BUSS1030 - Notes

Accounting,Business and Society (University of Sydney)

BUSS1030, Accounting, Business & Society

Factors affecting the complexity of the Business environment

1. **Information Explosion**: The managers should be able to use their skills to utilise this information for their advantage.
2. **Technological advances**: Adapting to devices and platforms is essential/ too much competition/ opens possibilities such as cross border communication/ changed the manufacturing industry(automation)
3. **Globalisation**: one can create and make use of a larger more diverse marketspace/ leads to hassle (translations multiple languages/channels for communication/ law based and cultural limitations).
4. **Increased regulations**: pollution limitations/ taxes/ duties/….
5. **More complex business activities:**
6. **Evolving forms of business:** numerous variations of the simple business organisation (sole proprietorships, partnerships and companies) now exist.

The Successful Business Person

A person entering this dynamic world must also be dynamic(open to lifelong learning/ work and returning to education as and when required)

Adapting to change: the successful business person thrives on change, seeing it as an opportunity rather than an obstacle. But, it's not just about perspective you must also be prepared for the change. You must be *willing* and *able*.

The language of business

Accounting is what accountants or CPA's (certified public accountants) do to prepare your taxes.

(1) Payables : paying bills, paying your employees, contractors and yourself
(2) Receivables : sending invoices(an official paper that lists goods or services that the customer has received and says how much they have to pay for them) to people who owe you money (debtors or accounts receivable) and making sure your invoices get paid.

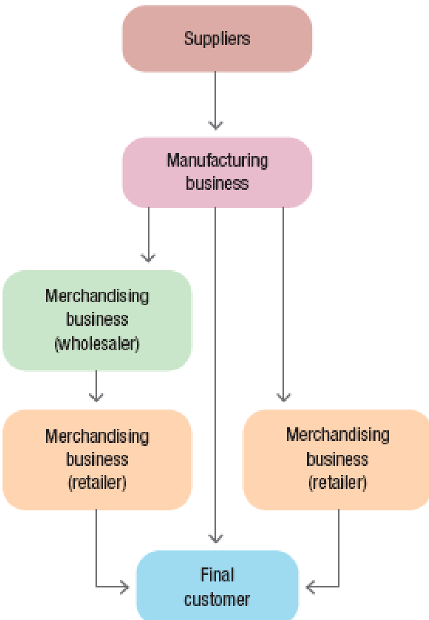
Business Enterprise Categories

Private businesses fall within 3 categories;

(1) **Service**: Performs service or activities that benefit the individuals/ business customers
(2) **Merchandising**: purchases goods(merchandise) for resale to its customers. An electrical supplier is an example of a wholesaler in this context.
Wholesaler: sells goods for further commercial purpose (reselling).
Retailer: sells goods directly to the customer.
(3) **Manufacturing**: Makes and sells the products

Merchandising businesses *buy* products that are physically ready for sale and then sell these products to their customers, whereas manufacturing businesses *make* their products first and then sell the products to their customers.

The Relationship between Types of Private Enterprises



Sometimes the line between the 3 can be blurry as an establishment could be multiple at once.

A Cafe may be a merchandise as it buys coffee beans from a producer, but it could also be considered a manufacturer as it is still providing cappuccino (made at cafe), and lastly even a possible service provider, as it may facilitate music/internet to users.

Entrepreneurship and sources of Capital

Entrepreneurship

Profit is the primary objective
Someone who is willing to risk uncertainty (hiring people/purchasing land/ debt/investments/ so on) in exchange for the reward of earning a profit is an entrepreneur.

Sources of Capital

1) **Investment** (by the owner): helps to initiate and acquire resources it needs to function. Once an investment has been made there is an expectation of getting a return called a return on investment (**ROI**). Furthermore, the entrepreneur periodically intends to receive additional amounts of money above the amount they originally contributed to the business (return on the contribution/ **ROC**).

2) **Borrowing**: money is borrowed from individuals or institutions like banks (creditors/lenders), in case the business is unable to pay back the debt, the owner assumes responsibility, or liability (something that is owed).
Generally risky.
A goal for debt-bound businesses is to achieve solvency (a business's long term ability to pay off its debts).

Business Structures

Characteristic	Sole proprietorships	Partnerships	Company/corporations
Number of owner(s)	Single owner	Two or more owners (partners)	Usually many owners (shareholders)
Size of business	Small	Most are small; some professional partnerships e.g. law firms) have several hundred partners	Many are very large; some may have stock traded on an exchange
Examples of businesses that typically have this legal form	Small retail shops; local service or repair shops; single practitioners such as CPAs, lawyers,doctors	Law firms; CPA firms; realestate agencies; family-owned businesses	Manufacturing companies; multinational companies; retail store chains; fast-food chains
Who makes business decisions	Owner	Depends on partnership agreement; small partnerships will have all partners involved in business decisions; large partnerships will have managing partners. Partners are agents	Decided by board of directors; large companies/corporations are managed by business professionals who often own little or no stock
Liability of owner(s)	Unlimited	Unlimited	Limited
Life of organisation	Limited	Limited	Continuous

1. **Sole proprietorship**
2. **Partnership**
3. **Company**

The decision to choose the legal format your company is going to assume is important as it determines how laws and regulations affect or open your options.

Sole Proprietorship

Is a business owned by one person, who is also the **sole investor** of capital into the business. Laws require you to pay tax on your taxable income. This is usually called the **Income Tax return**.

Unlimited liability(you may owe unlimited amounts if the condition requires so/ compensations upon death are an example): Often the owners are required to assume responsibility for the debts incurred by the business.

Unlimited liability adds financial risk, because if the receivables are not received then the business's creditors may force the owner to use personal assets and funds to pay them. This way the owner may lose more money.

Has a limited life as it can be sold/ run/ stopped by the owner and once dissolved then it is restricted under a new owner.

Partnership

A business owned by multiple individuals, who each invest capital into the business.

Key decisions to be made:
- the dollar amount each partner will invest
- the percentage of the partnership each individual will own
- how to allocate and distribute partnership income to each partner
- how business decisions will be made
- the steps to be taken if a partner withdraws from the partnership or if a new partner is added.

To limit disagreements, partners should always sign a contract, **partnership agreement**, before the business begins operating. This is a good idea even if the partners are close friends or relatives.

Characteristics of Partnerships

Each partner is required by tax laws and regulations to report their share of the partnership income on their individual ITR(s).

Unlimited liability applies here too. In case of a partnership it means that each partner is liable for all the debts of the partnership.

There are special agreements which accept partners into the ownership with limited liability as a means to protect from loss of personal funds (**LLP/limited liability partner**)

A creditor's claim is on the partnership, but if there aren't enough assets to pay the debt, each partner's personal assets may be used to pay the debt. (only excluded assets protected from bankruptcy law are not taken, like personal residence).

If one partner uses personal assets to pay the debts of the partnership, that partner has a right to claim a share of the payment from the other partner(s).

Has a limited life and is terminated when partners leave or when a new partner is added.

Has joint ownership

Each partner is an agent of the partnership. An agent is a person who has the authority to act for another.

Partnership equity

Equity: claims by creditors and owner(s) against the assets of a business.

Separate capital account for each partner

Factors that affect (usually) distribution of income among partners:
(1) The **amount** of capital **contributed** by each partner.
(2) The value of the **time** each partner **spends** working for the partnership.

Company/ Corporation

Even though it has individual owners, the law regards it as a **separate "being"**.

A company is a separate legal entity that is independent of its owners and is run by a board of directors. Therefore, it has a **continuous life** beyond that of any owner.

Because of legal separation in owners and company, the ownership can be passed on easily.

In exchange for contributing capital to the company, the owners of a company receive shares of the company's share capital, they are called **shareholders**.

These shares of stock are the "ownership units" and are transferable.

The share capital can be sold on organised stock markets (NASDAQ/NYSE/NZSE/ASX/…)

Because the company is a separate legal entity, a shareholder has no personal liability for the company's debts. Each shareholder's liability is limited to their investment.(**limited liability**)

Because of the company's ITR being shared on shareholder's incomes as dividends, the shareholders may be taxed on their personal incomes as a bracket higher than the one already paid by the company as a corporation.

Because the owners have limited liability, a company may find it more difficult to borrow money, since the creditors cannot go to the owners for payment / lack of credibility. Many national regulations **limit the dividends** that can be handed out as a means to protect the creditor (so that they can get their money back) as the company would have hands on more assets that way.

Some organisations use accounting information to organise but don't focus on profits (not-for-profit organisations)

The regulatory environment of business

Australia, taxation is regulated by the Australian Taxation Office (ATO).

Each business must withhold taxes from its employees pay and send them to ATO

ATO also collects 30% GST from business activities through a BAS (business activity statement).

ATO also taxes the profits themselves.

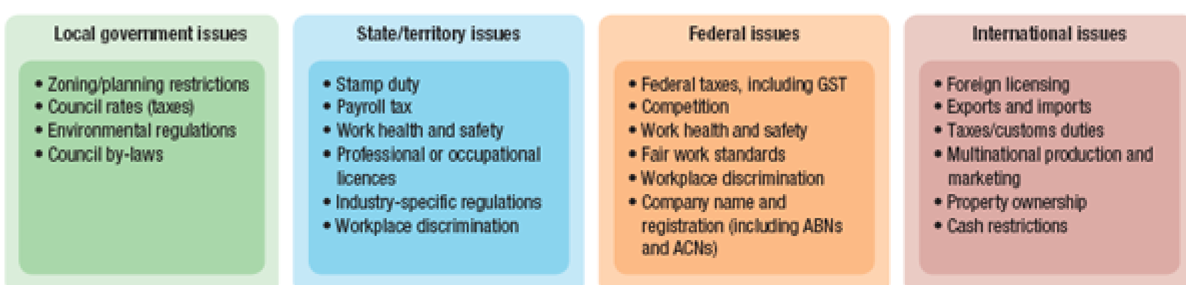
Companies have to pay their own income taxes to ATO, however as the ownership is not separated from the entity in proprietorship and partnership they don't have to pay taxes on their profits.

Laws and other government agencies

ACCC(the Australian Competition and Consumer Commission): Administers fair work/ health and safety of the workers/ workplace discrimination

AHRC(the Australian Human Rights Commision): pollution/ sustainability/ …

International regulations



The Accounting System

Accounting: the process of identifying, measuring, recording, summarising and reporting economic information about a business to users for decision making.

Accounting process: the series of actions (steps) involved in accounting.

Accountant: the person who carries out the above functions

Accounting system: the means by which accounting information about a business's activities is identified, measured, recorded, and retained so that the business can prepare its financial statements.

Manual systems vs computerised systems.

Expectation from employees and customers for pay and cost.

Accounting system:

(1) **Management accounting**: provides vital information about a business to internal users.
(2) **Financial accounting**: provides information about a business to external users.

Management accounting information

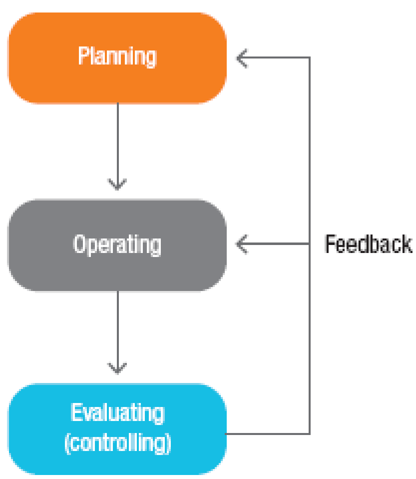
Helps managers inside the business to plan, operate and evaluate.

A lot of information and data needs to be collected to recognise defects, improve systems and take feedback.

Financial accounting information

Is information organised for the use of interested people outside the business.
They follow guidelines (GAAP) generally accepted accounting principles.

Management activities



Small business: owners will often be the managers

Large business: owner will employ multiple managers (possibly)

Planning

Every business must have a plan

Helps determine what resources, employees the business needs.

Needs to be dynamic and should keep changing

Becomes multifactorial in multinational businesses.

Operating

Activities in which a business engages to conduct its business according to its plan

Evaluating

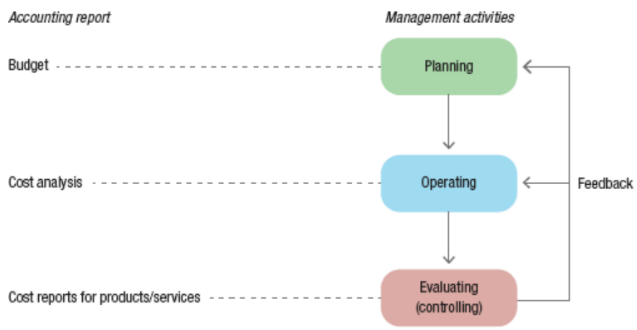
Management activity that measures the actual operations and progress of a business against set standards and benchmarks.

Should be a continuous process.

Accounting support for management activities

Basic Management accounting reports

Relationships among management activities and reports.



Budgets
Budgeting is the process of quantifying a manager's plans and showing the impact of these plans on the operating activities and financial position of the business. This information is presented in a report called a budget (or forecast).

Cost Analysis (cost accounting)
Is the process of determining and evaluating the costs of specific products or activities within a business.

Cost Reports for products and services
Might show that total actual costs for a given month were greater than total budgeted costs.

Accounting Support for External Decision Making

External users are people and groups outside the business who need accounting information to decide whether or not to engage in some activity with the business.

Guidelines for reporting to people outside the business

GAAP are the currently accepted principles, practices and procedures all over the world.

- Establish minimum disclosure requirements for external reports of businesses that sell shares to the public.
- GAAP covers issues such as how to account for inventory, buildings, income taxes and capital stock.
- Measuring results of business operations
- How to account for operations of business in different sectors in the industry.
- Several organisations contribute to GAAP through their publications, called pronouncements or standards.

AASB (Australian Accounting Standards Board) sets standards for Australian companies and government bodies.

Since 2005 the regulation has become globalised, with IFRS (International Financial Reporting Standards) generated by IASB (International Accounting Standards Board).

Companies whose shares are traded publicly in Australia report to the ASIC (Australian securities and investments commission).

Basic Financial Statements

To reach these goals; a business must first achieve its two primary objectives: earning a satisfactory profit and remaining solvent.

Profit is the difference between cash and credit sales of a business (revenues) and its total costs (expenses).

Solvency is a business's long-term ability to pay its debts as they come due.

Both internal and external users look at financial statements to see how well a company is doing.

Financial statement (a business's accounting system produces 3 major financial statements):
- Income statement
- Balance sheet
- Cash flow

Income statement (profit/loss statement)
Summarises the results of its operating activities for a specific time period and shows the business's profit for that period.
It also shows a business's revenues, expenses and net income (or net loss) for that time period, usually one year.

Revenues: Amounts earned by charging the businesses customers for the goods or services that the business has provided to them.
Expenses: costs incurred to provide the products (purchasing/operating/taxes)
Net income: excess of revenues over expenses, or the business's profit;
Net loss: excess of expenses over revenues.

INCOME STATEMENT OF DEFLAVA COFFEE CORPORATION

Revenue – sales		20 000
Less: Expenses – cost of goods sold	12 500	
Wages	5 000	
Rent	1 000	
Other operating expenses	500	
Total expenses		**19 000**
Net income or net profit		**$ 1 000**

This is where the business shows what it charged customers for the goods or services provided to them during a specific time period

Here's where the business lists the costs of providing the goods and services during that period

This is the difference between revenues and expenses

Statement of changes in Owner's Equity

Explains the amount shown in the owner's equity section of the business's balance sheet.

Term	Explanation
Beginning owner's equity	Here's where the business shows the owner's equity amount at the beginning of the period (the last day of the previous period). This amount also appears on the balance sheet on the last day of the previous period.
+ Net income	Here's where the business adds the net income from the current period's income statement (the profit that the business earned during the period).
+ Owner's contributions	Here's where the business adds any additional contributions to the business that the owner of the business made during the period.
– Withdrawals by owner	Here's where the business subtracts any withdrawals of cash from the business that the owner of the business made during the period.
Ending owner's equity	Here's where the business shows the resulting owner's equity amount that also appears on the business's balance sheet on the last day of the period.

Balance sheet

Summarises its financial position on a given date. It is also called a statement of financial position.

Lists the assets, liabilities and owner's equity at a given date.

Assets: are economic resources or items that a business owns and that it expects will provide future benefits to the business.
lands/buildings/receivables/cash at bank/stock of goods(or inventory).

Liabilities: business's economic obligations.
Debts(to creditors)/ employees (payables)/mortgage.

The **owner's equity** of a business is the owner's current investment in the assets of the business, which includes the owner's contributions to the business (called capital) and earnings (net income or profit).

Assets		Liabilities		
Cash	1 200	Accounts payable		2 100
Accounts receivable	1 600	Loan from bank		10 000
Inventory	2 300	Owner's equity		
Premises	42 000	Capital	34 000	
		Plus net profit	1 000	35 000
	47 100			47 100

Cash Flow statement
Summarises its cash receipts, cash payments and net change in cash for a specific time period.

Term	Explanation
Cash flow from operating activities	Here's where the business lists the cash it received and paid in selling products or performing services for a specific time period.
Cash flow from investing activities	Here's where the business lists the cash it received and paid in buying and selling assets such as equipment and buildings.
Cash flow from financing activities	Here's where the business lists the cash it received and paid in obtaining and repaying bank loans, and from contributions and withdrawals of cash made by the business's owners.

A business may publish its income statement, balance sheet and cash flow statement, along with other related financial accounting information, in its annual report (many businesses already do so).

