Revised Edition

Accounting and Finance

A resource for Year 12 ATAR

Marking Guide

Elizabeth Criddle
Kathy Kania

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Marking Guide for Chapter Questions

Selected marking guide for Unit 3 ATAR. NOTE: The following are suggested methods only. There is no intention to outline any 'one' method of responding to questions.

UNIT THREE ATAR

CHAPTER 1: COST CONCEPTS

Questions

1. Distinguish between management accounting and financial accounting.

Management accounting is a process of identification, measurement, accumulation, analysis, preparation, interpretation and communication of financial information that is used by management to plan, evaluate, and control within an organisation. It is the accounting used for the planning, control, and decision-making activities of an organisation. Management accounting is concerned with providing information to internal managers who are charged with directing, planning, and controlling operations and making a variety of management decisions.

Financial accounting involves the recording and summarising of business transactions and events. Financial accounting relates to the preparation of financial statements for external users such as creditors, investors, and suppliers. The financial statements include the balance sheet, income statement, and cash flow statement. These statements, including related footnotes, director's report, management's discussion of operations, appear in the annual report.

Financial Accounting information is usually public information and provided to external users. It involves accurate figures based on past company performance. Management accountinginformation is produced for internal users and involves estimates.

2. Complete a summary table showing the following cost classifications:

- *behaviours: fixed, variable and mixed costs*
- *relationships to cost objects: direct and indirect costs*
- *treatment of costs: product and period*
- *time orientation of costs: past and future.*

BEHAVIOURS

Fixed costs: expenses which remain fixed. For example, rent and electricity.

Variable costs: expenses which increase as production increases or decrease as production decreases.

Mixed costs: costs which have elements of both variable and fixed costs.

RELATIONSHIP TO COST OBJECT

Direct costs: materials, labor and expenses related to the production of a product.

Indirect costs: difficult trace to a specific product or service. For example, overheads.

TREATMENT OF COSTS

Product cost: the cost of goods purchased or manufactured for sale.

Period cost: any cost that cannot be capitalised into prepaid expenses, inventory, or fixed assets. Associated with the passage of time.

TIME ORIENTATION OF COSTS

Past (OR Sunk costs): costs that have occurred already and cannot be recovered or avoided. They have already been paid and could be fixed or variable.

Future (OR Relevant costs): relevant to the specific job under consideration. Costs can be relevant or irrelevant depending on the particular requirements of the job.

3. *Why is business planning important? In your answer, outline the relevance of business goals, objectives, generic business strategies and strategic initiatives.*

Business planning allows the business to realise the mission statement and vision. It provides a road map for the future and a course of action to manage cash flow, income, and expenses. Business plans articulate how the vision will be achieved through goals and objectives.

- Goals
  - Long term and big picture
  - Provide direction
  - Broad aims for the future
- Objectives
  - Medium term
  - Measurable and time bound
  - More specific than goals
- Strategic Initiatives
  - Short term
  - Complex goal broken down into steps
  - The planning and strategy required to achieve results

4. *What are the three key areas involved in the management process?*

The three key areas of the management process are planning, coordinating and controlling.

5. *Explain how the management accounting cycle of planning, coordination and control would function for a particular business (of your choice). Use specific examples in your answer.*

PLANNING
- The financial and operational needs of the business.
- *Reviewing strategies*

COORDINATING
- The management and organisation of the business.
- *Implementing plans*

CONTROLLING
- Comparing planned and actual results.
- *Performance analysis*

6. *Complete a summary table listing an example of each of the following types of business as well as their main characteristics.*

- *manufacturing*
- *service providing*
- *trading/retailing.*

TYPE OF BUSINESS	EXAMPLE	CHARACTERISTICS
Manufacturing	Ford Saville Row Clothing	A manufacturing business is a business which purchases raw material and converts these into a product for sale and then usually sells it to a retailer.
Service providing	Law firm General practitioner Dentist Roadside assistance business	This type of business is set up to offer a service such as tutoring, gardening or childcare. Service businesses can be less costly to start due to not having to buy inventory.
Trading/retailing	Clothing store Shoe store Supermarket Jeans retailer	A retail business purchases products that have already been manufactured and sells the goods to customers for a higher price to make a profit. This can also be referred to as a merchandising business.

