneously with the recognition of an increase in liabilities or a decrease in assets (for example, the accrual of employee entitlements or the depreciation of equipment).

## ROLE OF GOVERNMENT, USER GROUPS, BUSINESS ENTITIES AND PROFESSIONAL ACCOUNTING ASSOCIATIONS IN THE ESTABLISHMENT OF ACCOUNTING STANDARDS.

Accounting Standards are formal documents that establish accounting policies that must be complied with by a reporting entity in the preparation of general-purpose financial reports (GPFRs). Other reports are known as special purpose financial reports. The GPFRs comprise the statement of changes in equity, income statement, balance sheet and cash flow statement and all notes attached to these statements.

The government, user groups, business entities and professional accounting associations influence the preparation of these Accounting Standards.

### The role of government

Commencing on the 1 January 2005, Australia has adopted standards issued by the International Accounting Standards Board (IASB). These are called International Accounting Standards (referred to as IAS) or International Financial Reporting Standards (IFRS). These standards are being adopted with modification, and being given AASB numbers. Material is added to the international standards to assist with applying them within the Australian context.

The Federal Government of Australia controls the development, application and regulation of accounting standards which apply to all reporting sectors – corporate, public and non-for-profit. The revised Accounting Standards are developed by the Australian Accounting Standards Board (AASB), which is overseen by the Financial Reporting Council (FRC).

### The role of the Financial Reporting Council

The Federal Government has established the Financial Reporting Council (FRC), Australian Accounting Standards Board (AASB), and the Australian Securities and Investments Commission (ASIC). The main role of the FRC is to oversee the activities of the AASB. Its main functions are to monitor the process for adopting International Accounting Standards, to act as an advisory body to the AASB, and to give the Federal Treasurer reports and advice on the process of standard setting. The Federal Treasurer appoints the members of the FRC. The FRC may establish committees and advisory groups to facilitate its functions.

The FRC approves and monitors the AASB's plans, budget and staffing arrangements, but does not have the power to direct the AASB in relation to the development of Accounting Standards, nor does it have the power to veto any standard formulated and recommended by the AASB.

### The role of the Australian Accounting Standards Board

The main roles of the AASB are:

- To develop a conceptual framework for the purpose of evaluating proposed Accounting Standards and International Standards
- To make accounting standards for the purpose of the Corporations Act
- To formulate accounting standards for other purposes e.g. application by public and non-for-profit sectors
- To participate in and contribute to the development of a single set of Accounting Standards for worldwide use.

The AASB has the power to engage staff and consultants, and to establish committees, advisory panels and consultative groups to facilitate its functions. The members of the AASB are appointed by the FRC, with the exception of the Chair of the AASB, who is appointed by the Federal Treasurer.

The AASB is required by the FRC to adopt the IAS and IFRCs of the IASB in the preparation of Accounting Standards for use in Australia. It must carry out a cost benefit analysis of the impact of a proposed accounting standard to be used in Australia unless that standard is based on an existing international standard.

### The role of the Australian Securities and Investments Commission

The Australian Securities and Investments Commission (ASIC) is not directly involved in the development of the AASB Accounting Standards. However, it does issue interpretations of the standards in the form of Practice Notes, and is involved in monitoring compliance with the standards in relation to companies who are reporting entities. It is responsible for administering the Corporations Act in Australia.

### The role of the Urgent Issues Group

An important sub-committee of the AASB is the Urgent Issues Group (UIG). Business entities, user groups, and professional accounting associations may be involved in the UIG. It issues Abstracts, which deal with contentious issues in financial accounting with a view to reaching a consensus on the appropriate accounting treatment. These give directives to preparers of GPFRs on accounting matters which require urgent attention, and where there needs to be an interpretation of existing regulation.

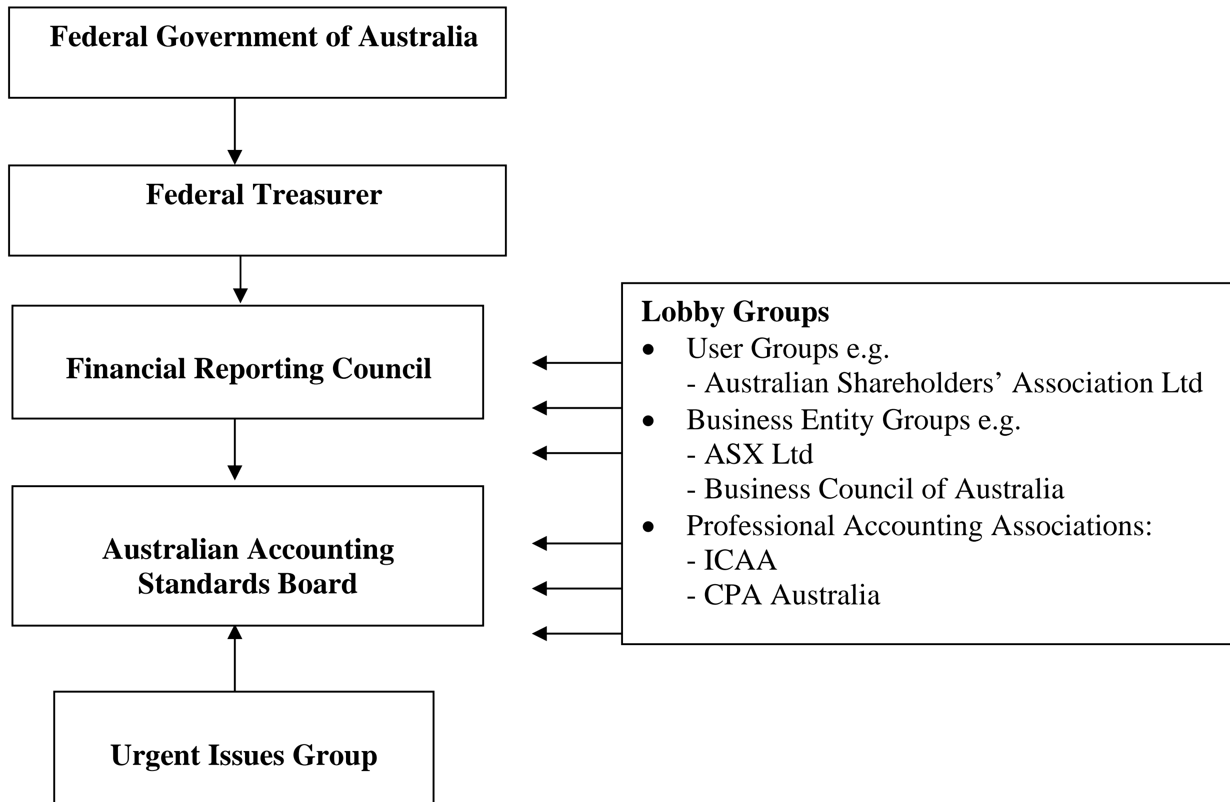
The UIG is also responsible for reviewing interpretations issued by the International Financial Reporting Interpretations Committee, which has a similar role at an international level.

### The role of business groups, user groups and professional accounting associations

The role of business groups (e.g. ASX, Business Council of Australia), user groups (e.g. Australian Shareholders' Association Ltd) and professional accounting associations (e.g. Institute of Chartered Accountants in Australia (ICAA) and CPA Australia) is to lobby for their goals and interests. They may do so:

- if appointed, as a member of the FRC or AASB;
- if appointed to a committee, or advisory group established by the FRC;
- if appointed to a committee, advisory panel or consultative group established by the AASB;
- by means of one of their members being engaged as staff of, or consultant to, the AASB;
- being involved in the process of setting Accounting Standards;
- engaging in general public debate on issues relating to Accounting Standards.

**Diagram showing the role of the parties involved in the establishment of Accounting Standards in Australia.**



## Background Knowledge For Teachers

The Financial Reporting Council adopted international standards commencing on 1 January 2005. Differences between Australian Accounting Standards and IASB standards have essentially been removed. Minor differences include the addition of extra explanatory material, for example. Some AASB standards have fewer reporting options than their related IAS/IFRS standard. However, compliance with a AASB standard will still mean compliance with the IAS/IFRS standard.

The establishment of Accounting Standards in Australia is now very much under the control of the Federal Government of Australia. This is as a consequence of the Corporate Law Economic Reform Program Act 1999 (CLERP Act 1999) which amended the Australian Securities and Investments Commission Act 1989.

### The role of government

The CLERP Act 1999 is part of the Government's economic reform agenda and has resulted in an increased role for business entities in the setting of Accounting Standards. It has also resulted in the downgrading of the role played by professional accounting bodies. The Public Sector Accounting Standards Board (PSASB) and old Australian Accounting Standards Board (AASB) are now dissolved. The Australian Accounting Research Foundation (AARF) is now just another lobby group with little influence in the development of Accounting Standards.

The AARF was seen by business as having too much say and being too academic in the establishment of Accounting Standards. Government and business also saw these standards as being based too much on the conceptual framework. More flexibility was desired with the standard setting process being more relevant to the business world.

The government's purpose in bringing about change is outlined in the CLERP Act 1999. In Part 12 - Accounting Standards, Section 224 states that the objectives of establishing Accounting Standards are:

(a) to provide information that:
- (i) allows users to make and evaluate decisions about allocating scarce resources; and
- (ii) assists directors to discharge their obligations in relation to financial reporting; and
- (iii) is relevant to assessing performance, financial position, financing and investment; and;
- (iv) is relevant and reliable; and
- (v) facilitates comparability; and
- (vi) is readily understandable;

(b) to facilitate the operation of the Australian economy by:
- (i) reducing the cost of capital; and
- (ii) enabling Australian entities to compete effectively overseas; and
- (iii) having Accounting Standards that are clearly stated and easy to understand;

(c) to maintain investor confidence in the Australian economy (including its capital markets).

The government's main role is to set policy and direction, and establish a framework for the setting of Accounting Standards in Australia. Through the CLERP Act 1999 it achieves this by means of the Financial Reporting Council (FRC) and the new Australian Accounting Standards Board (AASB).