Ethics in business and Accounting
Professional Organisations' Codes of Ethics

IFAC (international federation of accountants) has developed a code of ethics for each country.

Australia, CPA, CAANZ or ICAA and IPA adopt the code of ethics for Professional Accountants developed by the Accounting Professional Ethical Standards Board (APESB) which is based on IFAC.

Ethics at the Business Level
Many times 'sustainable business' is assumed to refer to a 'green' business, but generally it is one that ensures that all processes, products and activities, while maintaining a profit, addresses current environmental concerns. Which could mean adopting green practices as they are appreciated and if absent then

Judgement	Exercise judgement under supervision to provide possible solutions to routine accounting problems in straightforward contexts using, where appropriate, social, ethical, economic, regulatory, sustainability, governance and/or global perspectives.
Knowledge	Integrate theoretical and technical accounting knowledge in a business context.
Critical analysis and problem solving	Critically apply theoretical and technical accounting knowledge and skills to provide possible solutions to routine accounting problems.
Communication	Justify and communicate accounting advice and ideas in straightforward contexts to influence both specialists and non-specialists.
Teamwork	Contribute accounting expertise to a diverse team, collaboratively providing possible solutions to a routine business problem in a straightforward context.

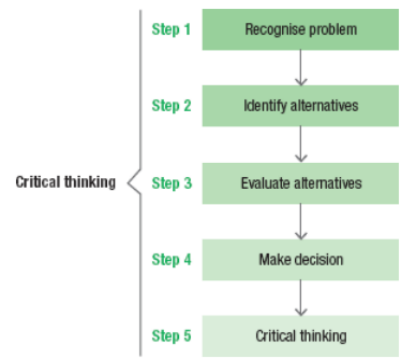
scrutinised to a point where they could possibly damage profitability.

Factors that contribute to longevity in terms of business's survival

1) Operate efficiently and productively in order to remain profitable and grow
2) Must engage responsibly and ethically with the triple bottom line issues it faces

The accountant in a changing society
LTAS standards in Australia:

Characteristics of the critical thinker:



Values truth rather than just the appearance of truth.

Independence (of thought too…)

Objectivity (quality of being unbiased enough): even when we try to understand someone else by trying to place ourselves in their shoes, we say "this is how I would feel if I were in that situation; therefore they must feel the same way".
We tend to unconsciously impose our own perceptions, beliefs and past experiences on our understanding of information, ideas and other people, which may bias the outcome.
Tolerate ambiguity and willingly defer judgement until they can collect more information.
Have **courage in convictions**.

Strategies of the Critical thinker

1) Resolve problem clearly and precisely

Applying Critical Thinking to Business Decisions
Critical thinking and 4 stages in problem solving and decision making

Stage 1: Recognising and Defining the Problem

An incorrectly defined problem will lead to an unproductive course of action at best, and could actually create new problems or make the current problem worse.

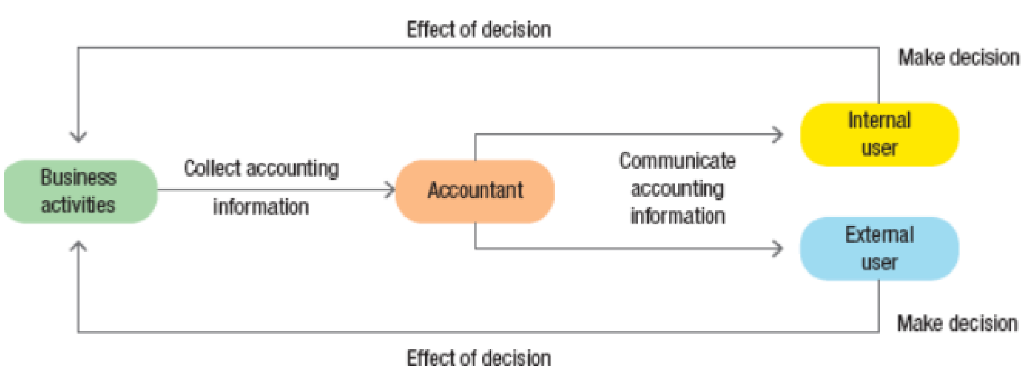
Stage 2: identifying Alternative Solutions

Brainstorming,

Stage 3: Weighing the Advantages and Disadvantages of Each Solution

Stage 4: Choosing a Solution

Accounting Information and Decision Making



The accounting information system and decision making are interactive - that is, an accountant collects information about a company and communicates this information both to internal and external users.

Planning in a New Business

A business plan is an evolving report that describes a business's goals and its current plans for achieving these goals.

Purposes of a business plan:

1) Helps an entrepreneur to visualise and organise the business and its operations.
2) Serves as a benchmark, or standard, against which the entrepreneur can later measure the actual performance of a business.
3) Helps an entrepreneur to obtain the financing that new and growing companies often need. (Potential creditors/ investors need this copy to help them decide).

Investors and creditors (such as the commonwealth bank) have two related concerns when they are making investment and credit decisions.

1) Level of risk involved
2) Return

1. Description of the business

Includes information about the business, its product or service, its current and potential customers, its objectives, where it is located and where it conducts its business.

The description of the business also includes a list of the important people within the business and the major roles they will play.

2. Marketing Plan

The marketing section of a business plan shows how the business makes sales, how it will influence and respond to market conditions.

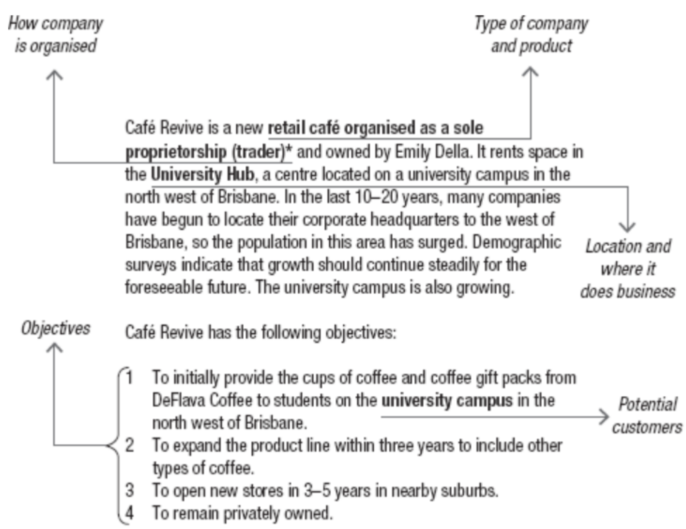
Provides evidence like any market research, describing **current and expected competition** in the market, as well as **relevant government regulations**. Outlines how the business will **promote**, **price** and **distribute** its products, as well as **predicted growth**, **market share** and **sales of products** (sales forecast) by period.

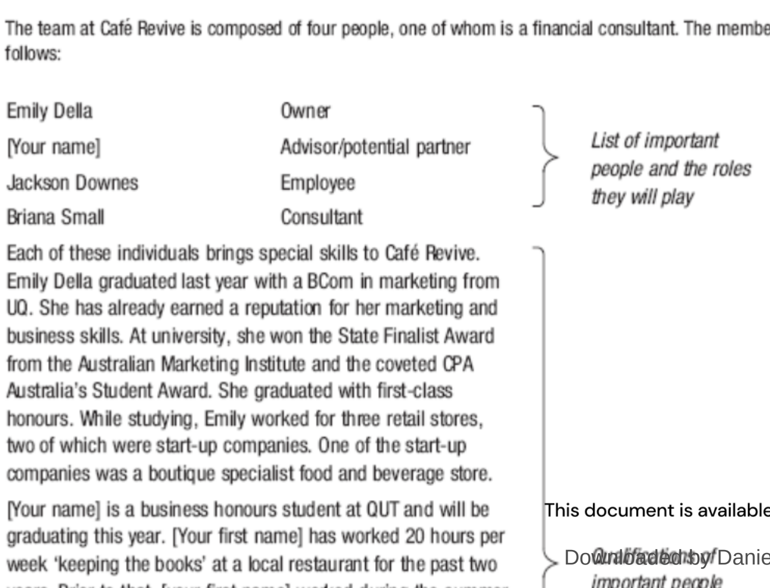
The marketing plan is also responsible to build a reputation for friendly service, quality products and environmentally friendly packaging.

3. Operating plan

Includes a description of the relationships among the business, its suppliers and its customers.

Other influences on the operations might also be described in this section.
These might include the **availability of employees**, concerns of **special-interest**





groups, **regulations**(including environmental), the impact of **international trade**, the need for **patents**, **trademarks** and **licensing agreements**.

4. Environmental Management Plan and sustainability.

Growing expectation of CSR (corporate social responsibility) and reports on environmental and social as well as economic aspects of a business (triple bottom line), need to be according to the GRI (global reporting initiative) sustainability reporting standards.

Environmental disclosures cover performance related to inputs (material, energy and water) and outputs , (emissions, effluents, waste), should also mention performance related to biodiversity and environmental compliance, as well as other relevant information such as environmental expenditure and the impacts of products and services.

(there exist modern slavery acts for big organisations)

Environmental Costs and Decision Making
Environmental costs are often not traced systematically or attributed correctly to the responsible processes and products, but instead are simply included in general overheads and therefore “hidden”.

** Environmental costs are not fully recorded and often leads to distorted calculations for improvement options. Environment protection projects aiming to prevent emissions and waste at the source(avoidance option) by better utilising raw and auxiliary materials, and requiring less (harmful) operating materials are not recognised and implemented. The economic and ecological advantages to be derived from such measures are not used. The people in charge are often not aware that producing waste and emissions is usually more expensive than disposing of them.

→ a business cannot seek to improve its environmental performance without the tools to measure that performance.

Public-Sector Reporting

Comprises organisations that are owned and operated by the government, and that provide services for its citizens, these do not strive to make a profit (section 516A on Environment protection and biodiversity conservation act 1999, Australian government organisations are required to produce an ecologically sustainable development and environment report as part of their annual report/ some are also required to report to NEPM/national environmental protection measures).

A recent tool available for organisations to assist them in complying with these statutory requirements is an EMS (Environmental Management System)

5. Financial Plan

- Include credit history
- Recent financial statements
- Identify capital requirements
- Sources of capital
- Describe projected financial performance
- Start-up costs

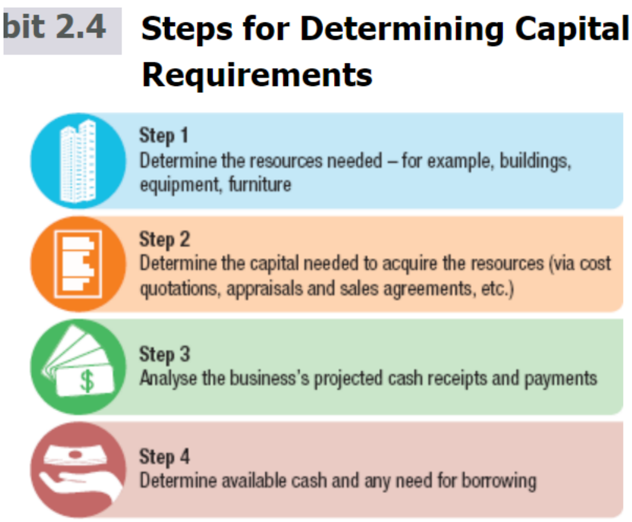
GST: flat 10 % in Australia. Each business that meets a certain criteria is required to register for GST. The business collects GST on the goods and services it supplies and pays tax on the ones it buys.
The business then pays GST collected - GST paid to ATO

GST/ DISTRIBUTION IN INDIA(valid as of 2022/sept)-

Down-payment : a sum of money which is the first payment of something, with the rest of the money to be paid later.

Identifying capital requirements

This is the most important part of the plan for new and small businesses.



Start up costs for a business can be significant. Planning capital requirements involves projections, not guarantees, so the entrepreneur must expect and provide for reasonable deviations from plans.

An example of this could be a cash buffer, which lets the business operate normally through downturns without having to look for financing. It also lets the business take advantage of unexpected opportunities that require cash.

Sources of capital

Once we know about the requirements, potential sources of capital can be identified. Government agencies also offer advice to small businesses.

One should know about both the length of time for which the business plans to use the capital before paying it back to creditors or returning it to investors, and the availability of short and long term sources of capital.

Short-term capital

Will be repaid within a year or less

Two sources;

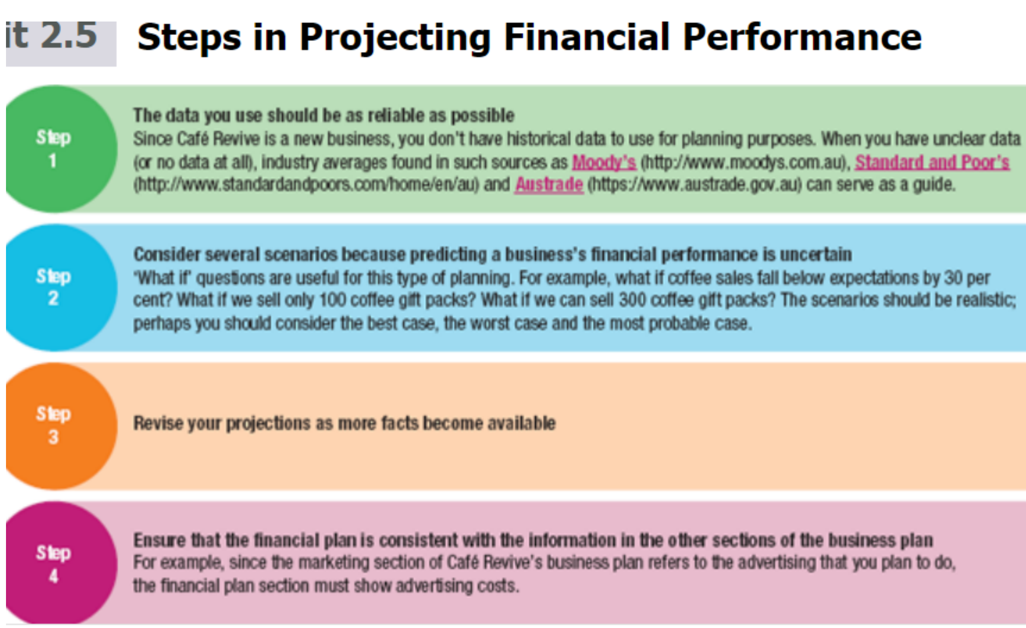
1) Suppliers to traders (credit/ **trade credit**)
2) Financial institutions, such as commercial banks, provide loans to companies, many of which are guaranteed by government agencies.

Line of credit: Amount of money a business is allowed to borrow with a prearranged, agreed-upon interest rate and a specific payback schedule.

Long-term capital

Usually repaid after more than a year

When a business grows too large to be financed by the owner and these other sources, it may offer private placements(securities that are sold directly to the private individuals or groups, called investors) or public offerings(issuing bonds or shares to the public, investors through securities firms and investment banks).



Cost-Volume-Profit (CVP) Planning

Shows how profit will be affected by alternative sales volumes, selling prices of products and various costs of the business.
Also called **break-even analysis**
Simple calculations

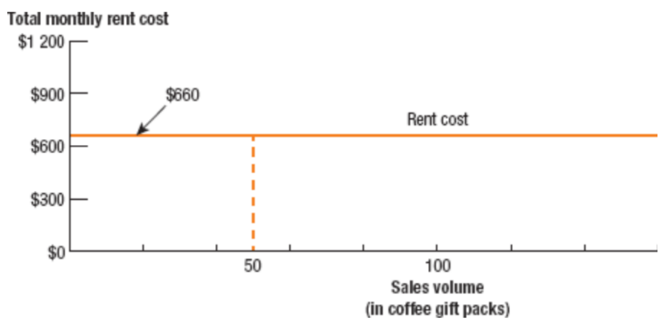
Cost behaviour

Volumes: activity level in a business (in case of cafe revive, this could be the number of cups of coffee sold).
The relationship between an activity's cost and its volume helps us determine the cost's behaviour pattern.

Fixed costs

Constant in total for a specific time-period, not affected by changes in volume.
Ex: managers' annual salary, monthly rent

Case Exhibit 2.6 Fixed Cost Behaviour – Coffee Gift Packs



Saying that a cost is fixed shouldn't mean that it cannot change from one time period on to the next.

Most companies consider the costs of using their buildings, factories, office equipment and furniture-called **depreciation** - to be fixed.

Relevant range is the range of activity levels over which the particular (fixed) cost behaviour pattern remains valid.

When volume is outside the relevant range then the fixed cost will be different. (if space is enough to store 50 packets, then cost is coming out to be $200 but if we lease other premises to store around 400 then the cost rises to $1980).

Decision makers sometimes state fixed costs as a dollar amount per unit, calculated by dividing the total fixed costs by the volume in units.

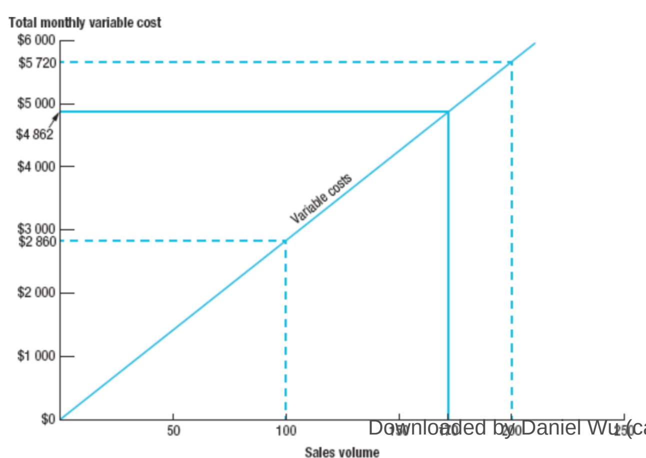
Ex. At a sales volume of 200 gift packs, Cafe Revive's fixed cost per unit pack will be $11.88 ($2376 fixed cost / 200 packs). At a sales volume of 300 this would be only $7.92…

That is why one shouldnt be misled, about fixed cost per unit without the information about the number of units.