7. *Define 'cost', and give an example of a product cost and a period cost.*

A cost in accounting terms is a sacrifice of resources, such as cash used to pay an electricity bill. Product costs consist of the cost of goods purchased or manufactured for sale. All the costs for a business which are not categorised as product costs will then come under period costs. These are costs which have been incurred and will be written off against income in the accounting period (treated as expenses).

Examples of product costs: direct labour, direct materials, factory overhead.

Examples of period costs: depreciation, rent, interest, sales commission.

8. *What is cost accounting, and why is it used?*

Cost accounting is an element of management accounting, it involves the collection, recording, processing and reporting of costs. Cost Accounting is used by managers to facilitate their decision making.

9. *Explain the relationship between volume of activity, costs and profit.*

As total sales or activity increase, costs will also increase in one of three possible ways: fixed, variable or mixed. In order to make a profit, the business must achieve sales above costs. This is the activity level where the dollar amount of sales is greater than the dollar amount of costs for that volume of activity.

10. Each of the following costs items pertains to one of these companies: Harpers (a manufacturing business), FoodWorld (a merchandising firm), and Advertize (a service business). Classify each of the costs as either product costs or period costs:

A. Bottled water purchased by FoodWorld for sale to its customers

Product Cost

B. Electricity used to provide lighting for production workers at the Harpers factory

Product Cost

C. Depreciation of the computers used by Advertize to update directories of websites

Product Cost

D. Electricity used to provide lighting in the aisles of the FoodWorld stores

Period Cost

11. In what way are direct materials and direct labour similar?

Direct materials and direct labour are both product costs which can be directly attributed to the cost of producing the good or service.

12. Why do managers consider direct costs to be more accurate than indirect costs?

Indirect costs are costs which cannot be easily identifiable with the product, for example the wages paid to the manager at a bottling factory. The managers are an important part of the water becoming bottled but they may also be managing the bottling of other drinks at the factory such as apple juice, therefore their cost cannot be directly attributed to the water. Unlike the cost of a bottle it would be too hard to work out the exact manager cost to the bottled water.

Direct costs are costs which are used directly in production and can be identified, for example the cost of bottles for bottled water. The cost of the bottle can be easily identified with the drink, which is why managers consider these costs to be more accurate than indirect costs.

13. What are manufacturing overheads?

Manufacturing overheads, also known as indirect costs as they cannot be directly traced to a specific product, can be variable or fixed. Manufacturing overheads comprise all the costs of manufacturing excluding the direct material and the direct labour cost. These include items like insurance, depreciation, indirect labour, indirect materials and all other costs of running the manufacturing division of the business.

14. How would the term 'overheads' be applied to a service firm?

Overheads in a service firm are the indirect cost of providing the service.

15. Compare and contrast the 'cost leadership' and 'product differentiation' strategies.

These are two alternative strategies that could be used by the business to gain an advantage over competitors:

- Have lower, more competitive cost than competitors
- Differentiate the product with a higher price.

16. *Cyclicko assembles both mountain bikes and street bikes. There is a separate production line for each type of bike. Classify each of the following cost items as either direct or indirect costs with respect to the total number of bikes of each type assembled (mountain or street).*

A. *Cost of tyres used on the street bike*

Direct Cost

B. *Salary of Marketing Manager for Cyclicko*

Indirect Cost

C. *Christmas presents for Cyclicko suppliers*

Indirect Cost

D. *Wages of engineer who designs the street bikes*

Direct Cost

E. *Freight costs of mountain bike frames from Sydney*

Direct Cost

F *Electricity cost for the whole factory*

Indirect Cost

G. *Wages of casual staff who only work in November when demand is high, due to Christmas*

Indirect Cost

17. *Discuss the two ways which product costs are treated by managers.*

Product costs are treated in two ways. First they are treated as work in progress inventory, second as finished goods inventory. This means that they are recorded as assets until the goods are sold. Once the goods are sold they become expenses in the form of cost of goods sold.

