Financial Accounting

Management Accounting

Finance

CHAPTER 1 – Accounting in Action

WORD	*EXPLANATION*
Accounting	An information system that: ***Identifies*** (Selecting economic activities relevant to an entity – selling of a product, wages etc.) ***Records*** (Provide a history of financial activities – events/transactions, measured in $ and cents) ***Communicates*** (Through accounting reports in a standardised way – similar transactions = accumulated, totalled) The economic events of an entity to interested users.
Analysis	Part of ***communication*** that uses ratios, percentages and graphs to highlight trends, relationships.
Interpretation	Part of ***communication*** that explains the uses, meanings and limitations of the data.
Corporate governance	System in which entities are *directed, managed and administered*, which influences a company's objectives setting, risk management and performance optimisation.
Internal users	I.e. Managers who plan, organise and run the business, making decisions through internal reports prepared – includes CFOs, marketing managers. Detailed, frequent info. required to make decisions on a daily basis.
External users	**Investors**, (eg. Shareholders) - use money to buy or sell shares. **Creditors** (eg. Suppliers, bankers) - use business info. to evaluate risks of lending. **Governmental/regulatory bodies** (eg. ATO) – use info. to determine compliance with rules/laws/regulations.
Sustainability reporting	Reporting/management of non-financial info. Sustainability – "Meeting needs of present without compromising ability of future generations to meet their own needs".
Reporting entity	An entity in which it is reasonable to expect the existence of users who depend on financial statements for info. to enable economic decision making.

GENERAL NOTES

Purpose of accounting

- To assist internal or external users of the information in making decisions about allocating scarce resources.

- Assists users in understanding where an entity **has been** by analysing past performance, **where it is** by its current financial position, and **where it is likely to be** in the future → helps MAKE INFORMED DECISIONS (about expansion, production etc.)

Corporate governance – enhancing financial reporting

- Involved with decision making, aligning management with shareholders.
- Good corporate governance = increased transparency, disclosure of info. = enhance reputation, prosperity of business, potential investment.
- Reasons for corporate governance:
  1) Increased number of small investors.
  2) Market globalisation, increased competition between entities.
  3) Rapid growth of accessible info.
- Important because of ***agency theory*** – delegation of shareholder's decision rights and business' daily operations onto management = separation of ownership and control = corporate governance ensures effective monitoring of business activities, ensuring interests of management are aligned with shareholders.
- Important to larger entities with larger separation of owner/manager control, but relevant to smaller businesses and any organisations with shareholders as well.
- ASX released optional Corporate Governance Principles & Recommendations for entities to follow, including:
  1) **Promoting ethical/responsible decision making** – companies should adopt code of conduct.
  2) **Safeguarding integrity in reporting** – establishing audit committee of independent directors = more effective monitoring of firm performance.
  3) **Respecting shareholder rights** – promotion of communication with shareholders, encouragement of participation at meetings, protection of owners and 'smaller investors'.

Accounting v. Bookkeeping

- Bookkeeping – <u>only</u> involves recording of economic events.
- Accounting – includes not only identifying and recording, but also **communication** *(interpretation/analysis)* of economic events.

Sustainability reporting

- In recent years there has been a requirement of users for ***non-financial information***, specifically that which relates to the community/environment = can contribute to value of entity.

- **Triple bottom line** – measurement of sustainability reporting, includes:
  1) Social bottom line – indicator of how entity deals with employee working conditions, safety, contribution to community services.
  2) Environmental bottom line – indicator of how an entity's products, operations impact on the environment (eg. Greenhouse gas emission, waste).
  3) Economic bottom line – indicator of an entity's profitability and business strategy i.e. traditional reporting of financial info.

Benefits of sustainability reporting include:

1) Increased loyalty from customers, employees and investors through brand/reputation/awareness of social responsibilities.
2) Increased investment by socially responsible investors.
3) Reduced risk of backlash if acting irresponsibly.

Disadvantages of sustainability reporting include:

1) Lack of benchmarks by which to assess measure of sustainability – however, **Global Reporting Initiative (GRI)** has pioneered a framework which develops benchmarks/guidelines, including:
   a) An entity's impact on human rights.
   b) An entity's environmental impact.
   c) A measure of decent labour practices/work.
2) It is difficult to quantify non-financial info.
3) Extra costs in gathering non-financial info.