### The role of the Financial Reporting Council

In the CLERP Act 1999 Part 12 - Accounting Standards, Section 225, the FRC's functions are outlined as:

(a) to provide broad oversight of the process for setting Accounting Standards in Australia; and

(b) to appoint the members of the AASB (other than the Chair); give the Minister reports and advice on that process; and
(c) to approve and monitor the AASB's:
  (i) priorities; and
  (ii) business plan; and
  (iii) budget; and
  (iv) staffing arrangements (including level, structure and composition of staffing); and
(d) to determine the AASB's broad strategic direction; and
(e) to give the AASB directions, advice or feedback on matters of general policy and the AASB's procedures; and
(f) to monitor the development of international Accounting Standards that apply in major international financial centres, and:
  (i) to further the development of a single set of Accounting Standards for world-wide use with appropriate regard to international developments; and
  (ii) to promote the adoption of international best practice Accounting Standards setting process if doing so would be in the best interests of both the private and public sectors in the Australian economy; and
(g) to monitor:
  (i) the operation of Accounting Standards to assess their continued relevance and their effectiveness in achieving their objectives in respect of both the private and public sectors of the Australian economy; and
  (ii) the effectiveness of the AASB's consultative arrangements; and
(h) to seek contributions towards the costs of the Australian accounting standard setting process; and
(i) to monitor and periodically review the level of funding, and the funding arrangements; for the AASB; and
(j) to establish appropriate consultative mechanisms; and
(k) to advance and promote the main objects of this Part; and
(l) any other functions that the Minister confers on the FRC by written notice to the FRC Chairman.

The FRC is given all powers to do those things necessary or convenient to be done for or in connection with the performance of its functions.

It may establish committees and advisory groups, but does not have the power to direct the new AASB in relation to the development, or making of a particular standard. It does not have the power to veto a standard formulated and recommended by the AASB.

The Federal Treasurer appoints the members and the chairperson of the FRC. The Treasurer may appoint a person by specifying an organisation or body that is to choose the person who is appointed. The FRC must report to the Treasurer and Parliament each year on its operations (including the AASB) and achievements.

**The role of the Australian Accounting Standards Board**

The functions of the new AASB are outlined in Section 227 as:

(a) to develop a conceptual framework, not having the force of an accounting standard, for the purpose of evaluating proposed Accounting Standards and international standards; and
(b) to make Accounting Standards under section 334 of the Corporations Act for the purpose of the national scheme laws; and
(c) to formulate Accounting Standards for other purposes; and
(d) to participate in and contribute to the development of a single set of Accounting Standards for world-wide use; and
(e) to advance and promote the main objects of this Part.

In carrying out these functions and in setting Accounting Standards the AASB must have regard to the objectives of the framework for the establishment of Accounting Standards as discussed previously. (See Section 224 of the Act.)

The AASB has power to:

(a) engage staff and consultants; and
(b) establish committees, advisory panels and consultative groups; and
(c) receive money contributed towards its operating costs; and
(d) do anything else that is necessary for, or reasonably incidental to, the performance of its functions.

Section 229 of the Act specifies that Accounting Standards made or formulated by the AASB may:

(a) be of general or limited application (including a limitation to specified bodies or undertakings); and
(b) differ according to differences in time, place or circumstance.

Furthermore in making and formulating Accounting Standards, the AASB:

(a) must have regard to the suitability of a proposed standard for different types of entities: and
(b) may apply different accounting requirements to different types of entities; and
(c) must ensure that there are appropriate Accounting Standards for each type of entity that must comply with Accounting Standards.

The AASB must also carry out a cost/benefit analysis of the impact of a proposed accounting standard before making or formulating the standard. In carrying out its functions it must follow the broad strategic direction determined by the FRC, the general policy of the FRC and take into account the advice and feedback given by the FRC.

The Treasurer appoints the Chair of the AASB and all other members are appointed by the FRC. Such persons must have knowledge of, or experience in, business, accounting, law or government.

**The role of user groups, business entities and professional accounting associations**

The role of user groups, business entities and professional accounting associations in the establishment of Accounting Standards is to lobby for their goals and interests. They may do so:

- if appointed, as a member of the FRC or AASB;
- if appointed, to a committee or advisory group established by the FRC;
- if appointed, to a committee, advisory panel or consultative group established by the AASB;
- by means of one of their members being engaged as staff of, or consultant to, the AASB;
- being involved in the process of setting Accounting Standards;
- engaging in general public debate on issues relating to Accounting Standards.

Examples of business entity lobby groups are:

- Australian Stock Exchange Limited
- Business Council of Australia
- Group of 100
- Australian Chamber of Commerce and Industry
- Australian Institute of Company Directors
- Council of Small Business Organisation of Australia.

Examples of user groups would be:

- Australian Shareholders' Association Ltd
- Australian Bankers' Association
- Law Council of Australia
- The Securities Institute of Australia
- Australian Institute of Valuers and Land Economists (Inc.)
- Insurance Council of Australia.

The two main professional accounting associations involved in the development of Accounting Standards are:

- CPA Australia
- Institute of Chartered Accountants in Australia (ICAA).

**The role of the Urgent Issues Group**

The Urgent Issues Group (UIG) is a sub-committee of the AASB. Business entities, user groups and professional accounting associations may be involved in the UIG. It continues to issue Abstracts containing Consensus Views. These abstracts deal with contentious issues in financial accounting with a view to reaching a consensus on the appropriate accounting treatment. These abstracts are necessary because Accounting Standards are not explicit on all issues relating to the preparation of financial reports. Members of the professional bodies of accountants must comply with these Abstracts.

**The role of the Australian Securities and Investment Commission**

Through the Australian Securities and Investment Commission (ASIC) the government is also indirectly involved in enforcing Accounting Standards. The ASIC is established and controlled by the government. Compliance with AASB standards is required under the Corporations Act and is enforced by the ASIC. The ASIC also issues Accounting Practice Notes (APN) which assist in interpreting Accounting Standards whenever there is doubt about their meaning.

## DEPRECIATION AND DISPOSAL OF DEPRECIABLE ASSETS – YEAR 11 AND 12

## NATURE OF DEPRECIATION AS AN ALLOCATION OF COST

**(Note: Students would be expected to be able to provide an in depth answer on the following.)**

Depreciation may be defined as the decline in the future economic benefits of a depreciable non-current asset through wear and tear and obsolescence.

A characteristic of all depreciable non-current assets held on a long-term basis is that their useful lives are limited i.e. their service potential declines over time to a point where it is, for practical purposes, used up or lost.

Depreciation can be distinguished from amortisation. Although these terms have the same meaning, amortisation relates to intangible assets and natural resources. Amortisation may be defined as the allocation of the cost of intangible assets and natural resources over the periods benefiting from their use.

Three factors contribute to a depreciable non-current assets decline:

- wear and tear, through physical use, in excess of that which maintenance can restore.
- technical obsolescence i.e. the asset becomes out of date and inefficient due to new technologies
- commercial obsolescence i.e. the asset becomes redundant through a fall in the market demand for the goods or services in the production of which the asset is used.

The accounting standard AASB 116, Property, Plant, and Equipment, views depreciation as an allocation process. Therefore depreciation is not a process of asset valuation. Depreciation is defined in AASB 116 as the systematic allocation of the depreciable amount of an asset over its useful life. Although the asset's market value may change, this is not normally recognised in the accounts. This is because the asset is purchased for use in the business not for resale. However, certain assets (notably land) may on occasion be revalued upwards (see below Page 43 – Companies. Revaluation Reserve)..

The cash flow for depreciation precedes the expense. The cash outflow occurs when the asset is acquired and not when the depreciation is charged.

Accumulated depreciation represents the aggregate, at a given point of time, of the depreciation expenses for a particular asset. The accumulated depreciation cannot exceed the depreciable amount of the asset. Accumulated depreciation does not represent a cash reserve that can be used to replace the asset when it is worn out. The charge for depreciation each period does not affect the cash account. Accumulated depreciation is a credit balance, while a cash account has a debit balance. Depreciation does not provide for an asset's replacement.

The calculation of depreciation requires knowing the *depreciable amount, useful life and the residual value* of the asset.

The *depreciable amount* of an asset means the cost of an asset, or other amount substituted for cost, less its residual value. Both initial and subsequent costs can be included in the carrying amount of an asset, provided that the future economic benefits associated with the cost will occur and can be measured reliably.

The *useful life* of an asset is defined asi) the period over which the asset is expected to available for use by an entity or
ii0 the number of production or similar units expected to be obtained from the asset by the entity.

In estimating the useful life of an asset, consideration must be given to the expected physical wear and tear, obsolescence, and legal or other limits on the use of the asset.

The *residual value* of an asset is the estimated amount recoverable on disposal of the asset at the end of its useful life. This figure is determined by considering similar assets which have reached the end of their useful lives and which have operated under similar conditions to the asset which is being considered.

The cost of an asset can be allocated by two methods – the straight line method or the diminishing balance method. The straight line method is a means of determining the systematic allocations which are constant from year to year and is often adopted for its simplicity. The diminishing balance method yields allocations which decrease from year to year. The straight line method is applied to those assets where the pattern of exhaustion for those assets' future economic benefits will remain constant from year to year. The diminishing balance method is adopted for those assets which yield more service in their earlier years than in latter years. The method adopted should be applied consistently from year to year.

The depreciation method applied to an asset must reflect the pattern in which the asset's future economic benefits are consumed by the entity. Depreciation is to be treated as an expense. The basis for allocating the depreciable amount ought to be appropriate to the nature of the respective assets and their expected use. It should reflect the underlying physical, technical, commercial and, where appropriate, legal facts.

# DEPRECIATION AND DISPOSAL OF DEPRECIABLE ASSETS – YEAR 11 AND 12

## NATURE OF A DEPRECIABLE NON-CURRENT ASSET

### Background knowledge for teachers

Depreciation essentially applies to property (excluding land and natural resources), plant and equipment. These are non-current assets purchased by an entity for use in business operations rather than for resale to customers. They are assets which have physical substance i.e. they are tangible. They are items you can see, feel or touch.

Non-current assets may be classified as long-term investments; property, plant and equipment; intangible assets; and other assets. Other assets represent assets which do not fit into one of the previous categories. It will include such items as plant and equipment held but no longer used in business operations.

Depreciation relates to assets with a physical substance i.e. it does not relate to intangible assets. AASB 116 outlines that an asset with physical substance which is expected to be used during more than one financial year must be recognised if, and only if:

i) It is probable that the future economic benefits associated with the item will flow to the entity; and

ii) The cost of the item can be measured reliably.

With the exception generally of land, a characteristic common to all physical assets (durable goods and other physical property) held on a long term-basis, is that their useful lives are limited i.e. their service potential declines over time to a point where it is, for all practical purposes, consumed or lost. It does not matter whether the life of the asset is known with certainty or not.

Investments (eg shares and debentures in other companies) are not considered to be depreciable non-current assets because they provide revenue directly in the form of interest or dividends on the money invested, rather than indirectly by the using up of their productive capacity.

Natural resources (eg minerals, oil wells and forests) are not depreciated but amortised. This is because such assets do not suffer from wear and tear or obsolescence. These assets are depleted as the natural resource is removed from the ground.

## WHAT STUDENTS NEED TO KNOW

Accounting Standards are concerned with the recognition of physical non-current assets; the depreciation of those assets having a limited life; and the disclosure of information relating to those two issues.

The requirements of the standard are consistent with the content of the topics dealing with depreciation in the Year 11 and 12 syllabuses.