18. *Explain what a period cost is, using an example.*

All the costs for a business which are not categorised as product costs will come under period costs. These are costs which have been incurred and will be written off against income in the accounting period (treated as expenses). This includes items such as office rent and sales commissions. The selling, administrative and finance expenses fall in this category.

19. *In what way does a period cost differ from a product cost? Use an example.*

A product cost consists of the cost of goods purchased or manufactured for sale. It is made up of three basic elements: direct materials, direct labour and manufacturing overheads. For example, the can used for tinned fruit is a product cost.

A period cost consists of any cost which cannot be categorised as a product cost. For example: the office rent for a manufacturing outlet.

20. *Define 'mixed costs', giving four examples of these, from your choice of two specific types of business.*

Mixed costs are costs which have elements of both variable and fixed costs. Some costs have a fixed amount regardless of production as well as a variable amount which is dependent on the production level. For example, some lights in a business must be kept on at all times for security purposes, however other lights will only be used when production is in process. Thus, increased production levels will increase lighting costs because the use of lighting is dependent upon the units of production required, or the changing volume of activity that comes with changing sales amounts. *(The rest of this solution will depend on the type of business the student has chosen.)*

21. Complete the following table, showing examples of each different type of cost for these businesses. Explain your reasoning for the choice of MIXED costs in the final column.

BUSINESS	FIXED COSTS	VARIABLE COSTS	MIXED COSTS	EXPLANATION
Florist	Rent	Cost of flowers	Advertising	Regular advertising and may choose to advertise on special occasions if funds permit.
Car retailer	Telephone	Cost of cars	Cleaning	Each car requires cleaning plus the showroom space.
Bakery	Electricity	Cost of ingredients	Cost of fruit	Business may choose to make fruit bread seasonally, such as Easter and Christmas.
Music retailer	Employee wages for permanent staff	Cost of stock	Cost of casual staff hired for stock-take	These staff are only employed if needed.
Butcher	Council Rates	Cost of meat	Electricity to run extra fridges	The extra fridges are only used when there high demand such as Australia Day.
Wheat farmer	Mortgage	Cost of seed, fertiliser	Water	Regular water bill plus ‘top-ups’ from tankers in times of drought

22. What is the difference between fixed costs and variable costs?

Fixed costs are expenses which remain do not change with the volume of production. All fixed expenses have to be paid regardless of the level of activity. If there were a situation where no services or goods were sold, the rent would still need to be paid. Examples: Office wages/salaries, rent, advertising, bank charges, government charges.

Variable costs are expenses which increase as production increases or decrease as production decreases. Examples: Factory wages/salaries, sales commission, product related promotions, raw materials, product packaging.

23. Give an example of each of the following:

A. A fixed cost for a bicycle manufacturing business

B. A variable cost for a spare parts assembler

C. A fixed cost for a cake manufacturer

D. A variable cost for a fish and chip shop

E. A fixed cost for a vegetable canning company.

Rent for a manufacturing plant is a fixed cost. If it is owned then the monthly mortgage repayment amount is a fixed cost.

Sales commission for sales staff is a variable cost.

24. A furniture-making business produces a range of leather lounge suites and pine office furniture.

A. The business has the following manufacturing costs for the production of its pine office furniture. Classify each one as direct material, direct labour or manufacturing overhead.

i. Wood

direct material

ii. Wages of furniture maker

direct labour

iii. Nails and screws

direct material

iv. Packaging

manufacturing overhead

v. Factory supervisor wages

manufacturing overhead

vi. Electricity

manufacturing overhead

vii. Advertising for holiday sale

manufacturing overhead

viii. Varnish and wood stain

direct material

ix. Insurance for factory.

manufacturing overhead

B. Classify each of the following costs as either fixed, variable or mixed.

i. Rent of factory

fixed

ii. Wood

variable

iii. Electricity

mixed

iv. Office rent

fixed

v. Monthly newspaper advertising

fixed

vi. Upholstery cloth

variable

25. How is performance management used to achieve the goals and objectives of the business?

Performance management involves activities which are undertaken to ensure that the goals and objectives of the business are being met in the most efficient manner possible. It focuses on performance in a specific sector, such as the performance of a specific department or product. Financial performance management in a business occurs when staff are rewarded for positively influencing the outcomes resulting from a cost centre. If the KPIs are achieved, then the business goals are being met.