Regulation of accounting

- As accounting has evolved, and entities have grown in size and complexity, Generally Accepted Accounting Principles **(GAAP)** have been developed to guide accounting practices and procedures.
- Australia has today adopted accounting standards consistent with those issued by the International Accounting Standards Board **(IASB),** as is the current trend in global standards.
- Given the increased regulation and standards, a framework needed to be developed that provided a conceptual basis for accounting standards, which would:
  1) Develop consistent and logical standards.
  2) Provide better guidance to accountants.
  3) Enable users to better understand financial info.

The AASB (Australian Accounting Standards Board) Australian Conceptual Framework (ACF)

- The *Framework* is a coherent system of interrelated objects/fundamentals that serve to solve accounting problems. It has three components:

SAC (Statement of Accounting Concepts) 1 – Defining a reporting entity

Criteria for definition:

1) **Separation of management from economic interest** – greater spread of ownership, greater separation of owner's from management = more likely users will depend on general-purpose financial statements (refer to def. above).
2) **Economic/political importance/influence** – great the economic/political influence/importance = more likely dependant users.
3) **Financial characteristics** – larger size of entity, greater allocation of resources to an entity = more likely dependant users.

SAC 2 – Determining which entities should prepare general-purpose financial statements

Key questions to ask when determining:

- Does the entity need the information?
- Do they have the power to get it?

If yes = dependant user group = **reporting entity.**

- Assumed includes government departments, public companies, large proprietary companies.
- Doesn't include sole traders, partnerships and small proprietary companies.

NOTE: Definition is important so as to determine reporting entities, who will know to make general purpose financial statements publicly available so that dependant users can access info. for decision making.

Step 3 – Objectives of financial reports, development of assumptions/qualitative characteristics of financial info., the elements of reporting, recognition, measurement of those elements i.e. ***Actual Framework***

Objectives of financial reports include:

1) Providing info. about the financial position, performance and cash flows of an entity – useful in decision making.
2) Showing results of accountability of management for the resources entrusted to it – i.e. how well management operated on behalf of the owners.

Assumptions of financial reports:

1) Monetary unit – only transactions which can be expressed in terms of money are included in accounting records = enables quantification of economic events.

- Important part is the assumption that the unit of measure remains constant over time – however, difficulty because currency does not remain constant.

2) Economic entity – the activities of the entity should be kept separate and distinct from the activities of the owner and all other economic activities.

- **Three** types of entities:
  1) Proprietorship – A business owned by one person, who is often the manager and owner of the business – no legal distinction between business and owner, as he receives profits and suffers losses, but accounting records should nevertheless be kept separate.
  2) Partnership – A business owned by two or more people, who have unlimited personal liability for debts of business – nevertheless, partnership affairs should be kept separate from personal activities.
  3) Company – A business which divides ownership into shares and is recognised under the corporations law. Shareholders enjoy limited liability i.e. are not responsible for debts. As such, the entity is usually kept separate from owners/shareholders.

Basic accounting equation – five elements

A = L + OE (I + K – E - D)

A – Assets

Characteristics:

- Resources controlled by an entity.
- Ability to provide future economic benefit.
- As a result of a past event/transaction.

L – Liabilities

Characteristics:

- Present obligation of an entity.
- As a result of a past event/transaction.
- Expected to result in an outflow of resources from the entity which previously embodied economic benefits.

OE – Owner's Equity (Net assets, proprietorship)

- Residual interest in the assets.
- After liabilities have been deducted.

I – Income (Revenue) – increasing OE

- Increases in economic benefits during the accounting period.
- In the form of an inflow of assets, or decrease in liabilities.
- Result in an increase in equity.
- Other than those relating to contributions by equity participants – a.k.a. **K – Capital contributions =** assets the owner puts into the business.

E – Expenses – decrease OE

- Decreases in economic benefits during the accounting period.
- In the form of an outflow of assets, or incurrence of liabilities.
- Result in a decrease in equity.
- Other than those relating to distributions to equity participants – a.k.a. **D – Drawings** = withdrawals of assets, usually cash, for personal use.

Note: If income exceeds expenses = **Profit.** If expenses exceed income/revenue = **Loss.**

Recognition of the elements

For assets and liabilities, two other criteria have to be met in order for them to be recognised and recorded in financial statements:

1) **Probability** – item is recognised if 'it is <u>probable</u> that any future economic benefit associated with the item will flow to or from the entity' i.e. more likely than less likely, not absolute certainty.

2) **Reliably measured** – item is recognised if 'it has a cost/value/$ figure that can be measured with reliability i.e. if item arises from a transaction and hence, possesses a cost.