## DEPRECIATION AND DISPOSAL OF DEPRECIABLE ASSETS – YEAR 12

## DETERMINATION OF THE COST OF A DEPRECIABLE NON-CURRENT ASSET

Accounting Standards deal with the determination of the cost of a depreciable non-current asset. AASB 116 requires that items of property, plant or equipment that are assets, are to be accounted for at the cost of acquisition, which is defined as :The amount of cash or cash equivalents paid, or the fair value of the other consideration given, to acquire an asset at the time of its acquisition or construction. This includes
any costs directly attributable to bringing the asset to the location and condition necessary for operation; andcosts of dismantling and removing the item and restoring the site on which it is located.

The *purchase price* is the fair value of assets given up or share capital issued, liabilities undertaken and other securities given by the purchaser, in order to acquire the asset(s) purchased. Where an asset is acquired by means of a cash transaction, the determination of the cost is fairly straightforward. However, many assets are acquired for consideration other than cash. It is important to note that the cost of acquisition is the fair value of the assets given up not the fair value of the asset acquired. When an asset is traded in, the cost of the new asset is the fair value of the asset given up to acquire it, plus any other outlay. In this situation the asset given up is a non-monetary asset.

When an asset is traded in and cash is paid to purchase a new asset, the value of the new asset is the fair value of the asset traded plus the cash paid. Both monetary and non-monetary assets have been given up. When a business constructs its own asset for its own use, the cost includes all expenditures directly related to its construction, such as direct materials, direct labour and overheads

*Costs directly attributable* to the acquisition are included in the determination of the cost of acquisition. These costs normally include legal fees, stamp duty and other government charges, and professional fees in the nature of feasibility tests and investigations preceding acquisitions. The cost of the asset includes all expenditures incurred to obtain the asset and to get it ready for its intended use. This can include the cost of assembly, freight, insurance, testing and installation.

### Subsequent costs

AASB 116 provides that the costs of day to day servicing and repairs is not included in the carrying amount. However, parts of an item may require replacement at regular intervals or require regular major inspections. These costs are included in the carrying amount if recognition criteria are met. The cost of a depreciable non-current asset can also include additions, extensions and improvements to the asset. Costs incurred relating to a non-current asset subsequent to it having been put into use of held ready for use must be added to the carrying amount of the asset. This relates only to those expenditures which result in an increase in the future economic benefit, which will flow to the entity in future years, from that asset. This can include the cost of extraordinary repairs. Examples of such expenditures include major overhauls and reconditioning which extend an asset's useful life beyond its initial estimate or which extend significantly the asset's future production capacity or service potential. Expenditure on repairs and maintenance, made to help maintain the future economic benefits that an entity can expect from an asset, are recognised as an expense.

Expenditure incurred in relation to a depreciable non-current asset subsequent to its acquisition, may only be capitalised (i.e. added to the asset's value) when it is probable that future economic benefits, in excess of the originally assessed standards of performance of the asset, will flow to the entity in future financial years. All other costs must be recognised as an expense in the financial year in which they are incurred.

# DEPRECIATION AND DISPOSAL OF DEPRECIABLE ASSETS – YEAR 12

## GROSS CALCULATION METHOD

For the purpose of internal reporting, a business can separately disclose income from the disposal (not just the gain or loss) of a non-current asset. Therefore, the carrying amount (i.e. the historical cost less accumulated depreciation) of a depreciable asset sold will be written off and treated as an expense to be deducted from the income from the sale of the asset. The proceeds from the disposal of the asset will be shown in the income statement as part of Income, and the carrying amount of the asset sold is shown under Expenses. The net gain or loss on disposal of the asset is calculated as the difference between the gross proceeds (income) and the carrying amount of the asset sold (expense). The gross proceeds on sale of the asset must also be disclosed in the cash flow statement if any cash flows occur.

### *Illustrative example:*

A Mills is the owner operator of West Traders. On 30 June 2005 it sold one of its items of machinery for $12 000. The machine had originally cost $30 000 and the accumulated depreciation as at 30 June 2005 was $16 000.

### Solution (Method One):

Firstly we need to record in the Cash Receipts Journal the gross proceeds received from the sale of the machine.

**Cash Receipts Journal (Extract)**

| Date | Particulars | Other | Bank |
|---|---|---|---|
| 30 June 2005 | Proceeds from Sale of Machinery | $12 000 | $12 000 |

Secondly we need to calculate the carrying amount of the machine sold.

Carrying amount = $30 000 – 16 000
= $14 000

Next we must record in the General Journal the elimination from the accounting records, of this carrying amount of the machine sold.

**General Journal**

| Date | Particulars | Debit | Credit |
|---|---|---|---|
| 30 June 2005 | Carrying Amount of Machinery Sold | $14 000 | |
| | Accumulated Depreciation on Machinery | $16 000 | |
| | Machinery | | $30 000 |
| | To recognise as an expense the carrying amount of the machine sold. | | |

After posting the above entries, the ledger accounts would appear as follows:

**Machinery**

| Date | Particulars | Amount | Date | Particulars | Amount |
|---|---|---|---|---|---|
| 30 June 2005 | Balance b/d | 30 000 | 30 June 2005 | Carrying Amount of Machinery Sold | 14 000 |
| | | | | Accumulated Depreciation on Machinery | 16 000 |
| | | 30 000 | | | 30 000 |

**Accumulated Depreciation on Machinery**

| Date | Particulars | Amount | Date | Particulars | Amount |
|---|---|---|---|---|---|
| 30 June 2005 | Machinery | 16 000 | 30 June 2005 | Balance b/d | 16 000 |

**Carrying Amount of Machinery Sold**

| Date | Particulars | Amount | Date | Particulars | Amount |
|---|---|---|---|---|---|
| 30 June 2005 | Machinery | 14 000 | | | |

**Proceeds from Sale of Machinery**

| Date | Particulars | Amount | Date | Particulars | Amount |
|---|---|---|---|---|---|
| | | | 30 June 2005 | Cash at Bank | 12 000 |

## Solution (Method Two):

Eliminate from the accounting records, the carrying amount of the machine sold is as follows:
Record in the Cash Receipts Journal the gross proceeds received from the sale of the machine.

**Cash Receipts Journal (Extract)**

| Date | Particulars | Other | Bank |
|---|---|---|---|
| 30 June 2005 | Proceeds from Sale of Machinery | $12 000 | $12 000 |

To eliminate the Carrying Amount of Machinery Sold from the accounting records:
Firstly transfer the original cost of the machine sold to the account Carrying Amount of Machinery Sold.

**General Journal**

| Date | Particulars | Debit | Credit |
|---|---|---|---|
| 30 June 2005 | Carrying Amount of Machinery Sold<br>Machinery<br>Transfer original cost of machine sold | $30 000 | <br>$30 000 |

Secondly transfer the accumulated depreciation on the machine sold.

**General Journal**

| Date | Particulars | Debit | Credit |
|---|---|---|---|
| 30 June 2005 | Accumulated Depreciation on Machinery<br>Carrying Amount of Machinery Sold<br>Transfer accumulated depreciation on machine sold | $16 000 | <br>$16 000 |

The remaining amount ($14 000 balance) in the Carrying Account of Machinery Sold is transferred to the Profit and Loss account on balance day.

The ledger accounts after posting would appear as follows:

**Machinery**

| Date | Particulars | Amount | Date | Particulars | Amount |
|---|---|---|---|---|---|
| 30 June 2005 | Balance b/d | 30 000 | 30 June 2005 | Carrying Amount of Machinery Sold | 30 000 |

**Accumulated Depreciation on Machinery**

| Date | Particulars | Amount | Date | Particulars | Amount |
|---|---|---|---|---|---|
| 30 June 2005 | Carrying Amount of Machinery Sold | 16 000 | 30 June 2005 | Balance b/d | 16 000 |

**Carrying Amount of Machinery Sold**

| Date | Particulars | Amount | Date | Particulars | Amount |
|---|---|---|---|---|---|
| 30 June 2005 | Machinery | 30 000 | 30 June 2005 | Accumulated Depreciation on Machinery | 16 000 |
| | | | | Balance c/d | 14 000 |
| | | 30 000 | | | 30 000 |
| | Balance b/d | 14 000 | | | |

**Proceeds from Sale of Machinery**

| Date | Particulars | Amount | Date | Particulars | Amount |
|---|---|---|---|---|---|
| | | | 30 June 2005 | Cash at Bank | 12 000 |

### Income statement using the Gross Calculation Method (irrespective of method used)

**West Traders**
**Income Statement (Extract)**
**For the year ended 30 June 2005**

| | $ | $ |
|---|---|---|
| **Other Income** | | |
| Proceeds from Sale of Machinery | | 12 000 |
| **Expenses** | | |
| General and Administration | | |
| Carrying Amount of Machinery Sold | 14 000 | |

## Gain or Loss on Sale

If, as in this example, the carrying amount of the asset sold is greater than the sale proceeds, then the asset has essentially been under-depreciated. This under-depreciation may be described as a 'loss on sale' and will have the effect of reducing the firm's profit by this amount through the inclusion of the expense (Carrying Amount) and income (Proceeds from Sale) in the firm's income statement. Had the asset been sold for more than the Carrying Amount (say, $18 000) this would represent an over-depreciation of the machine, or a 'gain on sale' and would be brought into the year's profit calculation in exactly the same way, though increasing the profit rather than reducing it. In the case of a company preparing external financial reports, this loss or gain on sale must be disclosed in the notes to the financial statements as well as including the expense and income in the statement itself.

## Credit Sale or Trade-in

If the machine had been traded in or sold on credit then the proceeds would be recorded in the general journal and not in the cash receipts journal as in the case above. The following are examples of the general journal extracts if this was the case in the original example above. Whether the machine is sold on credit or traded in, the entries in the general journal to eliminate the carrying amount of the machine sold from the accounting records are still required, as shown above.

- Sold machine for $12 000 *on credit* to F Graham

**General Journal**

| Date | Particulars | Debit | Credit |
|---|---|---|---|
| 30 June 2005 | F Graham | $12 000 | |
| | Proceeds from Sale of Machinery | | $12 000 |
| | Gross Proceeds from sale of machine | | |

- *Trade-in* machine for $12 000 to purchase a new machine costing $40 000 from Nelson Co. The balance owing was to be paid off over the next 3 months.