26. Explain how fixed costs are represented graphically and the reason why the graph is this way.

The fixed costs line is horizontal as fixed costs remain constant, no matter the level of sales or activity (see Fixed Costs Graph in this text).

27. As output increases, what happens to fixed costs?

As output increases fixed costs remain the same.

28. As output decreases, what happens to fixed costs?

As output decreases fixed costs remain the same.

29. Explain how variable costs are represented graphically and the reason why the graph is this way.

The variable cost line starts at the corner of the two axes due to the fact that no variable costs would be incurred if there was no activity. As the activity increases the total variable cost would also increase (see Variable Costs Graph in this text).

30. As output increases, what happens to variable costs?

As output increases so do variable costs.

31 As output decreases, what happens to variable costs?

As output decreases the variable costs decrease.

32. Why is management accounting said to be future orientated and financial accounting past orientated?

The financial statements produced at the end of the accounting period by financial accountants (Balance Sheet, Income Statement, Cash Flow Statement) can be used to examine and analyse what has happened with the business in the past and this is where the emphasis lies in financial accounting. Therefore financial accounting can be said to focus on historical accounts.

Management accounting is future orientated. It aims to deal with the future of the business through the use of planning, control and budgeting. Management accountants will still look at financial statement data to aid the future planning process, and use trend data to formulate their predictions for the future of the business.

33. In terms of time orientation, do management accounting and financial accounting have any similarities? In your answer clearly explain the concepts of sunk costs, relevant costs and irrelevant costs.

The time orientation of costs refers to sunk and relevant costs.

Sunk costs: costs that have occurred and cannot be recovered or avoided. They have already been paid and have 'sunk' into the costs associated with the job. Sunk costs could be fixed or variable. The management accountant needs to not include sunk costs in decision making about future costs. For example, if a piece of new machinery is invested in because the business wants to manufacture a new product line, but that machinery is then found to be inappropriate for the job, the cost of purchasing it is a sunk cost. It is an **irrelevant cost** as it cannot be reversed.

Relevant costs: a cost relevant to the specific job that the management accountant has under consideration. Costs can be relevant or irrelevant depending on the particular requirements of the job. The management accountant would select different costs depending on the decision, such as comparing the costs of buying instead of making a product, deciding whether to shut down a business or close production, and decisions about accepting or rejecting special orders.

34. Why is the job order costing process widely used by both manufacturing and service providers?

The job order costing system is used in both the service industry and manufacturing businesses when each product or service being produced is uniquely different. For example, a furniture manufacturer may take special orders which need to be priced per order, or an advertising firm would price per individual account.

There needs to be distinct units of a good or service to use job order costing because the process involves accumulating costs separately for each product or service. The job costing process has a separate job cost record for each job.

35. What is the main purpose of any costing system?

The purpose of a costing system is to calculate the cost of the product (good or service) being produced.

36. What is a material requisition form?

A material requisition form shows the details of the job number and the description, quantity and cost of the materials being used.

37. How is direct material for a job calculated?

The direct material cost only includes items used which are directly identifiable with the product or service. Any indirect material costs or manufacturing overhead costs will not be included.

38. How is the total cost of direct labour calculated?

Direct labour is calculated in a similar way to direct materials. A work record is usually kept for each employee. The employee time record summarises the activities completed by each employee. The calculation of direct labour is then a simple multiplication. The hourly rate is set, then multiplied by the time taken to complete the job as shown in the employee time record.

39. What role does the employee time record play?

The employee time record shows an hour by hour summary of the activities completed by the employee throughout the day.