If an item satisfies the above criteria, it is recorded into the financial statements, which include:

1) **Income statement –** presents income and expenses for a period of time, and resulting profit/loss.
2) **Statement of changes in equity** – changes in owner's equity for a specific period of time.
- First, beginning owner's equity, followed by investments, profit, and lastly, drawings.
3) **Statement of financial position** – reports assets, liabilities and owner's equity at a specific date a.k.a. Balance Sheet.
4) **Statement of cash flows** – summarises info. about the cash inflows and outflows for a specific period of time.

Qualitative characteristics of financial information

2 <u>fundamental</u> qualitative characteristics that info. should have:

1) **Relevance** – financial info. must be able to help users form predictions about outcomes of past, present and future events <u>or</u> confirm/correct past evaluations in the process of decision making. Therefore, to be **relevant,** info. must have *predictive* and *feedback* value.
2) **Faithful representation/Reliability** – info. is free from material error/bias, supported by evidence i.e. source documents, and is able to be depended upon to represent faithfully the transactions/events it claims to represent/expected to present – provides criteria for item recognition (shown above).

4 <u>enhancing</u> qualitative characteristics info. should have:

1) **Comparability** – info. should be comparable with aspects of an entity over time, and between entities at one time or another – users will be informed of accounting policies in preparation of reports, plus any changes to policy.
2) **Understandability** – info. should be comprehendible to users of those reports.
3) **Timeliness** – info. should be available to make decisions before it loses capacity to influence decisions – otherwise, loses **relevance.**
4) **Verifiability –** different independent observers can reach an agreement that info. represents the phenomena it purports to represent without error/bias, or that a method has been applied without error/bias.

2 <u>constraints</u> on relevance/faithful representation:

1) **Materiality** – info. is material if its omission/misstatement has the potential to adversely affect economic decisions. Eg, small, negligible expenses on their own are immaterial, and expensed immediately, but a build up of immaterial items could become material, meaning their omission could adversely affect the decision making of the information users.
- Used as a cut off point in determining relevance of financial information.
2) **Balance between benefit and cost** – benefits in deriving info. should exceed the cost of providing it - only relevant info. which may affect decision making should be provided. Therefore, a business may cut down on the provision of certain accounting information because it proves too costly, eventhough benefit could nevertheless be derived from it. As a result, omission of such information in such a situation could adversely affect the decision making ability of its users.

Chapter 2 – Transaction Analysis and the Recording Process

WORD	*EXPLANATION*
Account	Individual accounting record of increases and decreases in an asset, liability or owner's equity item.
Source documents	Evidence of transactions – cheque butt, receipts, cash register tape. Provide evidence of transactions and used as such in recording entries.
Journal	The book of original entry.
Ledger	Entire group of accounts maintained by a business. Keeps in one place all info. about changes in specific account balances. Each ledger is assigned a number to keep the ledger in order → **referenced to chart of accounts.**
Chart of accounts	List of accounts and account numbers, identifying location in ledger. Usually starts with balance sheet accounts, followed by income statement accounts.
Trial balance	List of accounts and their balances at a given time. Prepared at end of reporting period. Entries appear in order of appearance in ledger.

GENERAL NOTES

Transaction analysis and recording process:

Transaction analysed to determine effect on accounting equation → recorded through the journals (special/general) → trial balance is prepared to ensure debits = credits.

Cash v. Accrual accounting

Cash basis approach:

- Principle: All transactions for an entity within a particular reporting period are recorded on the basis of when the cash is received/paid. Therefore, profit = cash received as income – cash paid for expenses.
- Disadvantages:
  1) **Not all entities sell on a cash only basis** – many offer credit terms, meaning customers receive product/service first, paying cash at a later date. Under cash accounting, the income is only recorded when cash is received, which may be a long while after good/service was provided, even in the next reporting period! As a result, preparation of reports becomes distorted.
  2) **Customers may pay cash in advance** – revenue is recognised even when the good/service hasn't been provided, meaning reports become distorted.
  3) **Payment of expenses may be before or after expense is due** – in the case of a prepaid expense, the entire period for which the expense is allocated is recognised as an expense when the payment comes through – can potentially distort the allocation of expenses, and thereby, the recording process, leading to misleading financial statements.

In sum:

- Cash accounting can cause transactions to be recorded in a different period to when the transaction occurred (in the case of receiving cash for revenue in the period following the transaction), as it focuses on the cash flow recording, rather than the transaction recording.
- Cash basis accounting is not accordance with the GAAP.