Also, one shouldn't assume that fixed costs go down as the number of units increase as the total is still $2376.

Variable costs

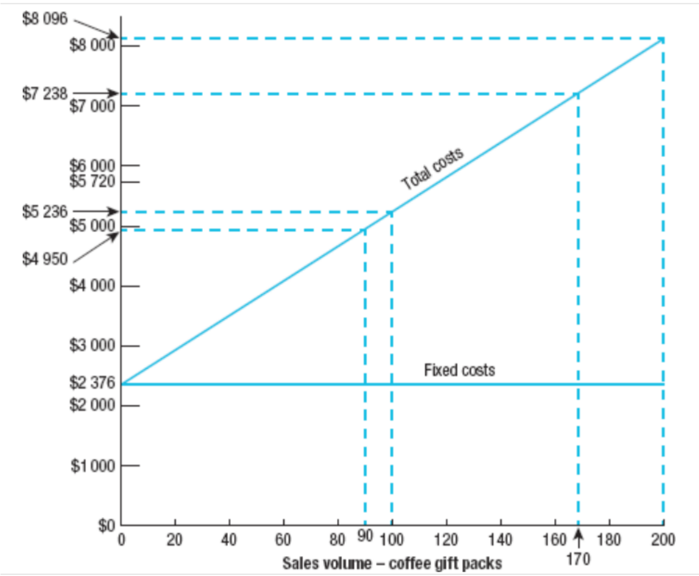
Are constant per unit of volume, and changes in total in a time period in direct proportion to the change in volume.



Total variable cost = vX
Where,
v = Variable cost per unit sold
X = sales volume

Total costs

Total costs at any volume are the sum of the fixed costs and the variable cost at that volume.



Total cost = f + vX
where,
f = total fixed costs
v = Variable cost per unit sold, &
X = sales volume

Profit calculation

Projected income statement for external users

Projected income statement – coffee gift packs
For the month ended 31 January 20X2

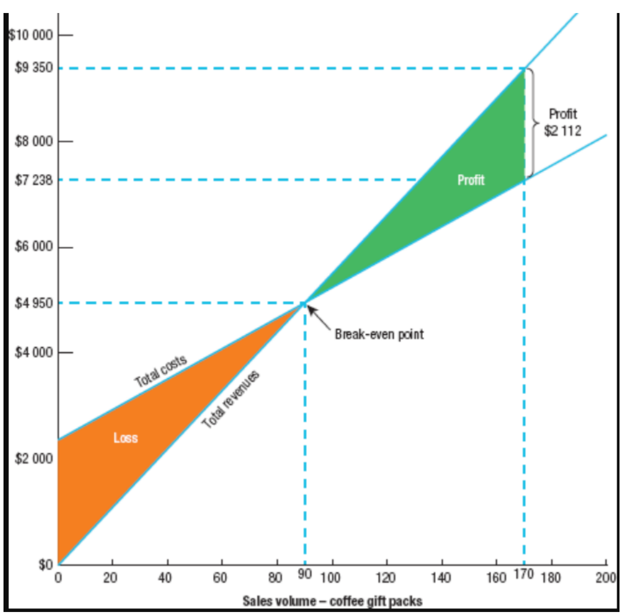
Revenues:		
Sales revenues – coffee gift packs (170 × 55)		$ 9 350
Expenses:		
Cost of gift packs sold (170 × 28.60)	$4 862.00	
Rent expense	660.00*	
Salaries expense	1 180.00	
Consulting expense	165.00*	
Advertising expense	115.50*	
Depreciation expense: fixtures	79.50	
Mobile and wifi expenses	71.50*	
Energy expense	104.50*	
Total expenses		(7 238)
Net income		$ 2 112

Profit graph

One way is to show both its revenues and its costs (expenses) on the same graph.

The unit sales volume at which a business earns a zero profit is called the break-even point.

Above the break-even unit sales volume, the total revenues of the business are more than its total costs, so there will be a profit. Below, the break-even point, the total revenues are less than the total costs, so there will be a loss.



A lot of business owners like to use another method, that shows a business's contribution margin

Contribution margin

To estimate profit at different volume levels, the entrepreneur needs CVP information in a form that relates the estimated revenues and estimated variable costs to the estimated fixed costs.

The income statement format is sometimes called the contribution margin approach

E.x. Our business calculates its estimated sales revenue for coffee gift packs by multiplying the number of packs it expects to sell by the selling price per pack.

Next we determine the total estimated variable costs of selling the packs of coffee by multiplying the number of packs it expects to sell by the variable cost per pack of coffee.

These total variable costs are then subtracted from the revenue
The difference is called the total contribution margin

Café Revive
Projected income statement – coffee gift packs
For the month ended 31 January 20X2

Total sales revenues ($55 × 170 coffee gift packs)		$ 9 350.00*
Less: Total variable costs		
Cost of coffee gift packs sold ($28.60 × 170 packs)		(4 862.00)*
Total contribution margin		$ 4 488.00
Less: Total fixed costs		
Rent expense	$ 660.00*	
Salaries expense	1 180.00	
Consulting expense	165.00*	
Advertising expense	115.50*	
Depreciation expense: display cases	79.50	
Mobile and wifi expenses	71.50*	
Energy expense	104.50*	
Total fixed costs		(2 376.00)*
Net income		$ 2 112.00

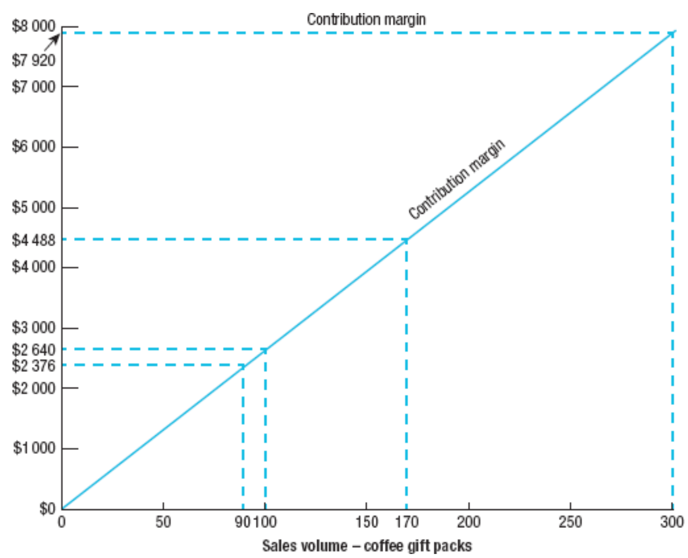
* These figures are GST-inclusive.

Café Revive
Projected income statement
For the month ended 31 January 20X2

Revenues:		
Sales – coffee gift packs ($55 × 170)		$ 9 350*
Sales – cups of coffee ($5.50 × 880)		4 840*
		$14 190
Less: Total variable costs		
Cost of coffee gift packs sold ($28.60 × 170 boxes)	4 862*	
Cost of cups of coffee sold ($2.20 × 880)	1 936*	
		(6 798)
Total contribution margin		$ 7 392
Less: Total fixed costs		
Rent expense	$1 320*	
Salaries expense	2 360	
Consulting expense	330*	
Advertising expense	231*	
Depreciation expense – display cases	159	
Mobile and wifi expenses	143*	
Energy expense	209*	
Total fixed costs		(4 752)
Net income		$ 2 640

* These figures are GST-inclusive.

Relationship between total contribution margin and unit sales volume



The total contribution margin is the amount of revenue remaining after subtracting the total variable costs.

It is the amount of revenue remaining after subtracting the total variable costs, which will contribute to covering the estimated fixed costs.

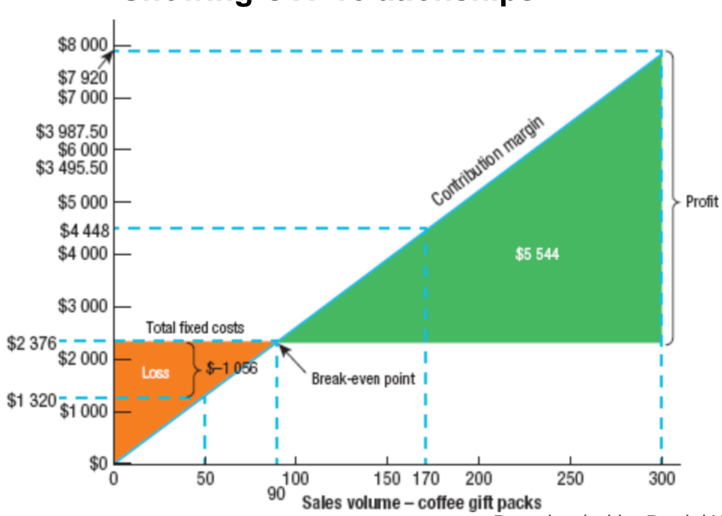
To compute the estimated profit, we subtract the total estimated fixed costs for the month from the total contribution margin.

If contribution margin > fixed costs: profit
If contribution margin < fixed costs: loss

Contribution margin per unit is the difference between the estimated sales revenue per unit and the estimated variable costs per unit.

** This can also be expressed as a percentage.
** The contribution margin per unit remains unchanged.

Showing CVP relationships



We can now show the estimated profit or loss at different volumes in a graph.

Profit calculation (Equation form)

How to answer ?

1. How much profit will the business earn at a given unit sales volume ?
2. How many units must the business sell to break even
3. How many units must the business sell to earn a given amount of profit? (The given amount

is usually a desired profit that the business uses as a goal.)

Using a CVP analysis

Estimating profit at given unit sales volume

$$\begin{matrix}\text{Profit} \\ \text{(for a given} \\ \text{sales volume)}\end{matrix} = \begin{bmatrix}\text{Selling} & & \text{Unit} \\ \text{price} & \times & \text{sales} \\ \text{per unit} & & \text{volumes}\end{bmatrix} - \begin{bmatrix}\text{Variable} & & \text{Unit} \\ \text{cost} & \times & \text{sales} \\ \text{per unit} & & \text{volumes}\end{bmatrix} - \begin{matrix}\text{Total} \\ \text{fixed} \\ \text{costs}\end{matrix}$$

$$\begin{matrix}\text{Profit} \\ \text{(for a given} \\ \text{sales volume)}\end{matrix} = \begin{bmatrix}\text{Contribution} & & \text{Unit} \\ \text{margin} & \times & \text{sales} \\ \text{per unit} & & \text{volume}\end{bmatrix} - \begin{matrix}\text{Total} \\ \text{fixed} \\ \text{costs}\end{matrix}$$

Finding the break-even point

This occurs when total sales revenue equals total costs (total variable costs plus total fixed costs)
Recall, contribution margin per unit is the difference between the sales revenue per unit and the variable costs per unit.

$$\text{Unit sales volume (to earn zero profit)} = \frac{\text{Total fixed costs}}{\text{Contribution margin per unit}}$$

Finding the unit sales volume to achieve a target profit

The break even-point is the sales volume at which the total contribution margin is equal to, or ‘covers’, the total fixed costs. Therefore, each additional unit sold above the break-even sales volume increases profit by the contribution margin per unit.

$$\text{Unit sales volume (to earn desired profit)} = \frac{\text{Total fixed costs} + \text{Desired profit}}{\text{Contribution margin per unit}}$$

Budget

Why?

Is a tool to align the activities of the business with the strategy of the business. It will include both long-term and short-term goals.
** Any key aspect about the business should be included.

Budgeting improves planning, operating and evaluating by

1) Add discipline, or order, to the planning process.
2) Recognise and avoid potential operating problems.
3) Quantify plans.
4) Create a benchmark for evaluating the business’s performance.
   To save time entrepreneurs use a management principle known as **management by exception**(management principle where an entrepreneur focuses on improving the activities that show significant differences between budgeted and actual results).

Who?

Budget committee: A group of managers formed to supervise and take responsibility for the budget setting process
Budget officer: An individual, often an accountant, appointed to carry out, or take immediate responsibility for having carried out, the tasks of the budget committee.
Top-down: An approach to budgeting where the senior management of each budget area originates the budget targets, perhaps discussing them with lower levels of management.
Bottom-up: A term applied to the decisions in which great weight is given to the views of relatively junior staff, who often have good experience and detailed knowledge of what is going on in the business and its markets. The term is often used in budgeting, where budgets are driven by the views of staff such as sales representatives.

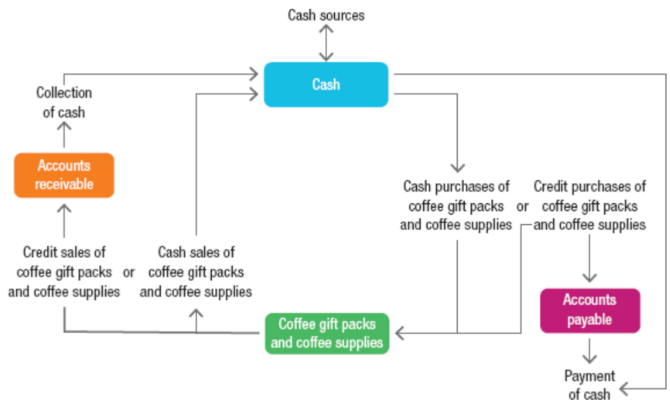
Operating cycles

A retails business's operating cycle

Is the average time it takes the business

1. to use cash to buy goods for sale (called **inventory**)
2. to sell these goods to the customers and,
3. to collect cash from customers.

hibit 3.1 Café Revive's Operating Cycle



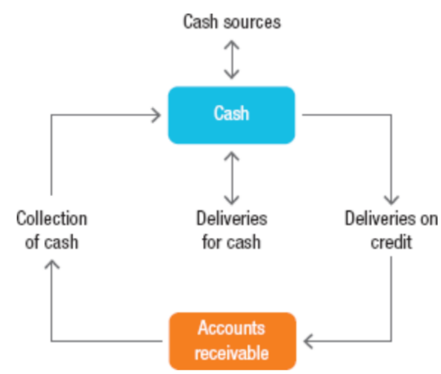
A service business's operating cycle

Is the average time it takes the business to

1. Use cash to acquire supplies services
2. Sell the services to customers
3. Collect cash from customers.

Ex. Express transfer company is a shipping company hired by DeFlava coffee to ship coffee to retail businesses around the country.

Express Transfer Company's Operating Cycle



The operating cycle for some service businesses can be much longer than the cycle for most retail businesses because, for certain service businesses, one service or job can take months or years.

Budget as a framework for planning

Budgeting is the most useful when used as a framework to help shape and frame planning.

Master budget

Is the overall structure a business uses to organise its budgeting process
Is a set of interrelated reports (or budgets) showing:

The master budget has two major categories:
Financial budget
Operating budget

A master budget for a retail business may include,

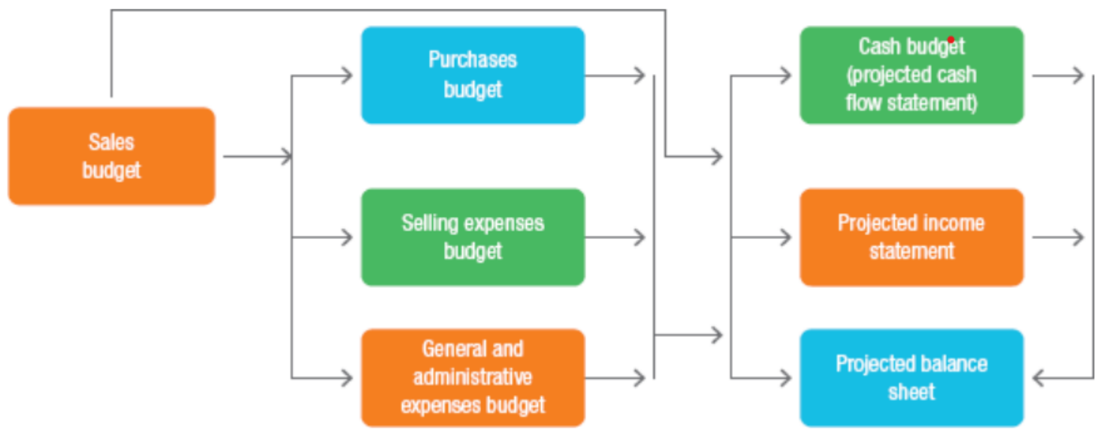
1. Sales budget
2. General and administrative expenses budget
3. Selling expenses budget
4. Purchases budget
5. Cash budget (projected cash flow statement)
6. Projected income statement

A service business' master budget does not include a purchase budget, and usually combines the expenses budgets.
A manufacturing business' master budget includes additional budgets related to its manufacturing activities- direct material purchases, direct labour and cost of goods sold.