**General Journal**

| Date | Particulars | Debit | Credit |
|---|---|---|---|
| 30 June 2005 | Machinery | $12 000 | |
| | Proceeds from Sale of Machinery | | $12 000 |
| | Gross Proceeds from sale of machine | | |
| | Machinery | 28 000 | |
| | Nelson Co | | 28 000 |
| | Balance owing on purchase of new machine | | |

## SUMMARY: GROSS CALCULATION METHOD

### Record EXPENSES as follows:

1. Transfer machinery at cost to Carrying Amount of Machinery Sold Account.

| | |
|---|---|
| **Debit** | Carrying Amount of Machinery Sold |
| **Credit** | Machinery |

2. Transfer Depreciation written off to date from Accumulated Depreciation Account to Carrying Amount of Machinery Sold Account.

| | |
|---|---|
| **Debit** | Accumulated Depreciation of Machinery |
| **Credit** | Carrying Amount of Machinery Sold |

NB: The balance of the Carrying Amount Account is reported as an EXPENSE in the Income Statement for internal reporting purposes.

**EXPENSES**
**General and Administrative**
Carrying Amount of Machinery Sold

### Record PROCEEDS as follows:

3. If cash is received – record in the Cash Receipts Journal.

| | |
|---|---|
| **Debit** | Cash at Bank |
| **Credit** | Proceeds from Sale of Machinery |

If sold on credit – record in the General Journal.

| | |
|---|---|
| **Debit** | Debtor |
| **Credit** | Proceeds from Sale of Machinery |

If machinery is a trade-in – record in the General Journal

| | |
|---|---|
| **Debit** | Machinery |
| **Credit** | Proceeds from Sale of Machinery |

NB: Show amount still owing on machinery to creditor.

| | |
|---|---|
| **Debit** | Machinery |
| **Credit** | Creditor |

NB: The Proceeds on Sale will appear as INCOME in the Income Statement for internal reporting purposes.

**OTHER INCOME**
Proceeds from Sale of Machinery

## ANALYSIS AND INTERPRETATION – YEAR 12

## INTERPRETATION OF THE INFORMATION AND TRENDS REVEALED BY RATIO ANALYSIS

Students are required to compare ratios between two or more businesses, between a business and industry averages/standards, and/or for a business between budgeted and actual results, and interpret the results. This is in addition to comparing ratios from year to year and interpreting the trend.

**Note:** Ratio formulas are to be given to students. The formula may be given to the students as part of the question or as an appendix.

***Illustrative examples:***

***a) The following information relates to the business of H Jacks Traders.***

**H. Jacks Traders**
**Budgeted Income Statement: Performance Report**
**For the year ended 30 June 2005**

| | **Budget** **$** | **Actual** **$** | **Variance** **$** | |
|---|---|---|---|---|
| Sales (all on credit) | 120 000 | 130 000 | 10 000 | F |
| Less: Cost of sales | | | | |
| Opening inventory | 15 000 | 15 000 | | |
| Purchases | 60 000 | 65 000 | 5 000 | U |
| | 75 000 | 80 000 | | |
| Less: Closing inventory | 14 000 | 12 000 | 2 000 | F |
| | 61 000 | 68 000 | | |
| Gross profit | 59 000 | 62 000 | 3 000 | F |
| Less: Operating expenses | 22 000 | 28 000 | 6 000 | U |
| Profit | 37 000 | 34 000 | 3 000 | U |

In relation to the above budget estimates the following ratios have been calculated:

| | |
|---|---|
| Gross Profit Ratio – | 49% |
| Profit Ratio – | 31% |
| Operating Expenses Ratio – | 18% |
| Inventory Turnover – | 4.2 Times |

**Required:**

Given the following ratio formulae calculate the ratio for the actual results for the year ended 30 June 2005 and comment on the profitability of the business.

| **Formula** | | **Calculation (Solution)** |
|---|---|---|
| Gross Profit Ratio: | $\frac{\text{Gross Profit}}{\text{Net Sales}}$ | $\frac{62000}{130000} x \frac{100}{1} = 48\%$ |
| Profit Margin: | $\frac{\text{Profit}}{\text{Net Sales}}$ | $\frac{34\,000}{130\,000} x \frac{100}{1} = 26\%$ |
| Operating Expenses Ratio: | $\frac{\text{Operating Expenses}}{\text{Net Sales}}$ | $\frac{28\,000}{130\,000} x \frac{100}{1} = 22\%$ |
| Inventory Turnover: | $\frac{\text{Cost of sales}}{\text{Cost of Average Inventory}}$ | $\frac{68000}{\left(\frac{15000+12000}{2}\right)} = 5 \text{ times}$ |

**Interpretation of information revealed by ratio analysis:**

Although the business has made a slight improvement in its actual gross profit compared to budget estimates, the gross profit ratio shows a very slight deterioration (i.e. 1%). This is in spite of a good increase in sales.

A comparison of the budgeted inventory turnover ratio (4.2 times) with the actual inventory turnover ratio (5 times) shows a positive result. This is reflected in the improved sales and reduced inventory on hand at the end of the year. The reason the gross profit has not shown an improvement appears to be due to the purchasing of extra inventory to meet increased sales demand. In future periods if sales continue to show the same level of demand and purchases of inventory are well controlled then the gross profit ratio should show an improvement.

The Profit Margin shows a negative result. The budgeted ratio was 31% while the actual result was 26%. This has mainly been due to the lack of control over operating expenses as shown in the deterioration in this ratio between budget estimates and actual results. This ratio shows an increase of 4% which is a negative result for the business.

***b) The following information relates to two similar businesses for the year ended 30 June 2005:***

| | **Como Stores** | **Albany Stores** |
|---|---|---|
| **PROFIT STATISTICS** | **$** | **$** |
| Credit sales | 280 000 | 280 000 |
| Less Cost of sales | 105 000 | 120 000 |
| Gross profit | 95 000 | 130 000 |
| Less Operating expenses | 45 000 | 65 000 |
| Profit | 130 000 | 95 000 |
| **BALANCE SHEET STATISTICS** | | |
| Current Assets: | | |
| -Cash at bank | 20 000 | - |
| -Inventory | 18 000 | 22 000 |
| -Accounts receivable | 37 000 | 47 000 |
| | 75 000 | 69 000 |
| Non current assets | 280 000 | 310 000 |
| Total assets | 355 000 | 379 000 |
| Current Liabilities: | | |
| -Bank overdraft | - | 9 000 |
| -Accounts payable | 23 000 | 32 000 |
| Total Current liabilities | 23 000 | 41 000 |
| Non-Current liabilities | 130 000 | 140 000 |
| Total liabilities | 153 000 | 181 000 |
| Net assets | 202 000 | 198 000 |
| Equity | 202 000 | 198 000 |

The following ratios relating to financial stability and managerial effectiveness have been calculated:

| | **Como Stores** | **Albany Stores** |
|---|---|---|
| Working Capital Ratio | 3.2:1 | 1.7:1 |
| Liquidity Ratio | 2.5:1 | 1.5:1 |
| Debtors' Collection Period | 48 days | 61 days |

**Required:**

Interpret the information revealed by the ratios calculated above to comment on the short-term financial stability of both businesses.

**Interpretation of information revealed by ratio analysis:**

Como stores shows a better short-term financial position. The Working Capital Ratio, Liquidity Ratio and Debtors' Collection Period ratio for Como Stores are all better than those for Albany Stores.

The main reason that Como Stores has a better Working Capital Ratio would appear to be due to it having cash in the bank whereas Albany Stores has a bank overdraft. It should be noted that Albany Stores Working Capital Ratio is less than the normally expected business practice of maintaining it at least at 2:1. This result is not good. The business of Albany Stores may have difficulty being able to repay its debts over the next financial year.

Although the accounts receivable of Albany Stores is larger than that for Como Stores this is not a good result. The debtors' collection period for Albany Stores (61 days) is much worse than that of Como Stores (48 days). However, the Como Stores ratio is still not good as it is normal business practice for this ratio to be less than 30 days. Both businesses need to improve their credit collection policy and policy in relation to the provision of credit to customers.

The Liquidity Ratio of Como Stores (2.5:1) is better than that of Albany Stores (1.5:1) because Como Stores has more cash in the bank and carry less inventory. However, the ratios for both stores indicates that they are able to meet their immediate debts with liquid assets.

c) ***The following information relates to Bradley Enterprises for the years ended 30 June 2004 and 2005:***

| | **30 June 2004** | **30 June 2005** |
|---|---|---|
| | **$** | **$** |
| Current assets | 100 000 | 130 000 |
| Non-current assets | 385 000 | 360 000 |
| Total assets | 485 000 | 490 000 |
| Current liabilities | 80 000 | 70 000 |
| Non-current liabilities | 200 000 | 180 000 |
| Total liabilities | 280 000 | 250 000 |
| Net assets | 205 000 | 240 000 |
| | | |
| Equity | | |
| - Capital | 160 000 | 205 000 |
| - Profit | 45 000 | 35 000 |
| Total equity | 205 000 | 240 000 |

Total Assets as at 30 June 2003 were $440 000.

The following ratios are for the year ended 30 June 2004 and the current industry standards:

| | **30 June 2004** | **Industry Standard** |
|---|---|---|
| Debt to Equity | 136% | 80% |
| Rate of Return on Assets | 10% | 6% |
| Rate of Return on Owners' Equity | 25% | 12% |

**Required:**

Calculate these ratios for the year ended 30 June 2005 (see Appendix for ratio formula). Interpret the trends in the ratios between 30 June 2004 and 2005 and compare the current year's ratios with the industry standard.

**Appendix – Ratio Formulae**

Debt to Equity: $\frac{\text{Total Liabilities}}{\text{Equity (End)}}$

Rate of Return on Assets: $\frac{\text{Profit}}{\text{Average Assets}}$

Rate of Return on Equity: $\frac{\text{Profit}}{\text{Average Equity}}$

**Solution:**

| Ratio | For the year ended 30 June 2005 |
|---|---|
| Debt to Equity Ratio | $\frac{250\,000}{240\,000} x \frac{100}{1} = 104\%$ |
| Rate of Return on Assets | $\frac{35000}{\left(\frac{485000+490000}{2}\right)} x \frac{100}{1} = 7\%$ |
| Rate of Return on Equity | $\frac{35000}{\left(\frac{205000+240000}{2}\right)} x \frac{100}{1} = 16\%$ |

**Interpretation of the information revealed by the ratio analysis:**

The past year has seen a downturn in the profitability of the business but an improvement in its long-term financial stability.

The Rate of Return on Assets shows a deteriorating trend. It has reduced from 10% in 2004 to 7% for the year ended 30 June 2005. However the result for 2005 is still marginally better than the industry standard. The downward trend appears to be due to the decline in profit over the past financial year.

The Rate of Return on Equity also shows deterioration over the past financial year. The ratio has declined from 25% in 2004 to 16% for the year ended 30 June 2005. This again appears to be due to the decline in profit over the past financial year. However the 2005 result (16%) for the Rate of Return on Equity is however better than the industry standard of 12%.

The Debt to Equity ratio shows an improving situation between 2004 and 2005. The Debt to Equity ratio in 2004 was 136% and this has declined to 104% as at 30 June 2005. The business is now geared at a lower level. However, the result for 2005 when compared to the industry standard of 80% shows that the firm is still more highly geared than most other businesses in the industry.