Accrual basis approach

- Principle: Revenues and expenses are recorded when are earned or incurred, regardless or whether the related cash has been received/paid.
- Advantage:
  1) **Profit better reflects the performance of an entity** – as all revenue and expense items are taken into account in the period in which the transaction occurred, regardless of whether cash has been received or paid. As a result, an entity may determine a cash surplus in a period, but still incur a net loss, as they will have, for example, incurred more unpaid expenses than revenues received. Therefore, profit/loss may not necessarily have a direct relationship to cash received/paid.

In sum:

- The accrual basis will produce very different performance results than the cash basis, but the accrual basis determines a better, and more accurate, reflection of profit/loss for a period than does cash basis.

Transaction analysis

- Advantage: While not formal recording, transaction analysis can assist in learning the rules relating to recording transactions.

The Accounting Equation – A = L + OE (I + K – E – D)

- Equation expresses relationship between the assets of the entity and how they are financed – inside funds = liabilities, outside funds = owner's equity.
- **MUST ALWAYS STAY BALANCED.**

The concept of duality

- Principle: Every business transaction will have a dual effect on the entity and accounting equation → allows recording of transactions while maintaining balance.

The Account

- Transactions are grouped and classified into categories so that results can be accumulated and summarised.
- *Debits* – left side of the account – increase asset, expense and drawings accounts. Decrease liability, revenue and owner's equity accounts.
- *Credits* – right side of the account – increase liability, revenue and capital accounts. Decrease asset, expense and drawings accounts.
- *Debit balance* – if total debit transactions exceed credit transactions – **normal balance** of asset, expense, and drawings accounts.

- *Credit balance* – if total credit transactions exceed debit transactions – **normal balance** of liability, revenue, and owner's equity (capital) accounts.

Steps in recording process

1) Identify transaction in source documents.
2) Analyse transaction for effect on accounts.
3) Enter transaction in a *journal.*
4) Transfer journal info. into appropriate *ledger accounts.*

Journals

Advantages:

1) Discloses in one place the complete effects of transactions.
2) Provides a chronological record of transactions which can be cross referenced to source documents and ledgers.
3) Helps to prevent/locate errors because debits and credits can be easily compared.

- If an entry involves two transactions = **simple entry.**
- If an entry involves more than two transactions = **compound entry.**

Standard format of journals (general)

Date	**Account titles + explanation**	**Ref.**	**Debit**	**Credit**
DD/MM/YYYY	*Debit* *Credit* *(Explanation)*	*Ledger account no.*	*####*	*####*

Ledgers

Standard format of ledgers (general) – three-column format

Date	**Explanation**	**Ref.**	**Debit**	**Credit**	**Balance**
DD/MM/YYYY	*Debit/Credit item*	*Journal page number*	*####*	*Or ####*	*#### Dr* *Or* *#### Cr*

Trial Balance

- Purpose: To prove that debits equal credits at the end of a reporting period – otherwise, if incorrect, can be used to correct errors in journalising.
- The trial balance balances can agree, eventhough numerous errors may still exist:
  1) A transaction may have been completely omitted i.e. wasn't journalised.
  2) A journal entry may have been posted incorrectly.
  3) A journal entry may have been posted twice.
  4) Incorrect accounts are used in the journalising process.
  5) Offsetting errors may have occurred eg. $2100 recorded as $2010 – **transposition error.**

Note: $ signs only appear in the first column of a trial balance, but never in journals/ledgers, and the total amount in both columns at the end of the trial balance is double underlined.