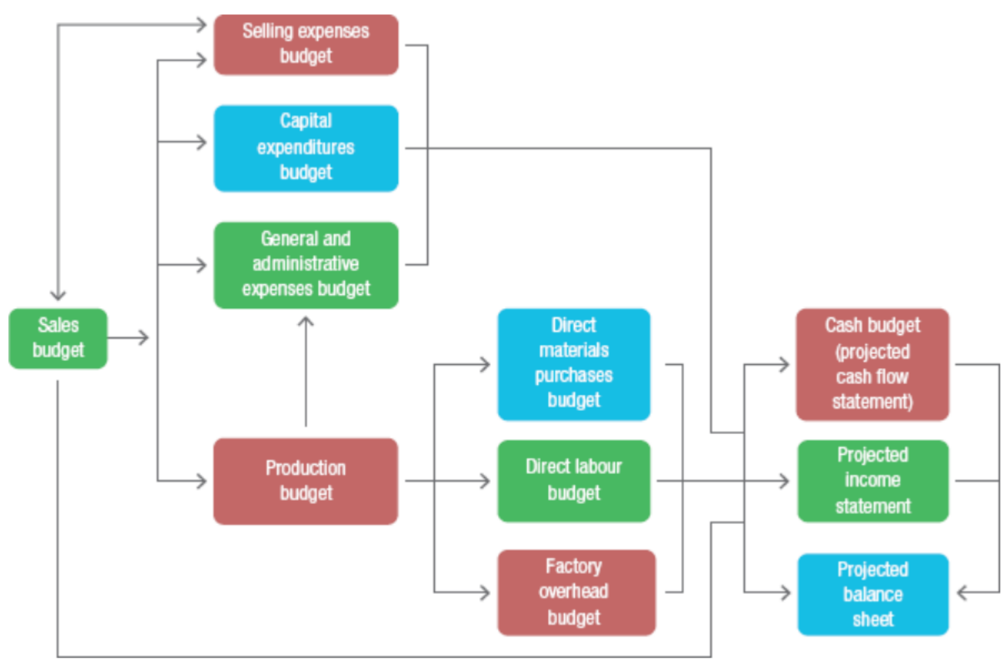
A business usually prepares a budget for a year or more in the future, it breaks down the master budget by each budget period.(usually by a quarter/ 3 months).

The last budgets prepared in a business's budgeting process are the projected financial statements for the budget period: the cash budget (also called a projected cash flow statement) and the projected financial statements (projected income statement and projected balance sheet)
The projected financial statements give a review of what the business' actual finances should look like at the end of the term.

.4 Interrelationships among Budget Schedules in the Master Budget – Retail



Interrelationships among budget schedules in the master budget - Manufacturing



The sales budget

This is where the budgeting process begins, because product sales/ service contracts affect all the other operating activities of a business.

The retail business's sales budget

Shows;

1) Number of units of inventory that the business expects to sell each month,
2) The related monthly sales revenue
3) the months in which the business expects to collect cash from these sales

To estimate the number of units it will sell: a business gathers various types of information, such as past sales data, industry trends of information, such as past sales data, industry trends and economic forecasts. Seeing the general state of the economy might also help (struggling economy/ less expenditure on luxury items).
Marketing should not be static-and budget-for the future.

After a business has estimated the amount of inventory it expects to sell,
It determines its estimated sales revenue by multiplying the number of units of inventory it expects to sell by the unit price
After calculating the sales revenue for a month, the business determines how much cash it expects to collect each month from sales.

For a lot of businesses, however, a portion (sometimes substantial) of their sales consists of credit sales. If a business allows credit sales, its cash collections of accounts receivable will lag behind its sales revenues.

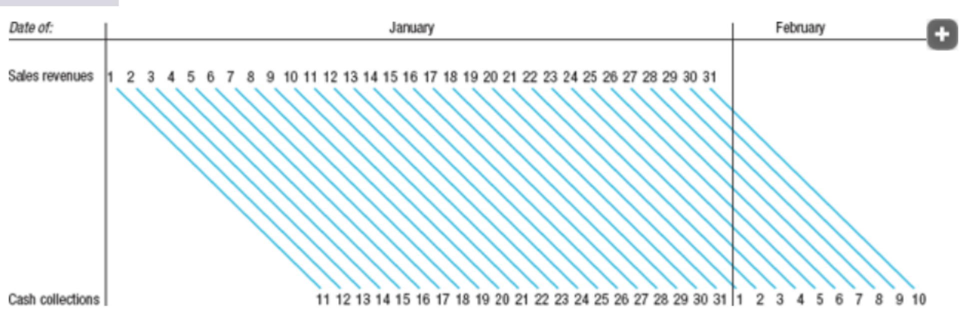
Revenue: money a company earns from the sale of its products and services
Cash flow: the net amount of cash being transferred in and out of a company.

The credit granting policy must have oversight, which guarantees the credit-repayment through a good credit history.

The idea is to shorten the amount of time between sales and collections of cash, asd to reduce the risk of not being able to collect from customers. At the same time businesses shouldn't have overly restrictive credit policies that discourage customers from buying on credit.

Ex. If a coffee shop decided to grant credit sales of gift packs and also decided to give these credit customers terms of n/10 (net 10), which means they will pay within 10 days of when they make credit purchases. Because of this the cafe will collect roughly two-thirds of each month's credit sales in a month of the sales (worst case) and the remaining one-third of the credit sales in the following month.

ibit 3.6 Relationship between Credit Sales and Cash Collections



hibit 3.7 Sales Budget – Coffee Gift Packs

CAFÉ REVIVE
Sales budget – coffee gift packs
First quarter 20X2

	January	February	March	Quarter
Budgeted total unit sales – coffee gift packs	170	250	200	620
Budgeted selling price per gift pack	$ 55	$ 55	$ 55	$ 55
Budgeted total sales revenue	**$9 350**	**$13 750**	**$11 000**	**$34 100**
Budgeted cash sales (94% of total sales revenue)	$8 789	$12 925	$10 340	$32 054
Budgeted credit sales (6% of total sales revenue)	$ 561	$ 825	$ 660	$ 2 046
Budgeted total sales revenue	**$9 350**	**$13 750**	**$11 000**	**$34 100**
Expected cash collections:				
From cash sales	$8 789	$12 925	$10 340	$32 054
From January credit sales (2/3; 1/3)	$ 374*	$ 187*		$ 561
From February credit sales		$ 550*	$ 275*	$ 825
From March credit sales			$ 440*	$ 440
Total cash collections	**$9 163**	**$13 662**	**$11 055**	**$33 880**

The service business's sales budget
It's very similar to a retail business, with the only difference being that they are selling services not products.

Seasonal sales
Some businesses experience dramatic changes in their sales in various seasons (festive,temperature-related,artificially popularised/ chess-netflix-queen's gambit)

The retail business's purchases budget
Once a business has estimated (budgeted) its unit sales for each month of the quarter, it can determine the best approach to purchasing the needed inventory.

How to determine when and how much inventory to order ?

1) There are costs for;
    a. Keeping the business's money invested into inventory (rather than investing it somewhere else)
    b. Storing and handling inventory
    c. Paying for insurance and taxes on inventory

Higher inventory levels also increase the risk of theft, damage and obsolescence, there is also a physical limit to most businesses' inventory
It can also be very expensive not to carry enough inventory (stockout)
→ resolve the said problem mathematically.

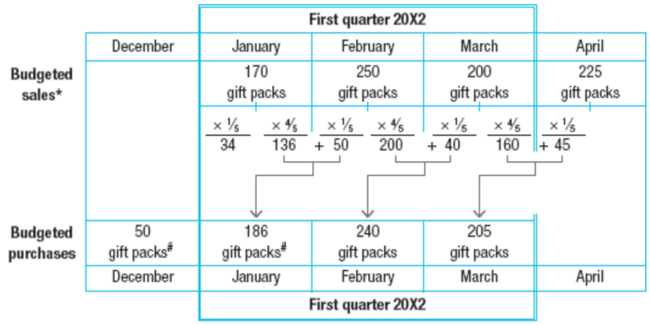
For these reasons, most businesses have JIT(jut-in-time) inventory systems

Purchases budget: shows the purchases (in units) required in each month to make the expected sales (from the sales budget) in that month and to keep inventory at desired levels.

Businesses often have extra inventory available in case their next shipment arrives later than expected, or they have underestimated their sales.

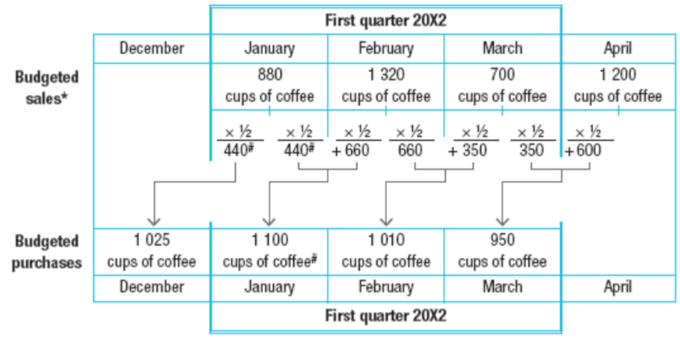
Ex. Let's assume that the owner of cafe revive decided to have a large enough inventory to cover one-fifth (20%) of the next month's sales of gift packs and half (50%) of the next month's sales of coffee cups. Based on this purchasing policy, cafe revive must have enough inventory during January to equal budgeted sales for January plus one-fifth (20%) of budgeted gift pack sales for February.

bit 3.9 The Link between Budgeted Purchases and Budgeted Sales – Coffee Gift Packs



*From Case Exhibit 3.7, except April, which was estimated as part of second-quarter projections.
#Ordered 50 instead of 34 because of the difficulty of estimating sales for the first month of a start-up business and because Café Revive did not want to run out of stock. Café Revive would only need to purchase 170 gift packs in January (186 – the extra 16 from December (50 – 34)) if they keep to the budget.

ibit 3.10 The Link between Budgeted Purchases and Budgeted Sales – Cups of Coffee



*From Case Exhibit 3.8, except April, which was estimated as part of second-quarter projections. Figures are rounded for simplicity.
Ordered 1 025 instead of 440 (585 extra) because Café Revive did not want a stockout situation.
The excess (1 025 – 440 = 585) reduces those required in January to 515 (1 100 – 585).

hibit 3.11 Purchases Budget – Coffee Gift Packs

CAFÉ REVIVE
Purchases budget
First quarter 20X2

	January	February	March	Quarter
Budgeted total unit sales (coffee gift packs)	170	250	200	620
Add: Desired ending inventory of coffee gift packs*	50	40	45†	45‡
Total gift packs required	220	290	245	655
Less: Beginning inventory of coffee gift packs§	(50)*	(50)	(40)	(50)**
Budgeted purchases of coffee gift packs	170	240	205	615
Purchase price per coffee gift packs	$28.60	$28.60	$28.60	$ 28.60
Cost of purchases	$4 862	$6 864	$5 863	$17 589
Cash payments for purchases	$1 430¶	$4 862	$6 864	$13 156

ibit 3.12 Purchases Budget – Cups of Coffee

CAFÉ REVIVE
Purchases budget
First quarter 20X2

	January	February	March	Quarter
Budgeted total unit sales (cups of coffee)	880	1 320	700	2 900
Add: Desired ending inventory of coffee supplies*	660	350	600†	600‡
Total coffee supplies required	1 540	1 670	1 300	3 500
Less: Beginning inventory of coffee supplies§	(1 025)¶	(660)	(350)	(1 025)**
Budgeted purchases of coffee supplies	515	1 010	950	2 475
Purchase price per cup of coffee	$ 2.20	$ 2.20	$ 2.20	$ 2.20
Cost of purchases	$1 133	$2 222	$2 090	$5 445
Cash payments for purchases	$ 0¶	$1 133	$2 222	$3 335

Many businesses deal with other parties from different countries, if any currency conversions are to be made, ensure that they are made into the foreign currency outside main books in subsections or in brackets around important figures.

The retail business's selling expenses budget

To sell its inventory, a retail business must engage in selling activities.

Shows the expenses and related cash payments associated with planned selling activities(shop rent, advertising, salespeople's salaries, commissions … are directly related to sales)

Usually this is developed by reviewing past selling expenses (if they are available) and then adjusting them from current plans.

It's important to understand prior cost behaviour patterns when creating a selling expenses are variable and change directly with the amount of inventory sold, whereas some remain fixed regardless of the sales volume.(Sales commissions are an example of variable selling expenses/ since total sales commissions increase in direct proportion to increases in sales.)

The entrepreneur should be able to distinguish the selling expenses from general and administrative expenses.

hibit 3.13 Selling Expenses Budget

CAFÉ REVIVE
Selling expenses budget
First quarter 20X2

	January	February	March	Quarter
Budgeted selling expenses:*				
Rent expense	$ 990.00	$ 990.00	$ 990.00	$ 2970.00
Salaries expense	$1770.00	$1770.00	$1770.00	$ 5310.00
Consulting expense	$ 247.50	$ 247.50	$ 247.50	$ 742.50
Advertising expense#	$ 231.00	$ 231.00	$ 231.00	$ 693.00
Depreciation expense: fixtures	$ 159.00	$ 159.00	$ 159.00	$ 477.00
Mobile and wifi expense	$ 107.25	$ 107.25	$ 107.25	$ 321.75
Energy expense	$ 156.75	$ 156.75	$ 156.75	$ 470.25
Total budgeted selling expenses	**$3661.50**	**$3661.50**	**$3661.50**	**$10984.50**
Budgeted cash payments for selling expenses†	**$2512.50**	**$2512.50**	**$2512.50**	**$ 7537.50**

* Case Exhibit 2.13 (Chapter 2) shows Café Revive's projected expenses for the month of January. Since these are fixed expenses, they are expected to be the same for February and March.
# Advertising expenses are only in the selling expenses not in the general and administration expenses as they relate only to the selling of the coffee, as does the depreciation expenses.
† The $1149 ($3661.50 – $2512.50) difference between the total budgeted selling expenses and budgeted cash payments for selling expenses each month occurs because the expenses for rent and depreciation ($990 + $159) relate to Café Revive's planned December expenditures for rent, and equipment. They are not counted again as cash payments. Note: Depreciation is a non-cash item (refer to Chapter 4).

Ex. Cafe Revive has decided to allocate 3/4th to the selling expenses and 1/4th to the general and administrative expenses.

The Retail Business's General & Administrative Expenses Budget

Shows the expenses and related cash payments associated with expected activities other than selling.

Ex. administrative staff salaries, consulting charges and the cost of renting office space.

ibit 3.14 General and Administrative Expenses Budget

CAFÉ REVIVE
General and administrative expenses budget
First quarter 20X2

	January	February	March	Quarter
Budgeted general and administrative expenses:*				
Rent expense	$ 330.00	$ 330.00	$ 330.00	$ 990.00
Salaries expense	$ 590.00	$ 590.00	$ 590.00	$1770.00
Consulting expense	$ 82.50	$ 82.50	$ 82.50	$ 247.50
Mobile and wifi expense	$ 35.75	$ 35.75	$ 35.75	$ 107.25
Energy expense	$ 52.25	$ 52.25	$ 52.25	$ 156.75
Total budgeted general and administrative expenses	**$1 090.50**	**$1 090.50**	**$1 090.50**	**$3271.50**
Budgeted cash payments for general and administrative expenses†	**$ 760.50**	**$ 760.50**	**$ 760.50**	**$2281.50**

The Service business's Expenses Budget

Do not have a purchase budget for inventory. Instead, in budgeting expenses, service businesses simply prepare an operating expenses budget. They don't divide their budgeted expenses into two different budgets, one for selling expenses and one for general administrative expenses.

Service businesses are labour intensive, and salaries are a major fixed cost, therefore many service businesses use the number of hours the employees work as a measure of volume.

Cash management and the cash budget

Done to make sure that:

1. There is enough cash on hand to pay for planned operations during the current period
2. There is a cash buffer on hand

3. There is not too much cash on hand

Usually a business's insurance policy would usually cover abnormal and unexpected events, such as natural disasters or fires.

A lot of cash balance is also a problem for the business, as it is essentially losing value (inflation) and isn't productive(unless the business invests it internally in profitable projects, or externally in an interest-bearing account or in government or business securities that earn dividends or interest.)

The Retail Business's Cash Budget (Projected cash flow statement)

Cash budget

Shows the business's expected cash receipts and payments, and how these affect the business's cash balance.
Besides helping the entrepreneur anticipate cash shortages and excesses, the cash budget can also help external users.
The cash budget shows the cash receipts (inflows) and cash payments (outflows) that the business expects as a result of its plans (why it is called projected cash flow statement).
A business's cash flow statement reports its actual cash receipts and payments.
Can have 3 sections;

1. **Operating activities section:**
   Summarises the cash receipts and payments the business expects as a result of its planned operations. (expected cash flows: sales, purchases and expenses budgets).
   Also shows the net cash inflows (excess of cash receipts over cash payments) or the net cash outflows (excess of cash payments over cash receipts) expected from operations.