## PARTNERSHIPS – YEAR 12

## INTEREST ON ADVANCES

### *Illustrative example:*

M House and T May are in a partnership operating the business, Armadale Suppliers. Their partnership agreement provides for interest on advances at 8% pa from the date of the loan.
Three years ago T May made an advance of $20 000 to the partnership business. At the 30 June 2005 the loan still amounts to $20 000. It is not due for repayment until 2009. For the year ended 30 June 2005 the operating profit (excluding any interest on advances) was $80 000. In addition the interest on advances has not been paid as at 30 June 2005.

### Discussion and solution:

Advances by partners to the partnership business are treated as a liability. Since this is the case, the **interest on advances is regarded as an expense and any interest owing is shown as a current liability** in the balance sheet. The expense of interest on advance is classified as a financial expense in the income statement. In the above example, the amount of the interest on advance for the year ended 30 June 2005 is $1 600 ($20 000 x 8% pa).

To record the interest on advance the entity is as follows:

**General Journal**

| Date | Particulars | Debit | Credit |
|---|---|---|---|
| 30 June 2005 | Interest on Advances Expense<br>Interest on Advances Payable<br>8% p.a. interest on $20 000 advances owing | $1 600 | <br>$1 600 |
| | Profit and Loss<br>Interest on Advance Expense<br>Transfer | 1 600 | <br>1 600 |

After the entry is posted, the accounts would be as follows:

**Interest on Advance Expense**

| Date | Particulars | Amount | Date | Particulars | Amount |
|---|---|---|---|---|---|
| 30 June 2005 | Interest on Advance Payable | 1600 | 30 June 2005 | Profit & Loss | 1600 |

**Interest on Advance Payable**

| Date | Particulars | Amount | Date | Particulars | Amount |
|---|---|---|---|---|---|
| | | | 30 June 2005 | Interest on Advance Expense | 1600 |

**Profit & Loss**

| Date | Particulars | Amount | Date | Particulars | Amount |
|---|---|---|---|---|---|
| 30 June 2005 | Interest on Advance Expense | 1600 | 30 June 2005 | Balance | 80 000 |
| | Profit and Loss Appropriation | 78 400 | | | |
| | | 80 000 | | | 80 000 |

Note that in the above accounts **no** entry is made in the partner's current account for T May.

An extract of the balance sheet for the business would show the following:

**Armadale Suppliers**
**Balance Sheet (Extract)**
**as at 30 June 2005**

| | $ |
|---|---|
| **Current Liabilities** | |
| Interest on Advance Payable | 1600 |
| **Non-Current Liabilities** | |
| Advance – T May | 20 000 |

## COMPANIES – YEAR 12

## REGULATION OF ACCOUNTING PRACTICE

### Role of Australian Accounting Standards Board (AASB)

The main role of the AASB is to develop and amend Accounting Standards, including the provision of standards for disclosure/presentation of information from all companies that are reporting entities. It has the following specific functions:

(a) to develop a conceptual framework for the purpose of evaluating proposed Accounting Standards and international standards
(b) to make Accounting Standards for the purpose of the Corporations Act
(c) to formulate Accounting Standards for other purposes
(d) to participate in and contribute to the development of a single set of Accounting Standards for world-wide use
(e) to advance and promote the main objects of setting Accounting Standards.

### Role of the Australian Securities and Investments Commission (ASIC)

The overall role of the ASIC is to administer corporate legislation. It is assigned by the Federal Government with the primary regulatory role for both listed and unlisted companies: in other words, the AASB sets the standards and the ASIC enforces them. It also interprets Accounting Standards where this is necessary and issues these interpretations through the medium of Accounting Practice Notes.

### Role of the Australian Stock Exchange Ltd (ASX)

Basically the role of the ASX extends only to those public companies which are listed on the stock exchange. Its main concern in relation to the preparation and presentation of accounting reports is with the presentation and disclosure of financial information by public listed companies.

In addition the ASX aims to ensure that all companies listed on the Stock Exchange act in a manner which is at all times in the best interests of shareholders and the general public good. The ASX has Listing Rules by which it specifies the form, content and frequency of published financial statements for public companies.

### The purpose and nature of accounting standards

The purposes of Accounting Standards as established by the Australian Government are:

1. To provide information that:
   - allows users to make and evaluate decisions about allocating scarce resources
   - assists directors to discharge their obligations in relation to financial reporting
   - is relevant to assessing performance, financial position, financing and investment
   - is relevant and reliable
   - facilitates comparability
   - is readily understandable.

2. To facilitate the operation of the Australian economy by:
   - reducing the cost of capital
   - enabling Australian entities to compete effectively overseas
   - having Accounting Standards that are clearly stated and easy to understand.

3. To maintain investor confidence in the Australian economy (including its capital markets).

## IMPORTANCE OF CORPORATE LEGISLATION IN THE REGULATION OF COMPANIES

The administration of the Corporations Act and the Regulations is a crucial part of the role of the ASIC. The Corporations Act requires compliance with applicable Accounting Standards in the preparation and presentation of the financial statements of a company.

The Corporations Act sets up the ASIC and the Australian Accounting Standards Board, and accordingly the standards issued by the AASB are recognised as being part of the Corporations Act, and are hence enforceable by the ASIC.

Because the Corporations Act is adopted throughout Australia, and because it makes compliance with Accounting Standards approved by the AASB mandatory, there is now consistent and coordinated regulation of corporations in Australia, backed up by the necessary body (the ASIC) to enforce those regulations.

The Corporations Act is important because of the need to create incorporated bodies which have the characteristics of a legal personality. This is necessary to meet the needs of commerce and promote efficient practice. It enables individuals to pool their resources, thus enabling ownership of property to be conferred on a legal entity which is separate from those individuals and which will continue to exist beyond the life span of these individuals. The Corporations Act is also important to protect the interests of those who interact and have a relationship with this legal entity i.e. it protects the interests of owners, creditors, employees, customers etc.

In summary, the Corporations Act deals with such issues as:

- the incorporations of companies, their legal capacity, the company constitution, membership and share capital
- the internal administration of companies e.g. duties of officers, shareholders' meetings, account and audit requirements
- regulation of company names and registration numbers including the requirements of particular types of companies
- external administration of companies and the winding-up and receivership of companies
- takeovers of companies
- the administration of securities exchanges, the conduct of securities business and the prospectus requirements for securities issues
- regulation of the futures industry
- registration of auditors and liquidators.

The Corporations Act is very important in that it establishes the role of the Australian Securities and Investments Commission, the Financial Reporting Council and Australian Accounting Standards Board, and regulates the Australian Stock Exchange Ltd.

## COMPANIES – YEAR 12

## DISTINCTION BETWEEN PUBLIC AND PROPRIETARY COMPANIES

A proprietary company must be either an unlimited company which has a share capital or a company limited by shares. It may not be a no liability company or a company limited by both shares and guarantee. A public company means a company which is not a proprietary company. It may be a company limited by shares or guarantee. A no liability company is also a public company.

Proprietary companies must have no more than 50 non-employee shareholders. They need have only one shareholder. A public company must have at least one shareholder but there is no maximum as to the number of members it may have.

A proprietary company is not allowed to engage in any activity which would require it to lodge, with the ASIC, a prospectus under Corporations Act 2001. (Note: This restriction does not apply to offering shares to existing shareholders or employees of the company.) A public company can issue a prospectus as it is allowed to offer shares for sale to the general public. Therefore a public company can offer its shares or debentures to a large number of people and thus raise large sums of money.

For a public company there is no restriction on the right of shareholders to transfer shares. For a proprietary company they are able to choose whether or not there will be a restriction on the right to transfer shares.

A proprietary company must have the word "proprietary" or initials "Pty" as part of its name.

A public company, except a no liability company, must have the word "limited" or initials "Ltd" as part of its name.

A proprietary company must also have the latter included as part of its name. This is to be inserted after the word "proprietary" or initials "Pty."

A public company must have at least three directors while a proprietary company must have a minimum of one director.

A public company must hold an Annual General Meeting (AGM) at least once a year. Proprietary companies do not have to hold an AGM.

A public company and large proprietary companies must prepare and lodge with the ASIC audited financial statements. Small proprietary companies need only comply with this requirement if requested to by the ASIC or a shareholder holding 5% of the shares.

## DISTINCTION BETWEEN SMALL PROPRIETARY COMPANIES AND LARGE PROPRIETARY COMPANIES

The characteristics of small proprietary companies and large proprietary companies are outlined under the Corporations Act 2001 which defines a proprietary company and describes the criteria for distinguishing between small and large proprietary companies.

Under Section 116(2) a proprietary company must be either a company limited by shares or an unlimited company that has a share capital, and it must have no more than 50 non-employee shareholders. Section 116(4) also requires that a proprietary company not engage in any activity such as issuing shares or debentures, which would require it to lodge a prospectus under the Corporations Act.

Section 45A(2) outlines the criteria for a proprietary company to be regarded as a small proprietary company. It must satisfy at least two of the following:

- The consolidated gross operating income for the financial year of the company and the entities it controls (if any) is less than $10 million.
- The value of the consolidated gross assets at the end of the financial year of the company and the entities it controls (if any) is less than $5 million.
- The company and the entities it controls (if any) have fewer than 50 employees at the end of the financial year.

In determining the value of consolidated gross operating income and consolidated gross assets applicable, Accounting Standards must be complied with. In counting employees for the purposes above, part-time employees are taken into account as an appropriate fraction of full-time equivalent employees.

A large proprietary company is therefore a proprietary company which does not satisfy at least two of the criteria, as outlined above, for a small proprietary company.

The main advantage of small proprietary companies is that generally they have reduced reporting requirements as relates to the preparation, lodgement and audit of financial statements.

Large proprietary companies are required to prepare annual financial statements and to have them audited. These financial statements must be sent to shareholders and lodged with the Australian Securities and Investments Commission.

Under Section 283c, a small proprietary company is required to keep accounting records, but not necessarily to prepare audited financial reports, unless requested by shareholders holding 5% or more of the voting shares or by the Australian Securities and Investments Commission. The shareholders may also specify that such financial reports are or are not prepared in accordance with applicable Accounting Standards.

## COMPANIES - YEAR 12

## RESERVES AND DESCRIPTION OF THEIR SOURCES AND POSSIBLE USES:

### REVALUATION RESERVE
### RETAINED EARNINGS
### GENERAL RESERVE

A *revaluation reserve* exists whenever items from property, plant or equipment are revalued to their fair value. A modified historical cost system is usually used in Australia to account for the cost of assets. This means that it is permitted to revalue non-current assets upward from cost to their fair value. Revaluation increments are credited directly to a revaluation reserve, which is part of shareholder's equity. Reversals of previous revaluations are possible.