Standard format of trial balances

Account	**Debit**	**Credit**
Account name	*####*	*Or ####*

Chapter 3 – Revisiting the recording process – trading firms

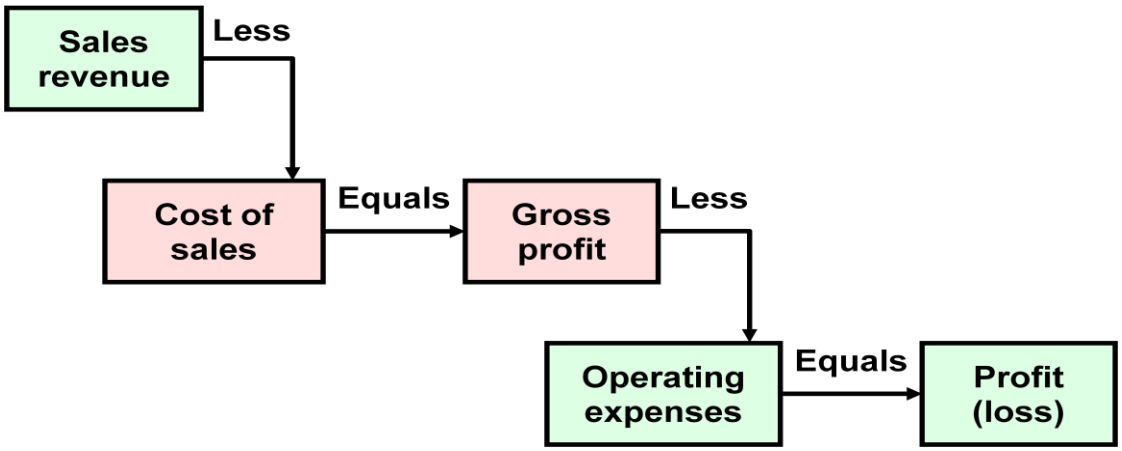
WORD	*EXPLANATION*
Inventory	- Otherwise known as stock/goods, trading firms purchase inventory to sell, and in so doing, earn revenue.
Special Journals	- Journals used to record similar types of transactions.
G.S.T	- A broad-based indirect tax (tax on measures than profit) on most goods & services in Australia. Rate is 10%.

GENERAL NOTES

Service v. Trading Firms

Service firms	*Trading firms*
- Earn revenue through provision of services.	- Earn revenue through the selling of goods.
- Wide range of expenses incurred through the earning of revenue eg. Advertising, wages, insurance etc.	- Expenses include two categories: 1) **Cost of Sales** – directly related to the sale of goods. 2) **Other expenses** – similar to those expenses of a service firm.
- Only deals with revenues – expenses = profit.	- Deals with revenues – cost of sales = **gross profit** – other expenses = *net profit.*
- Operating cycle: **Perform services → cash/accounts receivable →** if accounts receivable, **receive cash → use cash to perform services.**	- Operating cycle: **Use cash to buy inventory → sell inventory for cash or accounts receivable →** if accounts receivable, **receive cash → use cash to purchase more inventory.**

Income measurement for retailers



Perpetual inventory system – recording inventory as an asset

Core principles:

- Detailed records of the cost of each inventory **purchase/sale** are maintained.
- Continuously shows quantity + cost of inventory that should be on hand for every item → Bar codes/optical scanners facilitate the recording process.
- **Cost of Sales** determined every time a sale occurs.

Purchases

- Made for on cash/account;
  1) **Cash -** should be supported by cheque butts/cash receipts, indicating *quantity + amount.*
  2) **Account/credit** – should be supported by a purchase invoice, indicating *total price, quantity, name of seller, amount/item etc.*

- Recorded when **goods received from seller;**
  1) **Cash, account/credit**
- Under *perpetual inventory system,* results in **DR inventory, CR cash/CR accounts payable.**

Purchase returns + allowances

Buyers may return inventory for a variety of reasons, including:

1) Dissatisfaction with goods received.
2) Damaged/defective goods.
3) Inferior quality goods.

In such cases, the purchaser will either:

- Receive a refund in the form of cash or credit depending on initial purchase of goods:
  1) **If initial purchase was on cash:** Cash refund.
  2) **If initial purchase was on credit:** Reduction on amount payable.

  } ***Purchase returns***
- Be granted a deduction/discount on purchase price – ***Purchase allowance***

When goods are returned to supplier: **CR inventory, DR cash** (cash refund)**/accounts payable** (reduction on amount payable).

Sales

- Revenue recorded when earned under *revenue recognition principle* – typically, when goods are transferred from seller to buyer.
- Made on cash/credit:
  1) **Cash** – supported by cash register tapes, showing *quantity + amount.*
  2) **Credit** – supported by sales invoice (x2 – original to customer, copy kept by seller for recording purposes) showing *date, total sales price, customer name*.

Recording & posting:

Selling price

1) **Cash**
- DR cash, CR sales.
2) **Credit**
- DR accounts receivable, CR sales.

} Records <u>selling price</u> (revenue earned)

Cost price of goods

- DR Cost of Sales (cost of stock sold), CR inventory (decrease stock on hand) - cost price.

Hence, once sold, stock becomes an **expense**, recognised by Cost of Sales account → later compared against Sales to determine **'mark-up'** i.e. gross profit on sale.

NOTE:

Most firms use more than one sales account. By using separate accounts, management can **monitor trends closely, responding strategically to changes in sales patterns** eg. Increasing advertising for an inventory item if sales are decreasing.

However, on income statements, trading firms usually report **a single sales figure** in order to save length and cost, but, more importantly, to shield **operating results from competitors.**

<u>Sales returns + allowances</u>

When a customer returns goods, the seller may give:

1) A **cash refund,** if goods were originally purchased by cash.
2) A **credit note,** if goods were originally purchased on credit.