CAFÉ REVIVE
Cash budget
First quarter 20X2

	January	February	March	Quarter
Cash flow from operating activities:				
Cash receipts from sales of coffee gift packs*	$ 9 163.00	$13 662.00	$11 055.00	$33 880.00
Cash receipts from sales of cups of coffee	$ 4 840.00	$ 7 260.00	$ 3 850.00	$15 950.00
	$14 003.00	$20 922.00	$14 905.00	$49 830.00
Cash payments for:				
Purchases of gift packs†	$ 1 430.00	$ 4 862.00	$ 6 864.00	$13 156.00
Supplies: cups of coffee	$ –	$ 1 133.00	$ 2 222.00	$ 3 355.00
Selling expenses‡	$ 2 512.50	$ 2 512.50	$ 2 512.50	$ 7 537.50
General and administrative expenses§	$ 760.50	$ 760.50	$ 760.50	$ 2 281.50
Total payments	$ 4 703.00	$ 9 268.00	$12 359.00	$26 330.00
Net cash inflow (outflow) from operations	$ 9 300.00	$11 654.00	$ 2 546.00	$23 500.00
Cash (outflow) from investing activities				
Purchase of equipment	$ –	$ –	$ (1 400.00)	$ (1 400.00)
Net increase (decrease) in cash	$ 9 300.00	$11 654.00	$ 1 146.00	$22 100.00
Add: Beginning cash balance¶	$11 575.00	$20 875.00	$32 529.00	$11 575.00
Ending cash balance from operations	$20 875.00	$32 529.00	$33 675.00	$33 675.00

* From sales budget (Case Exhibits 3.7 and 3.8)
† From purchases budget (Case Exhibits 3.11 and 3.12)
‡ From selling expenses budget (Case Exhibit 3.13)
§ From general and administrative expenses budget (Case Exhibit 3.14)
¶ The cash balance at the beginning of January is the result of cash receipts and payments in December: $22 000 capital – rent $7920 – deposit for equipment $250 – coffee supplies $2255 = $11 575.

2. **Business plans for investing:**
Shows the cash payments and receipts the business expects from planned investing activities.(purchases or sales of land, buildings and equipment, or investments in the stocks and bonds of governments or other businesses).

3. **Financing activities:**
Shows the cash receipts and payments that the business expects from planned financing activities. A business's financing activities include borrowings and repayments of loans and investments and withdrawals by owners.

Although investing activities can occur at any time, businesses usually have policies about investing cash balances on hand in excess of a predetermined amount.

Cash receipt amounts come from sales budget, and cash payments amounts from purchases budget, the selling expenses budget, and the general and administrative expenses budget.

The service business's cash budget (projected cash flow statement)
Cash budget of a service business is similar to that of a retail business, except that the service business reports cash flow information that is obtained from fewer budgets.

In retails, information about the cash budget came from the sales, purchases, selling expenses, and general and administrative businesses.
In services, information about the cash budget came from its sales and operating budgets only.

The projected income statement
Summarises a business's expected revenues and expenses for the budget period, assuming the business follows its plans. (projected income statement is not the same as the cash budget).

Often the cash payment occurs much later than the activity that causes the expense. I.e., if a business has credit sales, cash receipts occur later than the related sales.

These timing differences between the operating activities and the related cash receipts and payments cause the differences between the projected income statement and the cash budget.

ibit 3.16 Projected Income Statement

CAFÉ REVIVE
Projected income statement#
For the quarter ended 31 March 20X2

Total sales revenue ($34 100 + $15 950)		$ 50 050*
Less: Total variable costs		
Cost of coffee gift packs sold	$ (17 732)†	
Cost of cups of coffee sold	$ (6 380)^	$(24 112)
Total contribution margin		**$ 25 938**
Less: Total fixed costs		
Selling expenses	$10 984.50‡	
General and administrative expenses	$ 3 271.50§	
Total fixed costs		$(14 256)
Profit		**$ 11 682**

Many businesses preparing a projected income statement will also produce a projected balance sheet, which shows the assets (resources owned or controlled by the business), liabilities(amounts owed by the business to external entities) and equity(the amount of owner investment in capital and past profits)

There is now a global recognition of organisationality and a move towards the GRI standards.

According to GRI, businesses should also take up the environmental and social expenses budget.

Using the Master budget in Evaluating the Business's Performance.

Finding difference between actual and budgeted amounts

A cost report shows the differences. Large businesses usually divide their cost report into selling expenses, and

hibit 3.17 Projected Balance Sheet

CAFÉ REVIVE
Projected balance sheet
As at 31 March 20X2

Assets			Liabilities		
Cash		$33 675	Accounts payable		$ 7953
Accounts receivable		$ 220			
Inventory		$ 2 607			
Prepaid rent		$ 3 960			
Equipment	$1 650		Owner's equity		
Less: Accumulated depreciation	$ 477	$ 1 173	Capital – E.Delta	$22 000	
			Profit for quarter	$11 682	$33 682
		$41 635			$41 635

general and administrative expenses, and would also divide it by department, manager, product or some other identifiable unit.

xhibit 3.19 Comparison of Actual versus Budgeted Amounts

CAFÉ REVIVE
Cost report
For the quarter ended 31 March 20X2

	Budgeted	Actual	Difference: Favourable/ (unfavourable)
Rent expense	$ 3 960	$ 3 960	–
Salaries expense	7 080	7 080	–
Consulting expense	990	990	–
Advertising expense	693	693	–
Depreciation expense	477	477	–
Mobile and wifi	429	429	–
Energy	627	580	$47
Total	**$14 256**	**$14 209**	**$47**

Just knowing there are differences is not enough for the manager, but a manager must also evaluate why those differences occurred.

Learning why differences occur
Formulate a bunch of questions, you need the answer to.
Devise a strategy to find their answers
(an analysis of the differences may lead an owner or manager to make changes in future budgets).
Differences can also be positive (energy bill was lesser than expected).

Exhibit 3.21 Five Basic Steps to Sustainability

1. Understand what is really meant by sustainability.
2. Define 'sustainability' for your organisation and determine the factors that are to be included and excluded during planning and budgeting.
3. Determine your time horizon for achieving profitability.
4. Ensure that upper management's definition of sustainability is understood widely throughout the organisation and that it is embedded into corporate strategy and objectives.
5. Ensure that the performance management system reports and rewards initiatives related to sustainability.[C]

Basic concepts and terms used in Accounting

Entity concept
An entity is considered to be separate from its owner(s) and from any other business. Thus, each business is an entity and has its own accounting system and accounting records.
“The owners assets are not the business's assets, and the businesses assets are the owners”.

Transactions
The accounting process usually begins with a transaction, which is an exchange of property or service with another entity.
Each of them must be recorded based on information from source documents.

Source documents
Is a business record that is used as evidence that a transaction has occurred.
→ could be a print from an EFT (electronic funds transfer machine).

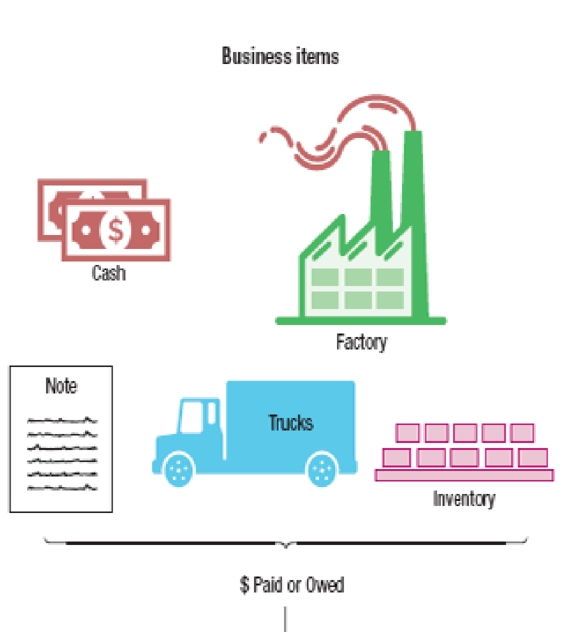
Monetary Unit Concept
The source documents for a transaction show the value of the exchange in terms of money.
In Australia and New Zealand the monetary unit is dollar, so businesses will show their financial statements.
Sony → yen
Audi and benetton → euro

Historical cost concept
The value of a currency changes.
Value of a particular goods and services change in the marketplace as supply and demand change.
In GAAP, businesses aren't required to keep track of the aforementioned two.

A business records its transactions based on the dollars exchanged (the cost) at the time the transaction occurred. The related documents show the cost involved in each transaction, regardless of whether the value of the property or service owned increases (or decreases) and whether the value of the currency changes over time.

Ex. a land bought for $100,000 should be shown as such even if next year the price increases to $130,000. However, ones allowed to acknowledge or adjust some assets for changes in their values in certain circumstances.

Developing a balance sheet,
a) Separate business items from personal items acc to the entity concept; and
b) Use the monetary unit concept to show dollar values for each item of the business.



DeFlava Coffee Corporation
Balance sheet
31 March 20X1
(in thousands of dollars)

Assets		Liabilities	
Cash	$ 1 200	Accounts payable	$ 3 000
Inventories	1 300	Notes payable	2 000
Other assets	16 800	Total liabilities	$ 5 000
		Shareholders' equity	
		Total shareholders' equity	$14 300
Total assets	$19 300	Total liabilities and Shareholders' equity	$19 300

External users are more concerned with the financial accounting information of a business which records all the financial business transactions in a General Purpose Financial Report (GFPR)

There are 6 kinds of users for this information all of which have unique agendas:

1) Owners and prospective owners
2) Employees and their unions
3) Governmental units
4) General public
5) Creditors and lenders
6) Customers

The dual effect of transactions
To keep the accounting equation in balance, a business must make at least two changes in its assets, liabilities or owner's equity when it records each transaction.

Ex. an owner invests $20000 in a business, assets are increased by $20000 and owner's equity is also increased by $20000 → (two changes): one change in the asset section of the balance sheet, and one change in the owner's equity section of the balance sheet.

Assets = Liabilities + Owner's equity : the equation stays in balance.

AASB definitions
Assets: A present economic resource controlled by the entity as a result of past events. An economic resource is a right that has the potential to produce economic benefits.
Liabilities: A present obligation of the entity to transfer an economic resource as a result of past events. An obligation is a duty or responsibility that the entity has no practical ability to avoid.
Owner's Equity: is the residual interest in the assets of the entity after deducting all its liabilities.

Owner's equity: the owner's current investment in the assets of the business(A partnership's balance sheet would refer to partner's equity, and a company's balance sheet would call this shareholders' equity.)

drawings/dividends: Owner's withdrawals of capital from the business.

Owner's equity is sometimes referred to as residual equity because creditors have first legal claim to the assets of a business. Once the creditors' claims have been satisfied, the owner is entitled to the remainder (i.e., residual).

The monetary total for the economic resources (assets) of the business must always be in balance (or equal) with the monetary total for the claims (Liabilities + Owner's equity).

Transaction 1: Investing cash

Gabriella White starts her business on 1 December 20X1 by transferring $40 000 to a bank account she opened for Scrumptious Donuts .

Transaction	Date	Asset	=	Liabilities	+	Owner's Equity
	1/12/x1	cash				G White, capital
		+ 40,000				+40,000

Transaction 2: Prepaying rent

To open Scrumptious Donuts, a rental agreement was signed in the company's name on 1 December 20X1. The monthly rent is $1320 and the agreement requires six months rent be paid in advance.

Transaction	Date	Asset	=	Liabilities	+	Owner's Equity
	1/12/x1	prepaid rent				
		+7920				
		cash				
		-7920				

* prepayments meet the defnition of an asset
** note that there has been an equal increase and decrease to the asset side of the equation, so it is still in balance.

Transaction 3: Purchasing supplies with cash

On 7 December 20X1, Scrumptious Donuts purchases $4510 of baking supplies from Baking Direct by transferring $4510 in cash.

Transaction	Date	Asset	=	Liabilities	+	Owner's Equity
		Supplies				
	7/12/x1	+4510				
		Cash				
		-4510				

Transaction 4: Purchasing inventory on credit

On 12 December 20X1, Scrumptious Donuts purchases $1100 of donut gift packs on credit from Donut Giant Corporation. Scrumptious Donuts agrees to pay within 30 days of purchase.

Transaction	Date	Asset	=	Liabilities	+	Owner's Equity
	12/12/x1	Inventory		Accounts Payable		
		+ 1100		+ 1100		

Transaction 5: Purchasing shop equipment with cash and credit

On 20 December 20X1, Scrumptious Donuts purchases shop equipment from Ace Equipment for $2650.
It pays $2000 immediately and the remaining $650 will be paid at the end of three months.

Transaction	Date	Asset	=	Liabilities	+	Owner's Equity
	20/12/x1	Equipment		Accounts Payable		
		+2650		+650		
		Cash				
		-2000				

Transaction 5: Selling extra shop equipment on credit.

		Assets							=	Liabilities			+	Owner's equity
Trans	Date	Cash +	Prepaid rent +	Supplies +	Inventory +	Shop equipment +	Accounts receivable +	GST paid	=	Accounts payable +	Loan payable +	GST collected	+	E Della, capital
(1)	1/12/X1	+$22 000												+$22 000
(2)	1/12/X1	−$ 7 920	+$7 200					+$ 720						
(3)	7/12/X1	−$ 2 255		+$2 050				+$ 205						
(4)	12/12/X1				+$1 300			+$ 130		+$1 430				
(5)	20/12/X1	−$ 250				+$1 500		+$ 150			+$1 400			
(6)	22/12/X1					−$ 400	+$440					+$40		
Balances		$11 575 +	$7 200 +	$2 050 +	$1 300 +	$1 100 +	$440 +	$1 205	=	$1 430 +	$1 400 +	$40	+	$22 000
		$24 870								$24 870				

Expanding the accounting Equation

$$\text{Assets} = \text{Liabilities} + \overbrace{\text{Owner's capital} + \underbrace{\text{Net income}}_{\text{Revenues} - \text{Expenses}}}^{\text{Owner's equity}}$$

Accounting Principles and Concepts related to Net Income

Accounting period: The time span for which a business reports its revenues and expenses
- A lot of businesses base their financial statements. On a 12-month accounting period called a financial year.
- A lot of businesses regard the financial year as the one which corresponds with the national taxation cycles (1 July to 30 June Australia).
- Any accounting period shorter than a year (interim period).

Earning and Recording revenues

Earning process: includes purchasing (or producing) inventory, selling the inventory (or services), delivering the inventory (or services), and collecting and paying cash.
Even though a business earns revenues continuously during the process, it generally records revenues near or at the end of the earning process, because the earning process is complete and the prices charged to the customers are collectable.

Matching principle: to determine its net income for an accounting period, a business calculates the expenses involved in earning the revenues of the period and deducts the total expenses from the total revenues earned in that period.

Going concern: assumes that entity is able to continue as a viable entity for the foreseeable future. Financial statements that are not prepared using this assumption are usually prepared for liquidation purposes.

Accrual accounting

A business using accrual accounting records its revenue and related expenses transactions in the same accounting period that it provides goods or services (i.e. in the period in which it earns the revenue), regardless of whether it receives or pays cash in that period.

Makes information helpful to external users.

Transaction 6: Withdrawal of cash by owner
A withdrawal is a payment from the business to the owner (drawing).

		Assets							= Liabilities			+ Owner's equity: Owner's capital	+ Net income	
Trans	Date	Cash	+ Prepaid rent	+ Supplies	+ Inventory	+ Shop equipment	+ Accounts receivable	+ GST paid	= Accounts payable	+ Loan payable	+ GST collected	+ E Della, capital	+ Revenues	− Expenses
Balances	1/1/X2	$11 575	$7 200	$2 050	$1 300	$1 100	$440	+ $1 205	$1 430	$1 400	$ 40	$22 000		
(1)	2/1/X2	+$ 1 650			−$ 780						+$150		+$1 500	− +$780
(2)	3/1/X2	−$ 1 430							−$1 430					
(3)	4/1/X2				+$4 940			+$ 494	+$5 434					
(4)	6/1/X2				−$ 260		+$550				+$ 50		+$ 500	− +$260
(5)	7/1/X2	+$ 440					−$440							
(6)	20/1/X2	−$ 250										−$ 250		
Balances		$11 985	+ $7 200	+ $2 050	+ $5 200	+ $1 100	+ $550	+ $1 699	= $5 434	+ $1 400	$240	+ $21 750	+ $2 000	− $800

Transaction 7 and 8: Payments for Consulting and advertising.