The possible uses of this reserve are:
- to transfer the reserve to retained earnings, or
- to pay out as a cash dividend, or
- to pay a share dividend, or bonus issue, or
- to record a subsequent write-down of the same assets which had been revalued upwards previously.

The *retained earnings account* is created by the retention of an entity's profits in excess of the dividends provided or paid and transfers to and from reserves.

The retained earnings account can be used as follows:
- to transfer amounts to reserve accounts, such as the general reserve, or
- to pay out further cash dividends or share dividends, or
- to offset losses in future years.

A *general reserve* is created by transferring an amount out of the retained earnings of the entity.

A general reserve can be used as follows:
- to pay out a cash dividend, or
- to pay out a bonus issue or share dividend, or
- by transferring back to retained earnings.

## COMPANIES – YEAR 12

## STEPS INVOLVED IN FORMING A PROPRIETARY COMPANY

## DOCUMENTS ASSOCIATED WITH COMPANY FORMATION OR OPERATION:

**REPLACEABLE RULES**
**CONSTITUTION**
**CERTIFICATE OF REGISTRATION**
**PROSPECTUS**

### Background knowledge for teachers

The establishment of a proprietary company essentially requires only one step. This is to complete a form 201 "Application for registration as a company" and lodge this form with the Australian Securities and Investments Commission (formerly known as the Australian Securities Commission), together with the prescribed fee.

However, the completion of this form requires a number of processes to occur beforehand.

The first process is to select a company name, if so desired. The name of a company on registration can simply be its Australian Company Number (ACN), which is allocated to a company upon registration. If a name is desired then the first requirement is to ensure that the proposed name is available. This is done through a search of the Australian Securities and Investments Commission's database of company and business names. The second step, which is optional, is to reserve the chosen name. This can be done by completing a form 410 "Application for reservation of a name" and lodging it, with the prescribed fee, with the ASIC. If it is not desired to reserve the name, then the selected name is applied for at the time of completing and lodging the form 201 "Application for registration as a company".

It should be noted that the name selected must meet certain requirements:

- It cannot be identical to a name already registered or reserved or listed as a business name by another corporation.
- It must not be of a kind that is declared by Corporations Regulations to be unacceptable e.g. offensive, suggestive of illegal activity. Certain names, such as including the words "Royal Family", "University", "chartered" or "savings banks", require ministerial approval.

A proprietary company must include the words "Proprietary Limited" or initials 'Pty Ltd'.

The company name and its ACN must be displayed at all offices and places where company business is carried out, and be shown on all company public documents, documents lodged with the ASIC, company negotiable instruments and the company seals (if any).

The second key requirement in the process to form a proprietary company is to decide whether to draw up a constitution, or opt for the Corporations Act 'replaceable rules', or a combination of both. A constitution regulates the internal affairs of a company and can be used to displace or modify all or parts of the "replaceable rules" stipulated under Corporations Act or add to these rules. A company can include in its constitution a replaceable rule that does not otherwise apply to it. A constitution has the effect of a contract between a company and each member, between a company and each director and company secretary, and between a member and each other member. A company's constitution may define legal rights, duties and restrictions of the company. The section below on "replaceable rules" gives some idea of what may be included in a constitution. If a constitution is required then legal advice should be sought to draft this document.

It should be noted that if a constitution is adopted, it is not necessary for a proprietary company to lodge this document with its application for registration. However, it must be kept with the company records so that it is available if required.

If a company does not adopt a constitution on registration, it may do so afterwards.

Replaceable Rules under the Corporations Act are a set of basic rules that govern the internal affairs of a company. It should be noted that these replaceable rules do not apply to a proprietary company with a sole director and sole member (Note: They may adopt a constitution). The Corporations Act contains a table of replaceable rules. This table indicates the subject of the rule and the relevant section of the Act that covers each rule. The content of each of those sections in the Act applies as the replaceable rule. The following are some examples of the issues that are dealt with in the table of replaceable rules:

- powers of directors
- remuneration of directors
- calling directors' meetings
- calling of meetings of members by a director
- how voting is carried out at members' meetings
- inspection of company books by a member
- transmission of shares on death of a member
- capitalisation of profits.

Some rules apply only to certain types of companies. For example, the following replaceable rules deal with issues which only relate to a proprietary company:

- who can appoint a proxy to vote at a members' meeting
- removal of a director in a proprietary company
- dividend rights for shares in a proprietary company
- additional general discretion for directors of proprietary companies to refuse to register transfers of shares.

The third major part of the process to form a proprietary company is to obtain the written consent from each person who agrees to become:

- a director of the company
- a secretary of the company
- a member of the company.

These declarations of consent are not to be lodged with the application for registration but are to be given to the company after the company becomes registered. They must be kept with the company's records and details recorded in the register of members.

The fourth and final major part of the process to form a proprietary company is to complete and lodge form 201 'Application for registration as a company', together with the prescribed fee. This form requires consideration to be given to deciding on the location of a registered office and principal place of business. All companies must have a registered office and a principal place of business.

The form 201 therefore requires details of:

- the proposed company name
- the class and type of company
- the registered office details
- the principal business office details
- director and secretary details
- members and share capital.

This form must be signed by the applicant and forwarded to the ASIC.

Once the application has been successfully processed by the ASIC, it gives the company an Australian Company Number, registers the company and issues a Certificate of Registration.
A company comes into existence as a body corporate at the beginning of the day on which it is

registered and remains in existence until it is deregistered. The company's name is specified in the certificate of registration.

For a proprietary company to remain registered it must be either limited by shares or be an unlimited company that has a share capital; and must have no more than 50 non-employee shareholders. In addition, it must not engage in any activity that would require the lodgement with the ASIC of a prospectus, except to offer shares to existing shareholders or employees of the company or one of its subsidiaries.

Preliminary expenses/Formation Expenses are the legal costs of registering and establishing the company including incorporation fees, legal and accounting consulting costs. These costs are to be regarded as an expense.

Share issue costs are legal, accounting and other costs, including underwriting fees, broker's fees and printing costs, of conducting an issue of shares. These costs are to be regarded as a reduction of share capital.

## WHAT STUDENTS NEED TO KNOW

### Steps involved in forming a proprietary limited company

Issues to be attended to in the formation of a proprietary company are as follows.

***Application for registration***

The establishment of a proprietary company requires only one step. That is the lodgement of the appropriate form (201) with the Australian Securities and Investments Commission (ASIC), together with the prescribed fee. The form must contain the following information:

- the proposed company name*
- the class and type of company
- the registered office details
- the principal business office details
- director and secretary details
- members and share capital.

*The company must have selected a unique name, which is acceptable under the Corporations Act. The name must include the words 'Proprietary Limited' or the initials 'Pty Ltd'.

***Declarations of consent***

A proprietary company must also obtain the written consent of each person who agrees to become:

- a director of the company
- a secretary of the company
- a member of the company.

The declarations of consent are not required to be lodged with ASIC.

***Constitution or Replaceable Rules***

A proprietary company must also adopt a document which regulates the internal affairs of the company. The document may take the form of either a constitution, a set of replaceable rules outlined under the Corporations Act, or a combination of both. The relevant document is not required to be lodged with ASIC.

**Replaceable Rules**

The Replaceable Rules are set out under the Corporations Act, and consist of a set of basic rules that govern the internal affairs of a company. The following are some examples of the issues dealt with in the rules:

- powers of directors
- remuneration of directors
- calling directors' meetings
- calling of meetings of members by a director
- voting at members' meetings
- inspection of company books by a member
- transmission of shares on death of a member
- capitalisation of profits.

The rules do not apply to a proprietary company with a sole director and sole member. The reasons are obvious when one considers the foregoing 'issues'.

Further, some of the replaceable rules apply only to certain types of companies.

**Constitution**

A constitution regulates the internal affairs of a company and can be used to displace, modify or add to the Replaceable Rules provided under the Corporations Act. A constitution must be drawn up using legal advice.

**Certificate of Registration**

This is issued by ASIC when the company's registration is approved. The company also receives its Australian Company Number.

**Prospectus**

If a company wishes to raise funds by issuing shares, debentures or other securities it must produce a prospectus. This includes all the information that potential investors need to know before making the decision to commit their funds to the company. The prospectus is lodged with ASIC, who are responsible for ensuring that there is no misleading information or breach of the requirements.

## COMPANIES – YEAR 12

## ENTRIES TO ESTABLISH ORDINARY SHARE CAPITAL

***Illustrative example:***

On 1 March 2005 Newman Industries Ltd was incorporated.

- On 15 March 2005 formation costs of $8 000 were paid in cash.
- A month later on 1 April 2005 a prospectus was issued calling for applications for 1 000 000 ordinary shares payable in full on application. The directors decided that the issue price of the shares would be $1.80.
- By 31 May 2005 applications had been received for all 1 000 000 shares. All monies received had been banked by 31 May 2005.
- On 30 June 2005 the directors met and allotted the shares.
- On 15 July 2005 share issue costs of $6 000 were paid in cash.

**Required:**
Prepare the general journal, cash receipts journal and cash payments journal entries required for the above transactions and post to the ledger accounts.