} Recorded as **Sales Returns and Allowances**

Recording & posting

<u>TWO</u> entries always required:

1) **Increase Sales Returns + Allowances;**
- If cash refund: **DR** Sales returns & allowances, **CR** cash
- If credit note: **DR** Sales returns & allowances, **CR** accounts receivable

} **SELLING PRICE**

2) **Increase Inventory;**
- **DR** Inventory (increasing stock), **CR** Cost of Sales (remove expense) – **COST PRICE**

NOTE: If goods returned were faulty/damaged, they cannot be returned for resale. In such an instance, an additional <u>TWO</u> entries would be required:

1) **Increase sales returns;**
- *Cash* – **DR** Sales Returns + Allowances, **CR** cash

- *Credit* – **DR** Sales Returns + Allowances, **DR** accounts receivable

2) Increase inventory expense (inventory write-down);

- **DR** Inventory write-down, **CR** Cost of Sales

NOTE: The **sales returns % allowances** account is known as a *contra-revenue account.* This is because it is the opposite of a revenue account, and as such, increases via debits, and decreases via credits. Same method true for all other contra accounts eg. Contra exp. = increase **CR,** decrease **DR**.

In the above instance, the reason a contra account for sales is used is because it can provide important info. to management about sales, including:

- Excessive returns/allowances suggesting:
  1) Inferior inventory
  2) Errors in invoicing customers
  3) Mistakes in delivery or shipment.
- Debiting sales can distort total sales comparisons between periods.

Stock Write-Downs

When an item cannot be sold at its original selling price after it has been returned, the method for judging its cost is determined by the **lower of cost and Net Realisable Value (NRV).**

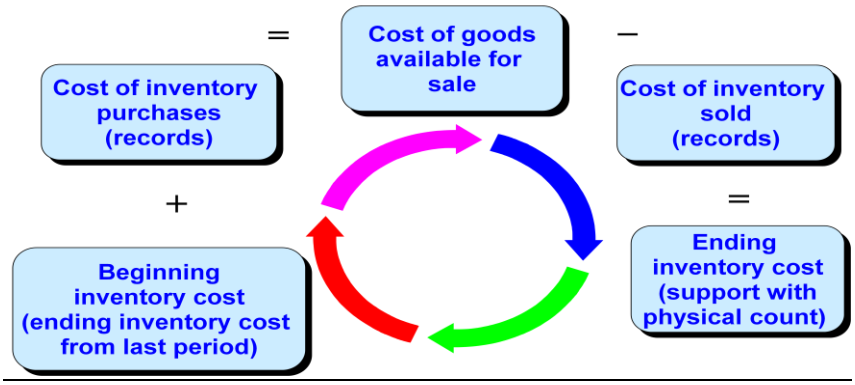
Reasons stock write-downs occur are due to:

- Obsolescence of items.
- Inventory which has been lost or stolen.
- Inventory which has been deemed waste eg. Building materials.

Stock write-downs are added to Cost of Sales in determining Gross Profit.

Note: At the end of reporting periods, a **physical count of stock**, known as a physical stocktake, is conducted to ensure that the quantity of stock on hand correlates to the balance in the inventory records.

THE PERPETUAL INVENTORY SYSTEM IS THUS:



The Periodic (Physical) Inventory Method – recording inventory as an expense

Core principles:

- Does not maintain a continuous, running balance of stock on hand/transactions involving stock – rather, relies on **periodic stocktakes** establish inventory on hand.
- Does not maintain an accumulating record of Cost of Goods Sold with each inventory transaction (purchase/sale) – rather, Cost of Goods Sold is calculated at the end of the period through the following formula:

BALANCE OF INVENTORY AT BEGINNING + PURCHASES OF STOCK = COST OF GOODS AVAILABLE (for sale) – BALANCE OF INVENTORY AT END = COST OF GOODS SOLD (assumes value of inventory sold at end of period – does not account for possible stock losses i.e. theft, loss etc.**).**

Purchases

- Under the **period inventory method,** stock is only known as **purchases**, and is treated as an *expense,* as opposed to an asset, at time of purchase.
- Therefore:
  1) **Cash purchases** – **DR** Purchases (exp.), **CR** Cash
  2) **Credit purchases** – **DR** Purchases, **CR** accounts payable

Purchase returns & allowances

- If purchases are returned to supplier (*purchase returns*), or supplier agrees to reduction in price with no return of purchases (*purchase allowance*), the **purchases account** is not credited; rather, a new account **Purchases Returns & Allowances**, is created:
- Therefore:
  1) **Return for cash – DR** Cash, **CR** Purchase returns & allowances
  2) **Return for credit** – **DR** accounts payable, **CR** Purchase returns & allowances
- At the end of the reporting period, **purchases returns & allowances** are deducted from **purchases** in the income statement = net purchases.