		Assets							= Liabilities			+ Owner's equity: Owner's capital	+ Net income	
Trans	Date	Cash	+ Prepaid rent	+ Supplies	+ Inventory	+ Shop equipment	+ Accounts receivable	+ GST paid	= Accounts payable	+ Loan payable	+ GST collected	+ E Della, capital	+ Revenues	− Expenses
Balances	1/1/X2	$11 575	$7 200	$2 050	$1 360	$1 100	$440	+ $1 205	$1 430	$1 400	$ 40	$22 000		
(1)	2/1/X2	+$ 1 650			−$ 780						+$150		+$1 500	− +$ 780
(2)	3/1/X2	−$ 1 430							−$1 430					
(3)	4/1/X2				+$4 940			+$ 494	+$5 434					
(4)	6/1/X2				−$ 260		+$550				+$ 50		+$ 500	− +$ 260
(5)	7/1/X2	+$ 440					−$440							
(6)	20/1/X2	−$ 250										−$ 250		
(7)	25/1/X2	−$ 363						+$ 33						− +$ 330
(8)	25/1/X2	−$ 121						+$ 11						− +$ 110
Balances		$11 501	+ $7 200	+ $2 050	+ $5 200	+ $1 100	+ $550	+ $1 743	= $5 434	+ $1 400	$240	+ $21 750	+ $2 000	− $1 480

Transaction 9: Purchase of Extra Supplies

		Assets							= Liabilities			+ Owner's equity: Owner's capital	+ Net income	
Trans	Date	Cash	+ Prepaid rent	+ Supplies	+ Inventory	+ Shop equipment	+ Accounts receivable	+ GST paid	= Accounts payable	+ Loan payable	+ GST collected	+ E Della, capital	+ Revenues	− Expenses
Balances	1/1/X2	$11 575	$7 200	$2 050	$1 360	$1 100	$440	+ $1 205	$1 430	$1 400	$ 40	$22 000		
(1)	2/1/X2	+$ 1 650			−$ 780						+$150		+$1 500	− +$ 780
(2)	3/1/X2	−$ 1 430							−$1 430					
(3)	4/1/X2				+$4 940			+$ 494	+$5 434					
(4)	6/1/X2				−$ 260		+$550				+$ 50		+$ 500	− +$ 260
(5)	7/1/X2	+$ 440					−$440							
(6)	20/1/X2	−$ 250										−$ 250		
(7)	25/1/X2	−$ 363						+$ 33						− +$ 330
(8)	25/1/X2	−$ 121						+$ 11						− +$ 110
(9)	29/1/X2	−$ 275		+$ 250				+$ 25						
Balances		$11 226	+ $7 200	+ $2 300	+ $5 200	+ $1 100	+ $550	+ $1 768	= $5 434	+ $1 400	$240	+ $21 750	+ $2 000	− $1 480

Transaction 10: Payment of Salaries

		Assets							= Liabilities				+ Owner's equity: Owner's capital	+ Net income	
Trans	Date	Cash	+ Prepaid rent	+ Supplies	+ Inventory	+ Shop equipment	+ Accounts receivable	+ GST paid	= Accounts payable	+ Loan payable	PAYG tax payable	+ GST collected	+ E Della, capital	+ Revenues	− Expenses
Balances	1/1/X2	$11 575	$7 200	$2 050	$1 300	$1 100	$440	+ $1205	$1430	$1400		$ 40	$22 000		
(1)	2/1/X2	+$ 1 650			−$ 780							+$150		+$1500	− +$ 780
(2)	3/1/X2	−$ 1 430							−$1430						
(3)	4/1/X2				+$4 940			+$ 494	+$5434						
(4)	6/1/X2				−$ 260		+$550					+$ 50		$ 500	− +$ 260
(5)	7/1/X2	+$ 440					−$440								
(6)	20/1/X2	−$ 250											−$ 250		
(7)	25/1/X2	−$ 363						+$ 33							− +$ 330
(8)	25/1/X2	−$ 121						+$ 11							− +$ 110
(9)	29/1/X2	−$ 275		+$ 250				+$ 25							
(10)	31/1/X2	−$ 2 050									+$310				− +$2360
Balances		$ 9 176	+ $7 200	+ $2 300	+ $5 200	+ $3800	+ $550	+ $1768	= $5434	+ $1400	$310	$240	+ $21 750	+ $2000	− $3840

Transaction 11 and 12: Payment of Mobile and Wifi and Energy Bills

		Assets							= Liabilities				+ Owner's equity		
													Owner's capital +	Net income	
Trans	Date	Cash +	Prepaid rent +	Supplies +	Inventory +	Shop equipment +	Accounts receivable +	GST paid =	Accounts payable +	Loan payable	PAYG tax payable +	GST Collected +	E Della, capital +	Revenues –	Expenses
Balances	1/1/X2	$11 575	$7 200	$2 050	$1 300	$1 100	$440	$1 205	$1 430	$1 400		$ 40	$22 000		
(1)	2/1/X2	+$ 1 650			–$ 780							+$ 150		+$ 1 500 –	+$ 780
(2)	3/1/X2	–$ 1 430							–$1430						
(3)	4/1/X2				+$4 940			+$ 494	+$5434						
(4)	6/1/X2				–$ 260		+$550					+$ 50		+$ 500 –	+$ 260
(5)	7/1/X2	+$ 440					–$440								
(6)	20/1/X2	–$ 250											–$ 250		
(7)	25/1/X2	–$ 363						+$ 33						–	+$ 330
(8)	25/1/X2	–$ 121						+$ 11						–	+$ 110
(9)	29/1/X2	–$ 275		+$ 250				+$ 25							
(10)	31/1/X2	–$ 2 050									+$310			–	+$2 360
(11)	31/1/X2	–$ 143						+$ 13						–	+$ 60
(12)		–$ 209						+$ 19						–	+$ 190
(13)	31/1/X2	+$11 000			–$5 200							+$1 000		+$10 000	+$5 200
(14)		$ 5 368										+$ 488		+$ 4 880 –	
(15)					+$1 350			+$ 135	+$1485						
Balances		$25 192 +	$7 200 +	$2 300 +	$1 350 +	$1 100 +	$550 +	$1 935 =	$6919 +	$1 400	$310 +	$1 728 +	$21 750 +	$16 880 –	$9 360

Transaction 13 and 14: Summary cash sales

Transaction 15: Managing Inventory level

End-of-Period Adjustments

To calculate a business's net income under accrual accounting, the business must make sure that all its revenues and expenses for the accounting period are included in the totals.

E.g. Emily(owner of cafe revive) can easily verify that the revenue total is correct because every sale is listed on a source document (a sales invoice or a cash-register tape) that she uses to record each sales transaction. Emily can verify that most of Cafe Revive's expenses are correct because she also has source documents (invoices, utility bills and timesheets) that she uses to record each sales transaction. Emily can easily verify most expenses because she has the source documents relating to these.

It's harder for a business to include all of their expenses they incurred during that month. Others are included in the net income calculation because some of the costs of providing goods or services occur without a source document.

These adjustments are called **EOP adjustments.**

Transaction 16: Supplies Used

Transaction 17: Expired Rent

Transaction 18: Depreciation of Shop Equipment
Equipment bought starts to wear out. A portion of the cost of the equipment is included as an expense in the net income calculation for the month.

Depreciation is the part of the cost of a physical asset allocated as an expense to each time period in which the asset is used.

The simplest way to calculate depreciation is to divide the cost by the estimated life of the asset.

E.g. assume the depreciation for the shop equipment is $19 a month. The owner can make EOP adjustments for a month's depreciation by increasing 'expenses' by $19 and decreasing the asset 'shop equipment' by $19. Now the equipment will show a lower value (book value).

At any point in time the difference between the original cost and the book value is the accumulated depreciation to date.

Transaction 19: Accrual of Interest
The interest assumed on a loan is an expense of doing business during the time between the signing of the note and the payment of the note. Interest accumulates(accrues) over time until it is paid. Loans go under liability, loans payable.

End-of-period Revenue Adjustments

There are few, two of prime importance.

1) Any commissions received has to be accounted for by increasing revenues and increasing the asset accrued revenue/ accounts receivables. (e.g. stocking and selling on behalf of another business)
2) If a business accepts payment for which the services will be provided later, the received cash is accounted for in increased liability as unearned revenue, and will be turned into asset revenue only when the service/ product is delivered.

Net income and its effect of balance Sheet

Case Exhibit 4.22 **Café Revive's Balance Sheet at 31 January 20X2**

CAFÉ REVIVE
Balance sheet
31 January 20X2

Assets		Liabilities	
Cash	$25 192	Accounts payable	$ 6 919
Accounts receivable	$ 550	Loan payable	$ 1 411
GST paid	$ 207**	PAYG tax	$ 310
Inventory	$ 1 350	**Total liabilities**	$ 8 640
Supplies	$ 345		
Prepaid rent	$ 6 000	**Owner's equity**	
Shop equipment	$ 1 081	E Della, capital	$26 085*
		Total owner's equity	$26 085
Total assets	$34 725	**Total liabilities and owner's equity**	$34 725

* $21 750 + $16 880 − $12 545 from Exhibit 4.21.

CAFÉ REVIVE
Comparative balance sheets
31 December 20X2 and 20X3

Assets	31 December 20X2		31 December 20X3	
Current assets				
Cash ($5783 + petty cash $35)	$ 5 818		$ 5 014	
Accounts receivable (net)	7 340		8 808	
Inventory	1 570		1 300	
Total current assets		$14 728		$15 122
Property and equipment:				
Store equipment (net)	$13 500		$10 420	
Total property and equipment		13 500		10 420
Total assets		$28 228		$25 542
Liabilities				
Current liabilities:				
Accounts payable	$ 6 200		$ 7 500	
GST clearing	1 340		231	
Total current liabilities		$ 7 540		$ 7 731
Non-current liabilities:				
Notes payable	$ 5 000		$ 5 000	
Total non-current liabilities		5 000		5 000
Total liabilities		$12 540		$12 731
Owner's equity				
E Della, capital		$15 688		$12 811
Total liabilities and owner's equity		$28 228		$25 542

Working capital = Current assets − Current liabilities
31/12/20X2: Working capital = $14 728 − $7540 = $7188
31/12/20X3: Working capital = $15 122 − $7731 = $7391

Net income = revenues - expenses

The assets on the balance sheet are rearranged, however, to show them in the order of their liquidity, or how quickly the assets can be converted to cash or used up. The net income is included in her capital amount on the 31 January 20X2 balance sheet.

Working capital

A business's working capital is the excess of its current assets over its current liabilities.
Refers to the net resources that managers have to work with (manage) in the business's day-to-day operations. (working capital management).

An appropriate amount of working capital is enough for a business's day-to-day operations and a little more, in case something happens.

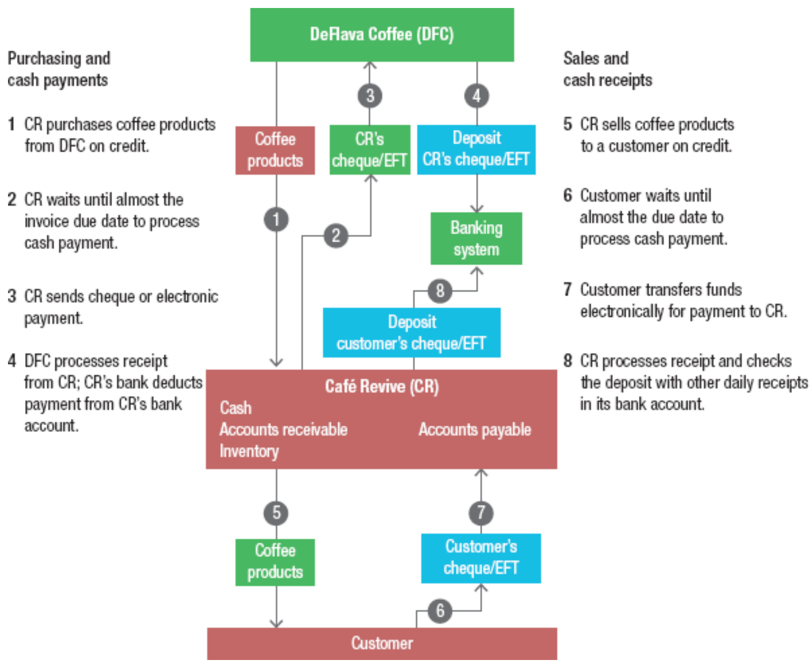
E.g. The extra cash could be useful when buying inventory when it comes at a reduced price, or to cover the lost cash when a customer doesn't pay their account.

If a business has too little working capital, it risks not having enough liquidity.

The two extremes are:

1) Having enough working capital to operate and to handle unexpected needs for cash, inventory or short-term credit; and
2) Having so much excess cash, inventory or available credit that profitability is reduced.

Since, the cash receivable is greatly dependent on the customer, businesses therefore have to encourage their customers to pay early.



Managers control each aspect of the operating cycle to ensure that operating activities are performed in accordance with business objectives.

Internal control structure: a set of policies and procedures that directs how employees should perform a business's activities.

Cash

A business's cash includes money on hand, deposits in bank accounts and other documents that are convertible to cash, such as cheques received from the customers but not yet deposited.

(what is cash ? : anything the bank will accept as a deposit/ simple rule)

Cash is also very easily misplaced as it does not leave a trace when it disappears, that's why internal records prove to be most important for cash.

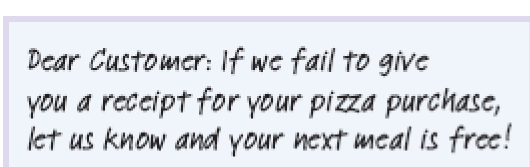
Simple cash controls
To prevent losses:

1) Hire competent and trustworthy personnel,
2) Establish cash controls

We concern ourselves with two categories of cash control:
1) cash receipts
2) cash payments

Controls over Cash Receipts

A business uses internal control procedures for cash receipts to ensure that it properly records the amounts of all cash receipts in the accounting system, and to protect these from being lost or stolen.



1) Use a cash register: managers should make sure that a pre-numbered sales receipt is completed for every sale, and that the salespeople ring up each sale on the register.
→ an employee can still steal cash, by making dummy receipts.
2) If a cheque/ voucher is accepted for payment, the salesperson should make sure that the customer hsa proper identification in order to minimise the likelihood that the bank might not accept it. (Even this procedure is not always adequate).

3) At the end of each employee's work shift, the employee should match the total of the amounts collected against the total of the cash register tape and repost any difference between the two totals to a supervisor.

Some use a (Coles) 4) Remove the big notes from the cash registers during a single employee's shift.

Control procedures to safeguard cash from accounts receivable

1. Separation of duties: Someone who doesn't handle accounting records should open the mail.
2. List details: immediately after opening the mail or receiving cash, the employee should list or input all of the details of the money received. Later, if a customer claims to have previously paid a bill, the business can review documentation. If the customer did pay the bill but the money is not deposited because the employee stole the money.
3. Endorsement: employees should ensure each incoming amount is registered at the cash register.(E.g. Ensure that all cash received is placed in the cash register till and the amount entered into the system.)

Final safeguard: it should deposit cash receipts intact daily. I.e., take all the cash earned in one day, and deposit it into a bank.
Helps in 2 ways:
1) keeping a substantial amount of cash with the business overnight, is of great risk. (reduces the odds of theft)
2) the bank deposit records show the business's cash receipts for each day in their statement.

Controls over cash payments

The basic rule for good internal control over cash payments is to have all payments authorised before they are made.

Very small businesses operated by the owner don't really have a need for any additional internal control.

1) The business should pay only for approved purchases that are supported by proper documents. (E.g. a freight receipt showing the evidence that the business received the items it ordered, and the supplier's invoice.) This procedure reduces the chances that the business will pay for either items that it did not want to purchase or items that it has not received.
2) Immediately after the payment, the owner should stamp 'paid' on the supporting documents, along with the date paid and the receipt number.

Bank Reconciliation

A business's bank independently keeps track of the business's cash balance.
Each month the bank produces a bank statement for the business that summarises the business;s banking activities during that month (deposits and payments).

A business can use the bank statement, along with its own cash records, to prepare a bank reconciliation. A business does this to analyse the difference between the ending cash balance reported by the bank in the bank statement.

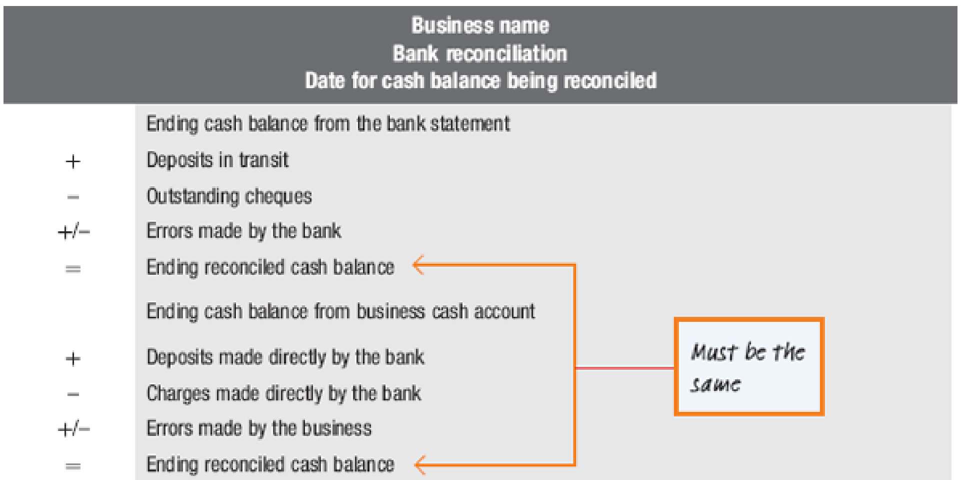
Causes of difference in cash balances

1. Deposits in transit: a deposit in transit is a cash receipt that the business has added to its 'Cash' account but that the bank has not included in the cash balance reported on the bank statement. In case of EFTs the delay is much less.
2. Outstanding or pending payments: could be an amount that the business has paid and deducted from its cash account but that the bank has not deducted from the cash balance reported on the bank statement because the payment hasn't been cleared.

3. Deposits made directly by the bank: bank accounts earn interest on the balance in the account. For these accounts, the bank increases the business's cash balance in the bank's records by the amount of interest the business earned on its account.
4. Charges made directly by the bank: A bank frequently imposes a service charge for managing a depositor's account, and deducts this charge directly from the bank account. Banks also charge for the cost of maintaining the account and other services delivered.
   Bounced cheques recorded as NSF (most NSF s are communicated to the business immediately)
   At the end of the month, the bank lists any service charges and NSF cheques as deductions on the bank statement
5. Errors in the bank or business's records.

The structure of Bank reconciliation

By adjusting the cash balance in each section for the amounts that either are missing or are made in error, the business is able to determine its reconciled (correct) ending cash balance.



Preparing a Bank reconciliation
The cash balance at the end of the month is correct if it includes all of the business's transactions and events that affected cash.

Upper section: what cash transactions have taken place that the bank doesn't know about

Lower section: What is not included in calculating the business's ending cash balance but should be (interest/ bank service charges)

We need two items:

(1) The bank statement for the month being reconciled, along with all of the items returned with the statement; and
(2) The business's cash records.