**Solution:**
1. Record the receipt of monies:

**Cash Receipts Journal (Extract)**

| Date | Particulars | Other | Bank |
|---|---|---|---|
| 31 May 2005 | Application | $1 800 000 | $1 800 000 |

2. Record the allotment of shares:

**General Journal**

| Date | Particulars | Debit | Credit |
|---|---|---|---|
| 30 June 2005 | Application | $1 800 000 | |
| | Ordinary Share Capital | | $1 800 000 |
| | To record the allotment of 1 000 000 ordinary shares at the issue price of $1.80 each | | |

3. Record the payment of the preliminary expenses:

**Cash Payments Journal (Extract)**

| Date | Particulars | Other | Bank |
|---|---|---|---|
| 15 March 2005 | Preliminary Expenses | $8 000 | $8 000 |
| 15 July 2005 | Share Issue costs | $6 000 | $6 000 |

4. Post the journal entries to the ledger:

**Bank**

| | | | | | |
|---|---|---|---|---|---|
| 31/5/05 | Application | $1 800 000 | 15/705 | Preliminary Expenses | $8 000 |

**Application**

| | | | | | |
|---|---|---|---|---|---|
| 30/6/05 | Ordinary Share Capital | $1 800 000 | 31/5/05 | Bank | $1 800 000 |

**Ordinary Share Capital**

| | | | | | |
|---|---|---|---|---|---|
| | | | 30/6/05 | Application | $1 800 000 |

**Preliminary Expenses /Formation Expenses**

| | | | | | |
|---|---|---|---|---|---|
| 15/3/05 | Bank | $8 000 | | | |

**Share Issue Costs**

| | | | | | |
|---|---|---|---|---|---|
| 15/7/05 | Bank | $6 000 | | | |

## COMPANIES – YEAR 12

## PREPARATION OF REPORTS: STATEMENT OF CHANGES IN EQUITY, COMPANY BALANCE SHEET AND ACCOMPANYING NOTES

***Illustrative example:***
The following is the trial balance of Redford Corporation Ltd as at 30 June 2005:

**Redford Corporation Ltd**
**Trial Balance**
**as at 30 June 2005**

| | **Debit** | **Credit** |
|---|---|---|
| | $ | $ |
| Cash at bank | 180 000 | |
| Accounts receivable (net) | 40 000 | |
| Machinery | 1 500 000 | |
| Accumulated depreciation on machinery | | 160 000 |
| Goodwill | 10 000 | |
| Land | 1 000 000 | |
| Buildings | 1 000 000 | |
| Accumulated depreciation on buildings | | 200 000 |
| Prepayments | 4 000 | |
| Inventory | 330 000 | |
| Accounts payable | | 70 000 |
| Mortgage (repayable 2009) | | 400 000 |
| Shares in Gibson Ltd | 300 000 | |
| Dividends Paid | 35 000 | |
| Debentures (repayable 2011) | | 500 000 |
| Current tax liability | | 70 000 |
| Ordinary share capital | | 2 400 000 |
| Retained earnings (1 July 2004 balance) | | 295 000 |
| General reserve | | 60 000 |
| Asset revaluation reserve | | 200 000 |
| Accrued expenses | | 5 000 |
| Accrued income | 9 000 | |
| Unearned income | | 3 000 |
| Profit and loss summary | | 45 000 |
| | $4 408 000 | $4 408 000 |

**Additional information:**

(a) The ordinary share capital consisted of 2 000 000 ordinary shares at an issue price of $1.20 each.

(b) Land had been revalued 6 months prior to balance date. The revaluation increased its value by $200 000.

(c) Dividends of $35 000 represent an interim dividend declared and paid in January 2005.

(d) Opening balance of Retained Earnings is $295 000. Directors have resolved to transfer $20 000 from Retained Earnings to General Reserve.

**(e) Directors have recommended a final dividend of $50 000 being 2.5 cents per share.**

**Required:**

- Prepare the balance sheet of Redford Corporation Ltd as at 30 June 2005 including the accompanying notes for property, plant and equipment, Equity and Dividends
- Prepare the statement of changes in equity for Redford Corporation.

*Notes for the movements in reserves are no longer required, as this detail is contained in the Statement of Changes in Equity.*

**Solution:**

***Current/Non-current Balance Sheet Presentation***

## Redford Corporation Ltd
## Balance Sheet
## as at 30 June 2005

| | NOTE | $ |
|---|---|---|
| **CURRENT ASSETS** | | |
| Cash and cash equivalents | | 180 000 |
| Trade receivables | | 49 000 |
| Inventories | | 330 000 |
| Other current Assets | | 4 000 |
| Total Current Assets | | 563 000 |
| | | |
| **NON-CURRENT ASSETS** | | |
| Investments | | 300 000 |
| Property, plant and equipment | (1) | 3 140 000 |
| Goodwill | | 10 000 |
| Total Non-Current Assets | | 3450 000 |
| | | |
| Total Assets | | 4013 000 |
| | | |
| **CURRENT LIABILITIES** | | |
| Trade and other payables | | 75 000 |
| Current tax liability | | 70 000 |
| Other current liabilities | | 3 000 |
| Total Current Liabilities | | 148 000 |
| | | |
| **NON-CURRENT LIABILITIES** | | |
| Borrowings | | 900 000 |
| Total Non-Current Liabilities | | 900 000 |
| | | |
| Total Liabilities | | 1 048 000 |
| | | |
| Net Assets | | 2 965 000 |
| | | |
| **EQUITY** | (2) | |
| Share capital | | 2 400 000 |
| Other reserves | | 280 000 |
| Retained earnings | | 285 000 |
| | | |
| Total Equity | | 2 965 000 |

## Redford Corporation Ltd.
## Notes to and forming part of the financial statements for the year ended 30 June 2005.

| **1. Non-current property, plant and equipment** | **$** |
|---|---|
| Land - at fair value | 1 000 000 |
| Buildings - at cost | 1 000 000 |
| Accumulated Depreciation | 200 000 |
| | 800 000 |
| Machinery - at cost | 1 500 000 |
| Accumulated Depreciation | 160 000 |
| | 1 340 000 |
| Total Property, Plant and Equipment | 3 140 000 |

**2. Equity**

| **Share Capital** | **$** |
|---|---|
| 2 million Ordinary shares issued at $1.20, fully paid | 2 400 000 |
| **Other Reserves** | |
| Revaluation Reserve | 200 000 |
| General Reserve | 80 000 |
| | 280 000 |

**3. Recommended final dividend**

The Directors have recommended a final Ordinary dividend of $50 000 being 2.5 cents per share.

**Redford Corporation Ltd**
**Statement of Changes in Equity**
**for the year ended 30 June 2005**

| | |
|---|---|
| Profit for the period | 45 000 |
| Changes in Revaluation Reserve during the period | 200 000 |
| Total recognised income and expense for the period | 245 000 |
| | |
| **SHARE CAPITAL** | |
| Ordinary Shares | |
| Balance at start of period | 2 400 000 |
| Issue of share capital | 0 |
| Share issue costs | (0) |
| Total Share Capital | 2 400 000 |
| | |
| **OTHER RESERVES** | |
| Revaluation Reserve | |
| Balance at start of period | - |
| Gain/(loss) on revaluation | 200 000 |
| Balance at end of period | 200 000 |
| | |
| General Reserve | |
| Balance at start of period | 60 000 |
| Transfer from retained earnings | 20 000 |
| Balance at end of period | 80 000 |
| Total Reserves | 280 000 |
| | |
| **RETAINED EARNINGS** | |
| Balance at start of period | 295 000 |
| Profit for the period | 45 000 |
| Total for the period | 340 000 |
| Transfers to general reserve | (20 000) |
| Interim Dividends | (35 000) |
| Balance at end of period | 285 000 |

## COMPANIES – YEAR 12 SUGGESTED FORMATS

These formats should be read in conjunction with the current syllabus document.

### STATEMENT OF CHANGES IN EQUITY

AASB 101 requires this statement to show all income and expenses recognised directly in equity, added to the total profit/loss for the period. It is to also show changes in share equity, changes to retained earnings, and changes to each reserve.

**Format Ltd**
**Statement of Changes in Equity**
**For the year ended…**

| | |
|---|---|
| Profit for the period | X |
| Changes in Revaluation Reserve during the period | X |
| Total recognised income and expense for the period | X |
| SHARE CAPITAL | |
| Ordinary Shares | |
| Balance at start of period | X |
| Issue of share capital | X |
| Share issue costs | (X) |
| Total Share Capital | X |
| OTHER RESERVES | |
| Revaluation Reserve | |
| Balance at start of period | X |
| Gain/(loss) on revaluation | X |
| Balance at end of period | X |
| General Reserve | |
| Balance at start of period | X |
| Transferred to (from) Retained Earnings for the period | X |
| Balance at end of period | X |
| Total Reserves | X |
| RETAINED EARNINGS | |
| Balance at start of period | X |
| Transfers into retained earnings | X |
| Profit for the period | X |
| Total for the period | X |
| Transfers from retained earnings | (X) |
| Interim Dividends | (X) |
| Balance at end of period | X |

## THE BALANCE SHEET

***Current/Non-current Presentation***

**Format Ltd**
**Balance Sheet**
**As at …**

| | NOTE | $ |
|---|---|---|
| **CURRENT ASSETS** | | |
| Cash and cash equivalents | | XX |
| Trade receivables | | XX |
| Inventories | | XX |
| Other current assets | | XX |
| | | XX |
| Total Current Assets | | XX |
| **NON-CURRENT ASSETS** | | |
| Investments | | XX |
| Other financial assets | | XX |
| Property, plant and equipment | (1) | XX |
| Goodwill | | XX |
| Other intangible assets | | XX |
| Other non-current assets | | XX |
| Total Non-Current Assets | | XX |
| **Total Assets** | | **XX** |
| **CURRENT LIABILITIES** | | |
| Accounts payable | | XX |
| Short term borrowings | | XX |
| Current tax liability * | | XX |
| Other current liabilities | | XX |
| | | XX |
| Total Current Liabilities | | XX |
| **NON-CURRENT LIABILITIES** | | |
| Borrowings | | XX |
| Total Non-Current Liabilities | | XX |
| Total Liabilities | | XX |
| Net Assets | | XX |
| **EQUITY** | **(2)** | |
| Share capital | | XX |
| Other reserves | | XX |
| Retained earnings | | XX |
| Total Equity | | XX |

To be read in conjunction with the notes to and forming part of the financial statements for the year ended …….
**Current tax liability is no longer a provision and is required to be shown separately on the balance sheet.*

## NOTES TO THE ACCOUNTS

**Format Ltd**
**Notes to and forming part of the financial statements**
**For the year ended …**

### 1. PROPERTY, PLANT AND EQUIPMENT

| | $ |
|---|---|
| Freehold land – at cost | xxx |
| | |
| Buildings – at cost | xxx |
| Accumulated depreciation | xxx |
| | xxx |
| | |
| Plant and equipment – at cost | xxx |
| Accumulated depreciation | xxx |
| | xxx |
| Total property, plant and equipment – carrying amount | xxx |

### 2. EQUITY

| **Share Capital** | **$** |
|---|---|
| xxx Ordinary shares issued at $xx, fully paid less share issue costs | xxx |
| xxx n% Cumulative Preference Shares issued at $ xx, fully paid less share issue costs | xxx |
| | xxx |
| **Reserves** | |
| Revaluation Reserve | xxx |
| General Reserve | xxx |
| | Xxx |

### 3. FINAL DIVIDEND

The Directors have recommended, for consideration at the Annual General Meeting, the payment of the annual n% dividend on Preference Shares and a final dividend of d cents per share on the Ordinary Shares.

## BUDGETS – YEAR 12

## PERFORMANCE REPORTS

A budget performance report is prepared to show the differences between budget estimates and actual results. It is an important tool in the central process of budgeting and control. Budgeting is an ongoing process and requires that management review its objectives and performance.

The budget performance report involves the comparison of budget estimates and actual results, and this will show up variances. These variances may be favourable or unfavourable. If the unfavourable variance is significant, then further investigation is required and corrective action taken if possible or necessary so as to achieve the targets and goals of the organisation.

A budget performance report can be prepared for any type of budget.

The results from a budget performance report can also be used to adjust or determine future budgets.