Note: *Purchases* and *Purchase returns & allowances* create new **expense** accounts in the general ledger.

Sales

- As the periodic inventory system does not maintain a running balance of stock on hand, *nor* records Cost of Goods Sold at time of sale, the only transaction is thus:
  1) **Cash Sale - DR** Cash, **CR** Sales.
  2) **Credit Sale** – **DR** Accounts receivable, **CR** Sales.

Note: Sales returns are treated same as in Perpetual, minus COGS/Stock Write-down transaction.

Calculation of Cost of Goods Sold & Inventory

To recap...

- When stock is purchased, it is immediately recognised as an **expense** under the account name **Purchases.**
- There is no continual maintenance of Cost of Goods Sold with each purchase/sale – rather, Cost of Goods Sold is calculated at the end of the period through a stocktake, where it assumed that: **Balance of Inventory at beg. – Inventory at end = Cost of Goods Sold.**
- As such, THREE journal entries are required for determining Cost of Goods Sold at end of month:
  1) *Transfer inventory at beginning + purchases of inventory to COGS:* **DR** COGS, **CR** Inventory Balance or Purchases.
  2) *Transfer purchase returns to COGS:* **DR** Purchase returns, **CR** Cost of Goods Sold.
  3) *At end of period, recognise inventory on hand as asset:* **DR** Inventory, **CR** Cost of Goods Sold.

Note: The above are all recorded under the *Cost of Goods Sold* section of the Income Statement.

Therefore, **Cost of Goods Sold:**

OPENING INVENTORY → + PURCHASES → - PURCHASE RETURNS → - CLOSING INVENTORY.

Differences between perpetual & periodic inventory in recording/posting

Perpetual vs Periodic Journal Entries

Transaction	Perpetual Method	Periodic Method
SALE OF INVENTORY	Bank/Accounts receivable xxx Sales xxx *Cash/credit sale of inventory* *(recorded at selling price)* Cost of goods sold xxx Inventory xxx *Cost of goods sold* *(recorded at cost price)*	Bank/Accounts receivable xxx Sales xxx *Cash/credit sale of inventory* *(recorded at selling price)*
RETURN OF SOLD INVENTORY	Sales returns and allowances xxx Bank/Accounts receivable xxx *Cash refund/credit note issued for inventory returned* *(recorded at selling price)* Inventory xxx Cost of goods sold xxx *Cost of goods returned* *(recorded at cost price)*	Sales returns and allowances xxx Bank/Accounts receivable xxx *Cash refund/credit note issued for inventory returned* *(recorded at selling price)*
PURCHASE OF INVENTORY	Inventory xxx Bank/Accounts payable xxx *Purchase of inventory for cash/credit*	Purchases xxx Bank/Accounts payable xxx *Purchase of inventory for cash/credit*
RETURN OF PURCHASED INVENTORY	Bank/Accounts payable xxx Inventory xxx *Cash refund/credit note received for inventory returned*	Bank/Accounts payable xxx Purchases returns and allowances xxx *Cash refund/credit note received for inventory returned*
PHYSICAL COUNT OF INVENTORY	Inventory shortage expense xxx Inventory xxx *Recording stock loss* Inventory xxx Inventory gain income xxx *Recording stock gain*	N/A: **Cannot determine whether there is an inventory shortage/gain**

Note: The physical stocktake serves different purposes in the perpetual inventory system v. the periodic inventory system:

Perpetual

- Used to derive stock loss/gain in order to **adjust** inventory balance to **correct amount**.

Periodic

1) Used to **establish** inventory balance**.**
2) Used to derive Cost of Goods Sold expense.

THE PERIODIC INVENTORY SYSTEM IS THUS:

Advantages/Disadvantages of the Perpetual & Periodic Inventory Methods

	ADVANTAGES	DISADVANTAGES
Perpetual	1) Facilitates **frequency, timeliness** of reporting through continual updating of CoGS, allowing **interim reports** to be prepared. 2) Better control & more efficient management of inventory through subsidiary records – avoids running out of stock, stock become obsolete etc. 3) Can determine stock loss/gain through physical stocktake as uses stocktake in conjunction with continual record of stock on hand.	1) In the past, required considerable record keeping, increasing cost of maintaining perpetual inventory method*.
Periodic	1) In the past, less detailed record keeping = lower cost*.	1) Requires a stocktake before CoGS can be prepared – costly, disruptive, less frequency of financial reporting. 2) No up-to-date info. on inventory = less efficient. 3) No continual record of stock on hand – stock loss/gain cannot be determined through stocktake.