Steps in preparing a bank reconciliation

1) Set up the proper form for the bank reconciliation. (fill in the information you already know)
2) Look for deposits in transit
3) Look for outstanding transfers payments or cheques.
4) Identify any deposits that were made directly by the bank but that are not included as increases in the business's cash account
5) Identify the charges that were made directly by the bank but that are not included as decreases in cash on the business's records.
6) Determine the effect of any errors (can do this in tandem with the other steps)
7) Complete the bank reconciliation, the amount should now be the same
8) Journalise and enter post reconciliation entries.

Additional controls over cash

1) The business should ensure that any deposit in transit listed on the bank reconciliation for the previous month is listed as a deposit on the current bank statement.

2) The business should investigate any outstanding cheque from the previous month that is still outstanding for the current month.

Petty cash fund

Although paying electronically serves as an automatic record keeper, but for very small amounts businesses will often not use EFTs
Is a specified amount of money under the control of one employee that is used for making small cash payments for the business.
(a small system (with $50 or so) that allows marked withdrawals, which are tagged by use but not by receipt/ could be managed by a petty cashier as well).
Show on balance sheet

Reporting the cash balance on the balance sheet

Cash: the first asset listed on the balance sheet (most liquid asset)

1	The 31 January reconciled cash balance in its bank account	$25 182.00
2	The amount in its petty cash fund	**55.00**
	Total cash balance on 31 January 20X2	**$25 239.00**

Accounts receivables

Businesses make sales on credit for 3 reasons:
1) Selling on credit may be more convenient than selling on cash. (it is common for customer to pay for goods after having received them, so when ordering credit might make more sense)
2) Managers believe that offering credit will encourage customers to buy items they might not otherwise purchase.
3) Is to signal product quality, by allowing customers to see and use the goods before paying for them.

Credit sales is not the same as credit card sales

If you use a credit card to pay for goods that are sold to you, it's the credit company that is extending credit to you (visa, mastercard), not the business that sold you the goods.

That's why credit card sales are sometimes referred to as instant cash.

The decision to extend credit

If account receivables increase the sales of a business, why not decide to grant all customers credit ?
2 disadvantages:
1) Having accounts receivables requires significant management effort (managers must make credit investigations, prepare and send bills, and encourage payments from customers)
2) There is some chance that the customer will not pay.

If the profits gained from extending credit outweigh the managerial/human cost and marginal losses (due to customers not paying) then one should do so… One can use CVP analysis to determine this.

Simple controls over accounts receivables

1) Before extending credit, a business should determine that a customer is likely to pay. The risk of not collecting customers' accounts is greatly reduced if a business extends credit only to customers who have a history being financially responsible
   Can use the name of bank account/ balances/ list of assets/ list of debts/ CC account numbers and amounts owed…
2) Credit customers agree to accept certain payment terms '2/10' (a 2 % cash discount will be granted if they make payment within 10 days, and that, if they do not make payment, then the full amount is due in 30 days), 'net/30'
3) Businesses should monitor its total accounts receivables balance. If the balance increases, they should investigate the reasons for the increase.

Accounts receivables balance

"Expect to receive": the amount a business shows on its balance sheet as accounts receivable is the total owed by customers (gross amount) less an amount that it expects to be uncollectible,
GAAP refers to this as the net realisable value of accounts receivable.

A business shows its accounts receivable at their net realisable value because, as part of an analysis of its liquidity, financial statement users are concerned with the business's ability to turn accounts receivable into cash.

How to estimate amounts expected to be uncollectible ?

- Based on past experiences.
- ageing analysis of the accounts receivable (the older a receivable is, the more likely it is to be uncollectible).

A business's inventory is the merchandise being held for resale.

A business can use a perpetual inventory system or a periodic inventory system.

Why is accounting of inventory important ?

1) Selling inventory is a primary way retail or manufacturing businesses get cash from operating activities.
2) A business usually expects to turn over its inventory (purchase it, sell it and replace it with newly purchased inventory), if inventory sales slow down, investors and creditors may become concerned about the business's ability to continue to sell the inventory at a satisfactory profit.
3) Can be stolen, lost or lose value over time.

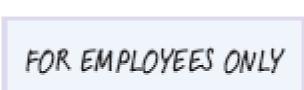
Simple Inventory controls

1) Control the ordering and acceptance of inventory deliveries

Purchase order: a document authorising a supplier to shop the items listed on the document at a specific price. It is signed by an authorised person.

Keep list of purchase orders

2) Check the quantity and condition of every order received.
3) Establish physical controls over inventory while the inventory is being held for sale.
   3a) restricting access to inventory
4) Make sure that inventory records are accurate.



"By physically counting inventory, it can determine the accuracy of its inventory records and estimate losses from theft, breakage or spoilage"

** Most businesses account for inventory at the end of their financial year.

Determining the cost of ending inventory

A business shows its inventory on its ending balance sheet as a dollar amount.

1) The relationship among cost of goods available for sale, cost of goods sold and year-end inventory;

	Beginning inventory for January	50 packs
+	January purchases	**240 packs**
=	Goods available for sale during January	**290 packs**
–	Goods sold during January	**(240)** packs
=	**Goods in inventory on 31 January 20X2**	**50 packs**

A business may use several methods to calculate the dollar amounts for inventory and cost of goods sold.

1a) specific identification; first in, first out (FIFO)
1b) last in ,first out (LIFO)
1c) weighted average

ibit 6.8 Café Revive's Inventory Information

Beg. inventory, 1 Dec.	50 packs	50 @ $26 per pack = $1 300
Jan. purchases	**240 packs**	190 @ $26 per pack = 4 940
		50 @ $27 per pack = 1 350
Cost of goods available for sale	290 packs	7 590
Dec. sales	**(240) packs**	
End. inventory, 31 Dec.	**50 packs**	50 packs @ $27 1 350

The Specific-Identification method

Allocates costs to cost of goods sold and ending inventory by assigning to each unit sold and each unit in ending inventory the cost to the business of purchasing that particular unit.

(usually through a computer system)

Other methods to determine inventory at end and cost of goods sold

FINANCIAL STATEMENT EFFECTS 1

Increases current assets and total assets on balance sheet
Increases revenues, which increases net income on income statement (and therefore increases owner's equity on balance sheet). Increases cash flows from operating activities on cash flow statement

1
2

FINANCIAL STATEMENT EFFECTS 2

Decreases current assets and total assets on balance sheet
Increases expenses (cost of goods sold), which decreases net income on income statement (and therefore decreases owner's equity on balance sheet)

3

FINANCIAL STATEMENT EFFECTS 3

Decreases current assets and total assets on balance sheet
Increases expenses (cost of goods sold), which decreases net income on income statement (and therefore decreases owner's equity on balance sheet)

FIFO method

The cost of inventory on hand at the end is valued at the last price paid as inventory that was purchased at the earlier prices would have been sold and recorded as the cost of goods sold.

LIFO method

Goods purchased last (most recently) are sold first. This method may result in unsold stock becoming out of date, but means that the cost of valuing inventory on hand at the end is usually at the earlier price, while costs of goods sold throughout the period are valued at most recent prices.

Weighted average

Requires the unit price of inventory to be calculated and updated after each transaction. The value is determined by recalculating the average price.

E.g. if on 1st Feb, there are 50 units at $26.17 worth $1309, and the purchases another 20 units at $27 worth at $27 worth $540, then the value of each unit would be calculated as:
1309 + 540 = 1849, 50 + 20 = 70, unit value = 1849/70 = $26.41 per unit.

2) The concept of cost flows

Accounts payable

Are the amounts that a business owes to its suppliers for previous credit purchases of inventory and supplies.

1) Often more convenient than purchasing with cash.
2) Delay paying for purchases and by doing so, to obtain a short-term ‘loan’ from the supplier. “Small businesses are often short on cash, and find it difficult to pay for their purchases immediately.”

Simple Controls over accounts payable

3 concerns:

1) Giving too many employees the authority to place orders for business purchases makes it more difficult for managers to coordinate and monitor credit purchases, and makes it easier for untrustworthy people to exploit the business. (limit the number of employees who have authority to make business purchases)
2) A business monitors the timeliness of its payments by having an employee keep track of the credit terms of each account payable, if discounts are available the business should take advantage of that as well.
3) Managers are concerned about a business’s total dollar amount of accounts payable because, in the very near future, the business will need to use its cash to pay its liabilities.
   If the accounts payable are large compared to the business’s current assets, the business may experience liquidity problems.

Accounts payable Balance

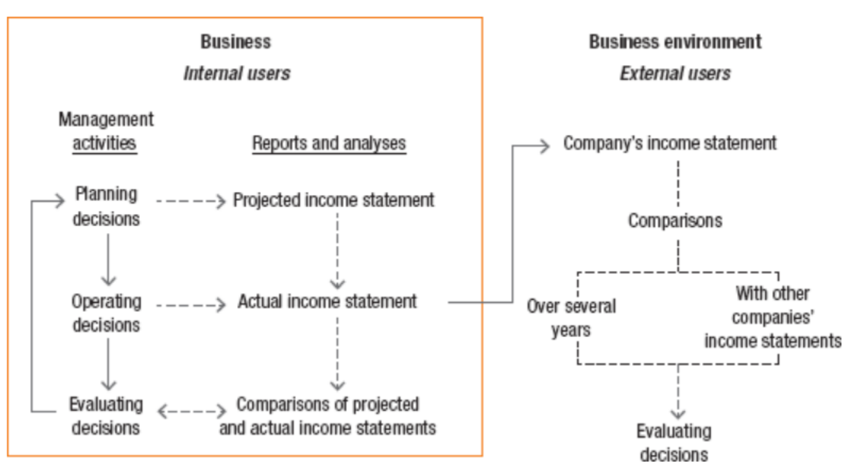
How aggressive should a business be in managing its working capital ? (Repeated calls to customers, continue to tell suppliers, that cheque is in the mail to delay payment)

E.g.
A business that signs a purchase agreement, even though it knows that it will make suppliers wait an additional 30 or 60 days before paying for the goods, can be viewed as untrustworthy, not as a shrewd financial planner.

Introduction to the Income statement (also ref. to as P&L statement, i.e., profit and loss statement)

Net income = revenues - expenses

Uses of a Business’s Income Statement



The income statement shows the relationships between managers’ decisions and the results of those decisions.

This information helps to evaluate how well the business’s managers have ‘managed’ during the period.

[remember every sale generates a sale invoice to document the transaction and the amount of the sale.]

A lot of the internal accounting information never makes it to the external user:
1) Lack of incentive: could hurt sales, if one reveals margins on sales
2) Competitive advantage
3) Too much volume(a lot of businesses will produce hundreds of accounting reports per year to have all of those in a single report would be exceedingly confusing)

Measuring Financial performance: The Income Statement

A business uses these revenue and expenses accounts for only one accounting period to record the effects of its transactions on its net income: **temporary accounts**.

Asset, liability and owner's capital accounts: **permanent accounts** (because these are used for the life of the business to record the effects of its transactions on its balance sheet).

Businesses can often have hundreds of assets and liabilities and therefore, they either used computerised accounting software, or a more complex manual accounting system, that involves journals, ledgers, debits and credits, and different forms of accounts.

The income statement of a retail business has two parts (usually):

1) **Operating income section** (all the revenues earned and expenses incurred in the primary operating activities of the business):
a) revenues;
b) cost of goods sold;
c) operating expenses.

2) **Other items** include any revenue and expenses that are not directly related to the primary operations of the business (E.g. interest revenue and interest expense)

CAFÉ REVIVE
Income statement
For the month ended 31 January 20X2

Sales revenues – coffee gift packs (net)		$12 000.00
Cost of goods sold		**(6 240.00)**
Gross profit		$ 5 760.00
Sales revenues – cups of coffee (net)		4 880.00
Interest revenue		25.00
		19 665.00
Operating expenses:*		
Selling expenses	$5 241.50	
General and administrative expenses	1 052.50	
Financial expenses^	46.00	
Total operating expenses		**(6 340.00)**
Net income		**$ 4 325.00**

Defining and Classifying Revenues/Income
Revenue is recognised at POS or delivery of service.

bit 7.3 Café Revive's Sales Invoice

Sales invoice Café Revive					
INVOICE: 0006			**Cash**		
Sold to: Beau Flower Shop			**Credit**		
Acct: 0103					
Date	**Description**	**ID**	**Number of units**	**Unit price**	**Amount**
06/01/20X2	Coffee gift packs	0122	10	$50.00	$500.00
				GST (10%)	50.00
				Total	**$550.00**
Thank you for your business.					

Sales Revenue
[source document for a sale, is a sales invoice]

Effects on financial statement

1) Increases accounts receivables under assets on balance sheet
2) Increases sales revenue, which increases on income statement (and therefore increases owner's equity on balance sheet)

As the cost of goods sold (an expense) increases, both net income and owner's equity decrease.

Assets		=	Liabilities	+	Owner's equity		
Accounts receivable			GST collected		Net income		
					Sales revenue	–	Expenses
Bal.	440		190		1 500		
6/1/20X2	**550**		**50**		**500**		
Bal.	**990**		**240**		**2 000**		

Assets		=	Liabilities	+	Owner's equity		
					Net income		
					Revenue	–	Expenses
Inventory							*Cost of goods sold*
Bal.	$5 460						$ 780
1/6/X2	**–260**					–	**+ 260**
Bal.	**$5 200**					–	**$ 1 040**

How sales policies(encourage sales) affect income statement reporting
Types;

1) Discount policies
   A quantity (or trade) discount is a reduction in the sales price of goods or a service because of the number of items purchased or because of a sales promotion.
   Before starting use CVP
   A **sales discount** is a percentage reduction of the invoice price if the customer pays the invoice within a specified period.
   Sales discount is also called a cash discount
   '5/7', 'n/31' → 5 is the percentage discount over 7 days in the discount period. The terms n/31 means the total invoice price is due within 31 days of the invoice date.
   Thus, '5/7 n/31' means that 5 % discount is allowed if the invoice is paid within 7 days; otherwise, the total amount of the invoice is due within 31 days.
   The invoice must reflect these terms

2) Sales return policies

When a customer buys merchandise, it is to be assumed that both the business and customer have it so that it's not damaged.
A business can do 3 things if their customer discovers a fault in their product;

1) Give them a future allowance of the invoiced price

Assets	=	Liabilities	+	Owner's equity		
Cash		GST collected		Net income		
				Sales revenue	−	Expenses
−55		−5		−50		

2) Exchange by replacement
3) Refund after return
   A business can grant a sales return or a sales allowance, it has to prepare a source document, **credit demo** (doc that lists information about a sales return or allowance), Includes: customer's name and address, how the OG sale was made, the reason for the sales return or allowance
   Also used to keep track of and measure external-failure-costs - those stemming from customer dissatisfaction.

3) Sales allowance policies

Revenues from other sources
Have an other(s) column that accounts for payments that are rarely unique, such as commission and interest on investments and gains on the sale of assets… if redundant, get 'em a column of their own.

Defining and classifying expenses

Cost of goods sold

A major expense for retail businesses.
The business's calculations depend upon how their inventory is structured:

- Perpetual inventory system
  Keeps a continuous record of the cost of inventory on hand and the cost of inventory sold. When a business purchases an item of inventory, it increases the asset 'inventory' by the invoiced cost of the merchandise, plus any freight charges (sometimes called transportation-in) it pays to have the inventory delivered.

  When selling merchandise, it reduces inventory and increases the cost of goods sold.
  Barcode read at retail stores logs all of this in their computer automatically.

  Before deciding to use a perpetual inventory system, managers should evaluate the costs of various systems and technology, employee training and the other support needed to operate it. In some cases the costs will not support the setting up of a perpetual inventory system.

Inventory	
Bal 1/1	$ 1 360
2/1	−$ 780
4/1	+$ 4 940
6/1	−$ 260
3/1–31/1	−$5 200
Bal 31/1	$1 350

Cost of inventory purchased

Cost of goods sold	
2/1	+$ 780
6/1	+$ 260
3/1–31/1	+$5 200
Bal 1/31	$6 240

Cost of inventory sold

Perpetual system is most widely used

- Periodic inventory system
  Does not keep a continuous record of the inventory on hand and sold.
  Instead, determine the inventory at the end of each accounting period by physically counting it.

  This way the only time the business gets to know the cost of its inventory is when it counts it.

  1. A lot of businesses are small, and find it more convenient to manage without a perpetual record.
  2. Some businesses sell a high volume of similar, inexpensive goods.

  STOCKTAKE CLEARANCE SALE!!! WE'D RATHER SELL IT THAN COUNT IT!

  This physical count taking, is called stocktaking (difficult and time consuming task / prone to error and manipulation)

$$\text{Cost of goods sold} = \overbrace{\text{Cost of beginning inventory} + \text{Cost of net purchases}}^{\text{Cost of goods available for sale}} - \overbrace{\text{Cost of ending inventory}}^{\text{Cost of goods not sold}}$$

  The beginning inventory cost is the same as the last fiscal year's ending inventory cost.

  Net purchases: amount of merchandise purchases (invoice cost and transportation-in) is adjusted (reduced) for purchases returns, allowances and discounts.

Operating expenses
Expenses that a business incurs in its day-to-day operations

Assets	=	Liabilities	+	Owner's equity Net income Revenue	−	Expenses
Cash						*Advertising expense*
− $121 (GST paid +11)					−	+ $110

A business may divide the section of its operation expenses into 3 parts:

1) Selling expenses
   Include expenses related to the sales activities of a business.
   E.g. salaries expense, advertising expense and delivery expense (transportation-out) for merchandise sold.