### *Illustrative example:*

S Parker operates the Perth-based business, Swan Industries, and he asks for your assistance in preparing performance reports for cash, and profit and loss.

S Parker expresses his concern that his bank balance has gone into overdraft over the past year and yet he is sure that his business is profitable. He seeks information on this matter.

During June 2004, the cash, and income statement budgets were prepared for the year ended 30 June 2005. The following are the summarised results:

**Cash Budget**
**For the year ended 30 June 2005**

| Receipts | $ |
|---|---|
| Cash sales | 70 000 |
| Collections from accounts receivable | 55 000 |
| Additional capital | 28 000 |
| Commission received | 1 700 |
| Proceeds from loan borrowings | 20 000 |
| | |
| Payments | |
| Cash purchases | 40 000 |
| Payments to accounts payable | 37 500 |
| Purchase of new equipment | 25 000 |
| Purchase of new plant | 14 000 |
| Drawings | 22 000 |
| Insurance | 1 600 |
| Wages and salaries | 19 000 |
| Interest | 4 200 |
| Electricity | 5 000 |
| Loan repayments | 8 700 |
| Advertising | 2 400 |

**Budgeted Income Statement**
**For the year ended 30 June 2005**

| | $ |
|---|---|
| <u>Income</u> | |
| Cash sales | 70 000 |
| Credit sales | 62 000 |
| Commission income | 1 800 |
| Discount received | 300 |
| | |
| <u>Expenses</u> | |
| Cost of sales | 79 000 |
| Wages and salaries | 19 700 |
| Interest expense | 4 200 |
| Electricity | 5 000 |
| Depreciation on plant and equipment | 11 000 |
| Bad debts | 800 |
| Advertising | 2 400 |
| Discount allowed | 250 |
| Insurance | 1 400 |

The business had $5 200 in the bank on 30 June 2004. Inventories as at 30 June 2004 were $21 000 and on 30 June 2005 it was planned that they would total $20 000. Cash purchases of $40 000 and credit purchases of $38 000 were expected for the year ended 30 June 2005. The bank balance as at 30 June 2005 was expected to be $500 and the anticipated profit for the year ended 30 June 2005 was $10 350.

The following actually occurred during the year ended 30 June 2005:

- Cash sales totalled $60 000.
- Collections from accounts receivable totalled $46 000. Credit sales were $68 000.
- Inventories on hand as at 30 June 2005 were valued at $28 000.
- Drawings for the year were $16 000.
- Payment for the purchase of new plant was $22 000.
- Credit purchases were $36 000. Payments to accounts payable were $38 500.
- The payment and expense for interest was $6 000.
- The payment for electricity was $5 800 but the expense was $6 500.
- All other receipts, payments, incomes and expenses were as expected.

**Required:**

Prepare a cash budget performance report and budgeted income statement performance report for the year ended 30 June 2005. Interpret these report results, including any comments on the owners management decisions, and explain the difference between the business's bank balance and profit/loss result.

## Solution:

### Swan Industries
### Cash Budget Performance Report
### for the year ended 30 June 2005

| | Budget<br>$ | Actual<br>$ | Variance<br>$ | |
|---|---|---|---|---|
| Cash balance at start of year | 5 200 | 5 200 | | |
| Estimated Receipts | | | | |
| Cash sales | 70 000 | 60 000 | 10 000 | U |
| Collections from accounts receivable | 55 000 | 46 000 | 9 000 | U |
| Capital contribution | 28 000 | 28 000 | NIL | |
| Commission received | 1 700 | 1 700 | NIL | |
| Proceeds from loan borrowings | 20 000 | 20 000 | NIL | |
| | 179 900 | 160 900 | | |
| Estimated Payments | | | | |
| Cash purchases | 40 000 | 40 000 | NIL | |
| Payments to accounts payable | 37 500 | 38 500 | 1 000 | U |
| Purchase of new equipment | 25 000 | 25 000 | NIL | |
| Purchase of new plant | 14 000 | 22 000 | 8 000 | U |
| Drawings | 22 000 | 16 000 | 6 000 | F |
| Insurance | 1 600 | 1 600 | NIL | |
| Wages and salaries | 19 000 | 19 000 | NIL | |
| Interest | 4 200 | 6 000 | 1 800 | U |
| Electricity | 5 000 | 5 800 | 800 | U |
| Loan repayments | 8 700 | 8 700 | NIL | |
| Advertising | 2 400 | 2 400 | NIL | |
| | 179 400 | 185 000 | | |
| Cash balance at end of year | 500 | (24 100) | | |

*U – used to denote an unfavourable variance*
*F – used to denote a favourable variance*

### Swan Industries
### Budgeted Income Statement Performance Report for the year ended 30 June 2005

| | Budget<br>$ | Actual<br>$ | Variance<br>$ | |
|---|---|---|---|---|
| Income | | | | |
| Cash sales | 70 000 | 60 000 | 10 000 | U |
| Credit sales | 62 000 | 68 000 | 6 000 | F |
| | 132 000 | 128 000 | | |
| Less Cost of Sales | | | | |
| Opening inventory | 21 000 | 21 000 | | |
| Cash purchases | 40 000 | 40 000 | NIL | |
| Credit purchases | 38 000 | 36 000 | 2 000 | |
| | 99 000 | 97 000 | | |
| Less Closing inventory | 20 000 | 28 000 | 8 000 | |
| | 79 000 | 69 000 | | |
| Gross Profit | 53 000 | 59 000 | 6 000 | F |
| Add Other Income | | | | |
| Discount received | 300 | 300 | NIL | |
| Commission income | 1 800 | 1 800 | NIL | |
| | 2 100 | 2 100 | | |
| | 55 100 | 61 100 | | |
| Less Other expenses | | | | |
| Selling and Distribution | | | | |
| Advertising | 2 400 | 2 400 | NIL | |
| General and Administration | | | | |
| Wages and salaries | 19 700 | 19 700 | NIL | |

| | | | | |
|---|---|---|---|---|
| Electricity | 5 000 | 6 500 | 1 500 | U |
| Depreciation on plant and equipment | 11 000 | 11 000 | NIL | |
| Insurance | 1 400 | 1 400 | NIL | |
| | 37 100 | 38 600 | | |
| Financial | | | | |
| Interest expense | 4 200 | 6 000 | 1 800 | U |
| Bad debts | 800 | 800 | NIL | |
| Discount allowed | 250 | 250 | NIL | |
| | 5 250 | 7 050 | | |
| Total other expenses | 44 750 | 48 050 | 3 300 | U |
| Profit | 10 350 | 13 050 | 2 700 | F |

*U – used to denote an unfavourable variance*
*F – used to denote a favourable variance*

### Interpretation of the reports:

The cash budget performance report shows a deterioration in the cash at bank balance compared with budget. Instead of the expected cash balance of $500 there is an overdraft of $24 100.

This change is in the main the result of cash sales being below budget by $10 000 and a reduction in collections from accounts receivable of $9 000. The downturn in cash sales will need investigation and a plan developed to rectify the problem. The credit collection policy of the business needs review with a view to improving the rate of collection.

There is little difference overall between the total of payments planned and the actual result. However, the increased payment for the purchase of the new plant needs investigating. Drawings were somewhat below budget.

It should be noted that the downturn in cash sales should perhaps have resulted in a decrease in cash purchases. Inventory purchases management needs investigating.

Given the reduced receipts for the year it may have been wiser to delay the purchase of new equipment and plant. If not, then perhaps a greater contribution of capital or further loan borrowings of a long-term nature were warranted.

The budgeted income statement performance report shows a slight improvement in profit over budget from an estimate of $10 350 to an actual result of $13 050.

Once again the under-achievement in cash sales of $10 000 is noted. However, this is offset to some extent by the credit sales being $6 000 over budget. This change needs investigation. The operating expenses for the year are $3 300 over budget. Greater control over expenses is warranted.

One area of concern is the amount of inventory on hand as at 30 June 2005, which is $8 000 over budget. This needs investigating given the overall downturn in sales.

The reason why the business has made a greater than expected profit and yet has a bank overdraft is due to a number of possible factors. These are:

- The greater than budgeted purchases of new plant
- lower than expected collections from accounts receivable compared to an increase in credit sales
- cash expenses being generally above budget

## CASH FLOW STATEMENTS – YEAR 12

## CONCEPT OF CASH

AASB 107: *Cash Flow Statements* defines cash as cash on hand and demand deposits. Cash equivalents are short term, highly liquid investments that are readily convertible to known amounts of cash and subject to insignificant risk of changes in value. Cash equivalents are held for the purpose of meeting short term cash requirements.

Cash equivalents are held for the purpose of meeting short-term cash commitments rather than for investment or other purposes. For an investment to qualify as a cash equivalent it must be readily convertible to a known amount of cash and be subject to an insignificant risk of changes in value. Therefore, an investment normally qualifies as a cash equivalent only when it has a short maturity.

Bank borrowings are generally considered to be financing activities. However, in some countries, including Australia, bank overdrafts which are repayable on demand form an integral part of an entity's cash management. In these circumstances, bank overdrafts are included as a component of cash and cash equivalents.

Cash flows exclude movements between items that constitute cash or cash equivalents because these components are part of the cash management of an entity rather than part of its operating, investing and financing activities. Cash management includes the investment of excess cash in cash equivalents.

***Interesting questions for students to consider:***

1. Explain the difference between cash and accrual accounting.
2. Define liquidity and explain how it is possible for a business to have high profitability but low liquidity.

## CLUBS AND SOCIETIES – YEAR 12

## SUBSCRIPTIONS SCHEDULE

***Illustrative example:***

Assume that each member of the Bullcreek Bowls Club is required to pay a $50 yearly subscription. The club's financial year finishes on the 31 December each year.

On 1 January 2005 the club had unearned subscriptions income (ie. Subscriptions in Advance relating to 2005) of $500. However 3 members had not yet paid their subscriptions for 2004.

By the completion of 2005 the club had received $5000 relating to subscriptions. This amount comprised of:

- $150 subscriptions in arrears relating to the previous financial year;
- $300 subscriptions received in advance for the 2006 financial year; and
- $4550 subscriptions relating to the current financial year.

At the completion of the 2005 financial year 4 members had not yet paid their annual subscription for the current year.

The subscription schedule would be shown as follows:

**Bullcreek Bowls Club**
**Subscriptions Schedule**
**For the year ended 31 December 2005**

| | $ |
|---|---|
| Subscriptions cash received during 2005 | 5000 |
| Add Subscriptions received in advance in 2004 | 500 |
| | 5500 |
| Add Subscriptions in arrears for 2005 (4 members x $50) | 200 |
| | 5700 |
| Less Subscriptions in arrears for 2004 | 150 |
| | 5550 |
| Less Subscriptions received in advance for 2006 | 300 |
| Subscriptions Income for 2005 | $5250 |