*__NOTE:__ With the use of barcode scanning and computerised software, the perpetual inventory system has become more economical and efficient nowadays, making it more useful and widely used than the periodic inventory system = no longer advantage of periodic.

Special Journals

FOUR types of special journals:

1) **SALES JOURNAL** – records only credit sales during a period.

Format:

Date	**Customer's name**	**Inv. No.**	**Ref. No.**	**Sales**	**Cost of Sales**
DD/MM	*Account name*	*####*	*####*	*$$$$*	*$$$$*

At end of month:

Sales – **CR** Sales, **DR** Accounts receivable

Cost of Sales – **DR** Cost of Sales, **CR** Inventory

2) **PURCHASES JOURNAL** – records only credit purchases during a period.

Format:

Date	**Supplier's name**	**Inv. No.**	**Ref.**	**Inventory**
DD/MM	*Account name*	*####*	*####*	*$$$$*

At end of month:

Inventory – **DR** Inventory, **CR** Accounts payable

3) **CASH RECEIPTS JOURNAL** – records entries which debit cash at bank.

Format:

Date	**Account**	**Post ref.**	**Rec. No.**	**Debits**	**Credits**
DD/MM	*Account name*	*###*	*###*	*Cash, Disc. Exp. etc.*	*Accounts receivable, Sales, Other accounts**
				$$$$	*$$$$*

At end of month:

*Other accounts: Would include Cost of Sales for cash – **DR** Cost of Sales, **CR** Inventory

Note: Total debits must equal total credits.

4) **CASH PAYMENTS JOURNAL** – records all entries that require a credit to cash at bank.

Format:

Date	Account	Post. Ref.	Chq. No.	Credits	Debits
DD/MM	*Account name*	*####*	*####*	*Cash at bank, Disc. Rev.*	*Accounts payable, Cash purchases, Other accounts*
				$$$$	*$$$$*

At end of month: Total debits must equal total credits.

<u>Manual v. Computerised Accounting System</u>

Manual system – steps in the accounting system are performed by hand.

Computerised system – computer programs perform steps in the accounting system.

<u>G.S.T – The Goods and Services Tax</u>

Core principles:

- Tax is paid at each stage of product & distribution to the ATO (Australian Taxation Organisation), from initial purchase to provision of goods/services, but it is <u>the final consumer who bears the cost</u>.
- <u>TWO</u> exceptions to G.S.T.:
  1) G.S.T Free Supplies – basic food, education, health services.
  2) Input taxed supplies – financial services, rents.

Two types of G.S.T.

1) G.S.T PAID

- This refers to G.S.T that is paid to suppliers for the provision of goods (inventory).
- When acquiring inventory, G.S.T is paid to supplier along with cost of goods, making the supplier act as a **'collecting agent'** of G.S.T. for the ATO.

2) G.S.T. COLLECTED

- This refers to the G.S.T received/collected from customers through the provision of good (inventory).
- When selling inventory, G.S.T. is received from customer, along with cost of goods, making the business the **'collecting agent'** of G.S.T for the ATO.

Remitting G.S.T to the ATO

- **G.S.T paid** is recognised as an asset as the business can potentially claim this amount from the ATO (potential inflow of economic benefit) → account must be **CR** to clear.
- **G.S.T collected** is recognised as a liability as the business collects the tax to pass on to the government (outflow of economic benefits) → account must be **DR** to clear.

To deduce amount owing/receivable from the ATO – difference between **GST PAID & GST COLLECTED.**

- When remitting tax to ATO (i.e. G.S.T collected from sales more than G.S.T paid to suppliers):

  DR GST Collected, **CR** GST Paid, Cash

- Although unlikely, when receiving refund from ATO (i.e. G.S.T paid is more than G.S.T collected from sales):

  DR Cash, GST Collected, **CR** GST Paid

Note: A single GST account can be used, known as the **GST Clearing** account, which uses the same methods, but simply **DR** GST paid and **CR** GST received – typically, GST clearing is a *liability* account, as most businesses collect more GST from sales than pay to suppliers in a period. However, can sometimes be the other way round, making GST clearing an *asset.*