2) General and administrative expenses
   Used for the general management of a business.
   E.g. office salaries expense, insurance expense and office supplies expense.

3) Financial expenses
   Relate to the financing of the business and its operations and debt collection
   E.g. bank charges, interest expense, discounts allowed to customers, bad debts and debt collectors' fees.

Some Operating expenses may involve both sales and general management of a business,
Consider utilities.
E.g. suppose a business keeps telephones at sales desks and office desks, and both sales areas and office spaces are provided with electricity. Then the business allocates part of the total expense to selling

expenses and remainder to general and administrative expenses, based on an estimate of how much is used for each activity.

A lot of business expenses are related to waste, initiatives to reduce wastage of water, installing energy-efficient light globes and increasing the use of recycling, can reduce costs, and thus increase profitability, while at the same time improving a business;s environmental credentials.

Evaluating the income statement using ratios
Investors use the income statement to help judge their return on investment and creditors use it to help make loan decisions.
Financial statement users evaluate a **business's risk** (an estimation of the business's capacity to earn a satisfactory profit), **operating capability** (a business's ability to continue a given level of operations) and **financial flexibility** (a business;s ability to adapt to change in the future / will be able to take advantage of a business opportunities, such as introducing a new product or building a new warehouse).

Ratios
To analyse a business's operating performance, managers and external users may perform ratio analysis.
Ratio analysis consists of calculations in which an item on the business's financial statements is divided by another related item.
Groups that specialise in financial analysis calculate and publish ratios for many businesses and industries.

Profit margin (ak/as return on sales)

$$\text{Profit margin} = \frac{\text{Net income}}{\text{Net sales}}$$

Usually reported as a percentage
If a business's profit margin is higher than that of previous years, or higher than that of other businesses, it usually means that the business is doing a better job of controlling its expenses in relation to its sales.

Gross profit percentage (ak/as gross profit margin)

$$\text{Gross profit percentage} = \frac{\text{Gross profit}}{\text{Net sales}}$$

Usually ranges from 20 to 60 %
Some businesses use a pricing strategy of offering lower selling prices to increase their sales volume, thereby increasing their total gross profit.
E.g. If GPP is 48 percent, then that would imply that for every dollar in sales, 48 cents is left to cover operating expenses, other expenses and to increase the net income of the business.

When comparing businesses:
- A higher profit margin percentage, would mean that the business was more successful at generating net income from its revenues than its competition.
- A higher gross profit percentage would mean that for the same sale, there was more profit compared to competition.

Statement of comprehensive income
AASB requires that entities present a statement of comprehensive income, which is effectively the income statement plus all other comprehensive income.

Other comprehensive income 'comprises items of income and expense' that are not recognised in profit or loss as required or permitted by other Australian Accounting Standards.

Written under AASB 101, para 7

Example 1 **Income Statement and Statement of Comprehensive Income in One Statement**

Statement of comprehensive income	20X1 ($000s)
Revenue from continuing operations	**2 100**
Other income	420
Raw materials and consumables used	(735)
Employee benefits expense	(525)
Depreciation and amortisation expense	(210)
Impairment of goodwill	(42)
Other expenses	(252)
Finance costs	(105)
Profit before income tax	**651**

Note: Figures used are for illustration only.

Linking profit to owner's equity and closing the accounts

A business owner's equity is affected by the owner's investments and withdrawals, as well as by the business's revenue and expense transactions.

An income statement does not include all the activities that affect owner's equity, for this purpose we require a statement of changes in owner's equity.

A business presents this statement to 'bridge' its income statements and the amount of owner's capital it reports on its balance sheet.

Owner's withdrawals are recorded directly in the owner's capital account, withdrawals are not expenses, they are disinvestments of assets by the owner.

Statement of comprehensive income	20X1 ($000s)
Profit for the year	462
Other comprehensive income:	
Fair value movements on financial assets available-for-sale	(126)
Income tax relating to components of other comprehensive income	(42)
Other comprehensive income for the year, after tax	**42**
Total comprehensive income for the year	**504**

Closing the temporary accounts
Temporary accounts: Accounts used for one accounting period to record the effects of a business's transactions on its net income (revenues and expenses)

Closing entries are entries made by a business to transfer the ending balances from its temporary revenue and expense accounts into its permanent account for owner's capital

A business uses closing entries so that when a new accounting period starts:

1. The revenue and expense amount have 0 balances, and no longer contain the amounts of any transactions from previous periods.
2. The accounting system keeps the revenue and expense transactions of the current period separate from the revenue and expense transactions of other periods.
3. The permanent (balance sheet) accounts are up-to-date (net income has been added to the previous balance of the owner's capital account).

	Owner's equity				
	Owner's capital	+	Net income		
	E Della, capital		Revenues	–	Expenses
Balances prior to closing	$21 750		$16 905	–	$12 580
Summary closing entry	+$ 4 325		–$16 905	–	–$12 580
Balances after closing	$26 075		$ 0		$ 0

Business issues and values: Corporate Social Responsibility (CSR),
Having casual workers instead of full-time workers significantly enhances the financial flexibility of an institution, as they can avoid paying for paid leaves and holiday pay.

"There are but two ways of paying debt - increase of industry in raising income, increase of thrift in laying out".

~ Thomas Carlyle

Why the balance sheet
Provides information that helps internal and external users to evaluate a business's ability to achieve its primary goals of earning a satisfactory profit and remaining solvent.

An income statement presents a summary of a business operating activities for an accounting period: revenues earned, expenses incurred and the net income that resulted.
It reports a business's actions over a period of time, representing the flow of its operating activities.

The balance sheet presents a business's financial position on a specific date, allowing users to 'take stock' of a business's assets, liabilities and owner's equity on that date.

Questions such as, 'What types of resources does the business have available for its operations?' and, 'what are the business's obligations ?'

Why do users need both the balance sheet and the income statement
Trying to determine whether a business could earn a satisfactory profit, we need to know,

1) Does the business have the assets, liabilities and owner's equity (ingredients) needed to earn a profit
2) Had the business been able to use its resources in the past to earn such a profit

Cost-Volume-Profit (CVP) Analysis, Budgeting and the Balance Sheet

- The amount of inventory on hand grows at a faster rate than sales from year to year, the business probably over-estimated both sales and its need to make inventory purchases.
- If the amount of inventory is decreasing as a proportion of sales from year to year, the business may have under-estimated sales and the need to make additional inventory purchases.

CSR disclosure is also becoming an important part of the balance sheets of businesses.

Balance sheets are prepared according to GAAP standards.

The Accounting Equation and the Balance Sheet

Idea: economic resources = claims on economic resources
⇒ Assets = liabilities + owner's equity

Assets		=	Liabilities		+	Owner's equity			
						[Owner's capital		+	(Revenues − Expenses)]
Cash			Accounts payable			E Della, capital			
31/1/X2 Bal	$25 182		31/1/X2 Bal	$ 6919		31/1/X2 Bal	$26 075		
Accounts receivable			Loan payable						
31/1/X2 Bal	$ 550		31/1/X2 Bal	$ 1400					
Inventory			PAYG payable						
31/1/X2 Bal	$ 1350			$ 310					
Supplies			GST collected	$ 1728					
31/1/X2 Bal	$ 345								
Prepaid rent									
31/1/X2 Bal	$ 6000								
Shop equipment									
31/1/X2 Bal	$ 1081								
GST paid									
31/1/X2 Bal	$ 1935			$10 368			$26 075		
	$36 443		=			$36 443			

Note: liability and owner's equity items are listed below the assets, in the report format
→ common, as it is easier to show the accounts vertically on a standard piece of paper

The account form lists components in an accounting equation format-assets on the left and liabilities and owner's equity on the right.

Some businesses maintain classified balance sheets, show subtotals for assets, liabilities and owner's equity in related groupings

A business decides on these classifications based on the type of business it is.

Assets
Physical: land, buildings, …
Non-physical: legal obligations as receivables.

Current assets: are cash and other assets that the business expects to convert into cash, sell or use up within one year.

(1) Cash:
    Incl. cash in hand, banks, safes…
(2) Marketable securities;
    Also called, temporary investments or short-term investments (government bonds, capital stock of companies) / an investment of a year or less.

    This is done when a business has cash it won't need in the immediate future.
(3) Receivables;
(4) Inventory; and
(5) Prepaid items:
    Insurance, rent, office and shop supplies

Present these items in order of their liquidity.

CAFÉ REVIVE
Balance Sheet
31 January 20X2

ASSETS		
Current assets:		
Cash	$25 182	
Accounts receivable	550	
Inventory	1 350	
Supplies	345	
Prepaid rent	6 000	
GST control	207	
Total current assets		$33 634
Property and equipment:		
Shop equipment (net)	$ 1 081	
Total property and equipment		1 081
Total assets		$34 715
LIABILITIES		
Current liabilities:		
Accounts payable	$ 6 919	
PAYG	310	
Loan payable	1 400	
Interest payable	11	
Total current liabilities		$ 8 640
Total liabilities		$ 8 640
OWNER'S EQUITY		
E Della, capital		$26 075
Total liabilities and owner's equity		$34 715

Non-current assets
Financial assets such as notes receivable, government bonds, bonds and share capital of companies, and other securities (k/as non-marketable securities)
Must hold an investment for more than a year to classify it into non current.

Property and equipment
Includes all the physical(land, buildings, equipment and furniture), long-term assets used in the operations of a business.
Referred to as fixed assets or operating assets.
Land is listed on the balance sheet at its original cost
Remaining assets are listed at book values (og cost - accumulated depreciation).
Every year, the business uses a portion of the asset, but the entire asset still continues to physically exist in the business.
What the business reports (book value) on its balance sheet represents the portion of the property or equipment that the business has not yet used.

Intangibles
Assets that do not have a tangible or physical substance, but the ownership of which entitles the owner to future economic benefits.
Intellectual property : patents; trademarks; copyright; management rights; purchased goodwill; licences and software.

Liabilities
Are economic obligations of a business

Current liabilities
Are obligations that the business expects to pay within one year by using current assets

1) Accounts payable (amounts owed to suppliers) and salaries payable (amounts owed to employees);
2) Unearned revenues (advance collections from customers for the future delivery of goods or performance of services), and
   E.g. If a customer pays a business in advance for rent or for some service, the business owes the customer the future use of the rental space or service, and it records the liabilities as unearned rent or unearned fees.
3) Short-term loans and notes (and interest) payable.

Provisions are liabilities of uncertain timing or amount. (E,g, provisions for long-service leaves or for bad debts)

Non-Current liabilities
Also called long-term liabilities, are obligations that a business does not expect to pay within the next year.

Includes: long-term notes payable, mortgages payable and bonds payable.

Owner's Equity
Is the owner's current investment in the assets of the business.
For sole proprietorships, the balance sheet lists the total ending owner's equity in a single capital account.
Companies and partnerships show it differently

SCHEDULE A
CAFÉ REVIVE
Statement of Changes in Owner's Equity
For month ended 31 January 20X2

E Della, capital, 1 January 20X2	$22 000
Add: Net income	4 325
	$26 325
Less: Withdrawals	(250)
E Della, capital, 1 January 20X2	$26 075

Using the Balance sheet figures for Evaluation
A balance sheet serves as a tool to evaluate the performance of the business for the manager.
A manager knows that the balance sheet affects its ability to get a bank or attract new investors, as external users will also be seeing this.

Short-term creditors are mostly interested in a business's short-term liquidity
Long-term creditors are concerned with whether their interest income is safe, and whether the business can continue to earn income and generate cash flows to meet its financial commitments
Potential investors are interested in 'solid' business - that is, businesses whose financial statements indicate stable earnings (and so a steady return).
Newer businesses that may earn higher income (and so a higher return), but have more risk.

Evaluating liquidity
External users assess how well a business manages its liquidity by studying its working capital

Current ratio
Shows the relationship between current assets and current liabilities,

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

More useful than working capital as a measure for a business's liquidity as the current ratio allows comparisons of different-sized businesses.

Past, people thought a current ratio of 2.0 or 2 to 1 (signifying that a business has twice the amount of current assets as current liabilities) was satisfactory.

Today, users have to pay more attention to industry structure, the length of a business's operating cycle and the 'mix' of the business's current assets.

E.g(s):
If a business has a high proportion of prepaid items within its current assets, it may be in a weak liquidity position because prepaid assets are used up rather than being converted into cash.

If a business has too high a current ratio compared with the ratios of similar businesses in the same industry, this may indicate poor management of current assets.
→ maybe the business keeps too much cash on hand rather than investing its excess cash.

The shorter a business's operating cycle, the less likely it is to need a large amount of working capital or as high a current ratio to operate efficiently.

Quick Ratio (acid-test ratio)
More convincing indicator
Often used by short-term lenders
Only uses the current assets that may be easily converted into cash (quick assets)
Quick assets: cash, short-term marketable securities, accounts receivable and short-term notes receivable, excludes inventory because this may not be sold soon and it may be sold on credit (in either cases it can't be turned quickly), also excludes prepaid items

$$\text{Quick ratio} = \frac{\text{Quick assets}}{\text{Current liabilities}}$$

When there is a poor mix of assets, it will show that a business with a lot of inventory has less liquidity than indicated by its current ratio.

The current ratio wont show this because it includes inventory in the numerator.

Quick ratio calculation excludes the inventory, supplies and prepaid rent.

Evaluating Financial flexibility
A business with financial flexibility can revise its purchasing plan to take advantage of temporary reductions in wholesale inventory prices.

Debt-Ratio

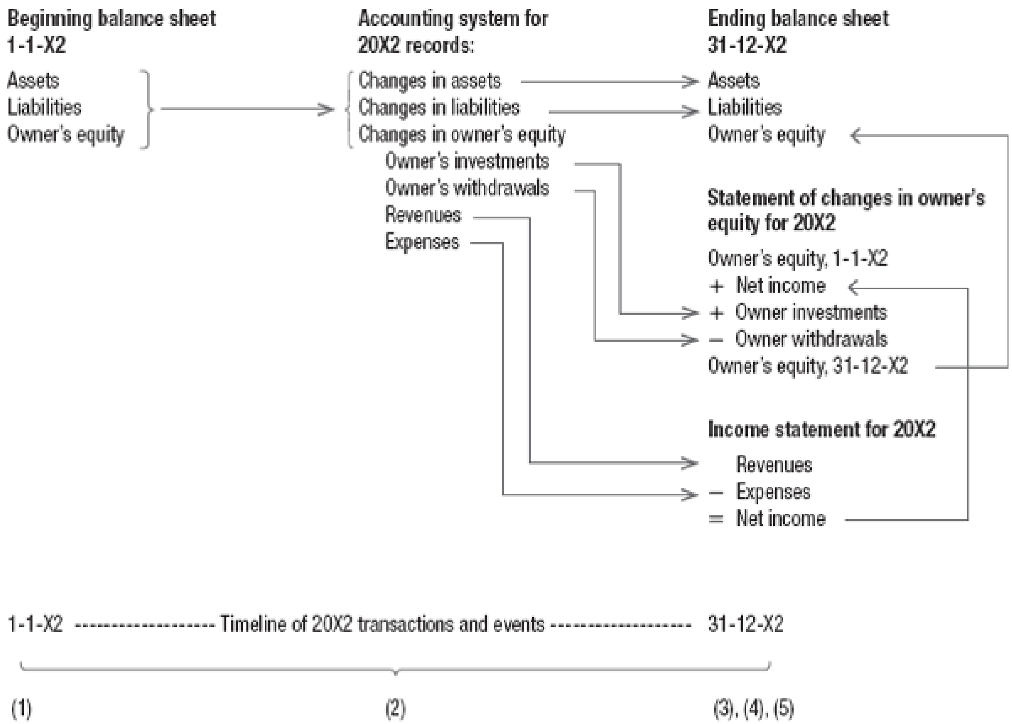
$$\text{Debt ratio} = \frac{\text{Total liabilities}}{\text{Total assets}}$$

Higher debt ratios, mean lower financial flexibilities
→ a higher debt ratio indicates that a business might not be able to borrow money (or may need to pay a higher interest rate to borrow) to adapt to business opportunities.

Creditors prefer lower debt ratios, so that in the event a business declines, then at least it is more likely to be able to pay the interest it owes as well as other fixed costs.

Owners might prefer a higher debt ratio, to some point, when the return earned on assets purchased by the business with the borrowed money is higher than the interest the business has to pay to its creditors.
Total assets contributed by the owner = 100 % - debt ratio

Relationship between the income statement and the balance sheet



Managers use ratios to evaluate performance,

The numerator is an income statement amount showing the 'flow' into or out of the business.

The denominator of each ratio is a balance sheet amount showing the resources used to obtain the 'flow'.

Some denominators are averages, as they want to account for the entirety of the accounting period, not just the point in time when the balance sheet was ordered.

Activities

(1) The beginning balance sheet lists the resources and claims on resources at the start of 20X2.

(2) During 20X2, the accounting system records all 20X2 transactions and events according to GAAP.

(3) An income statement for the period ending 31-12-X2 is prepared and net income is calculated.

(4) A statement of changes in owner's equity is prepared that shows how net income and owner investments and withdrawals affected the 31-12-X2 owner's equity amount.

(5) A balance sheet is prepared that shows the assets, liabilities, and owner's equity amounts for 31-12-X2.