40. Calculate the total direct materials cost for the following:

A. 178 units at a cost of $5.60 each

$996.80

B. 3 000 units at a cost of $2.33 each

$6 999

C. 1 500 000 units at a cost of $0.58 each

$870 000

41. Calculate the total direct labour cost for the following:

A. Hourly rate is $180 and the job takes 3 hours

$540

B. Hourly rate is $300 and the job takes 23 hours

$6 900

C. Hourly rate is $250 and the job takes 15 minutes

$62.50

D. Hourly rate is $75 and the job takes 3.5 hours

$262.50

42. Why are overheads not as straightforward to calculate as direct materials or direct labour?

Overhead costs are not as straight forward as the calculation of direct materials and labour because they are an indirect cost so it can be difficult to trace them to a specific item – either product or service.

43. Explain the concept of predetermined overhead rate.

A predetermined overhead rate overcomes the problem that overhead costs are not as straight forward to calculate as direct materials and labour. They are an indirect cost so it can be difficult to trace them to a specific product or service.

To overcome this a business can allocate overhead costs to each job on a predetermined basis and rate. This predetermined rate is based on an estimate. The business will estimate the total overhead costs for the accounting period and the total activity level.

44. Explain the formula for calculating the predetermined overhead rate.

The formula for the predetermined overhead rate is:

$$\frac{\textbf{Estimated Overhead Costs}}{\textbf{Estimated Direct Labour Hours}}$$

45.

A. Chadwick Enterprises has the following estimated costs:

Direct Labour Hours $160 000

Direct Materials Cost $800 000

Overhead Cost $1 072 000

Calculate the predetermined overhead rate.

Chadwick Enterprises

$$\frac{\$1\ 072\ 000}{160\ 000} = \$6.70 \text{ per direct hour}$$

B. *The manufacturing manager at Busselton Boats has provided you with the following information about the costs for the next period of production. The business manufactures small dinghy boats for recreational fishing trips and prides itself on the uniqueness of each hand manufactured boat. Busselton Boats uses a labour rate of $120 per hour. What is the total overhead cost for the manufacture of one boat?*

Cost item	*Amount*
Raw materials	*$3,600.00*
Direct labour	*$6,600.00*
Total labour for period	*$78,000.00*
Overhead costs for period	*$32,500.00*

Busselton Boats

Direct labour hours = total labour/ labour rate
= 650 Hours

Recovery rate = total overheads/ direct labour hours
= $50

Labour hours for job = direct labour/ labour rate
= 55 Hours

Overhead cost = recovery rate x labour hours for job
= $2 750

46. *Sakai Holdings has the following estimated costs:*

Direct Labour Hours	*$80 000*
Direct Materials Cost	*$400 000*
Indirect materials	*$50 000*
Overhead Cost	*$536 000*

A. *Calculate the predetermined overhead rate.*

$\frac{\$536\ 000}{80\ 000}$ = $6.70 per direct labour hour.

B. *If the smallest job involves 18 direct labour hours, what would be the overhead cost of this job?*

$6.70 x 18 hours = $120.60

47. *Fabian Hunt Inc has the following estimated costs:*

Direct Labour Hours	*$200 000*
Indirect Labour Hours	*$10 000*
Direct Materials Cost	*$1 000 000*
Overhead Cost	*$1 340 000*

A. *Calculate the predetermined overhead rate.*

$\frac{\$1\ 340\ 000}{200\ 000}$ = $6.70 per direct labour hour.

B. *If the largest job involved 150 direct labour hours, what would be the overhead cost of this job?*

$6.70 x 150 hours = $1 005

48. *The business Choco-lot Manufacturing produces three different chocolate products: chocolate in a box, a chocolate bar and a chocolate drink. Each product has its own production line.*

Total overhead manufacturing costs at the factory for October 2025 are $75 million, of which $10 million are fixed costs. This total amount is allocated to each product line on the basis of the direct manufacturing labour costs for each product for October as follows:

	Box	*Bar*	*Drink*
Direct Materials Cost	*$42 000 000*	*$27 000 000*	*$31 000 000*
Direct Manufacturing Labour Cost	*$7 000 000*	*$14 000 000*	*$4 000 000*
Manufacturing Overhead Costs	*$21 000 000*	*$42 000 000*	*$12 000 000*
Units Produced	*40 000 000*	*60 000 000*	*50 000 000*

Required:

Calculate the manufacturing cost per unit for each product produced in October.

Box = $1.75
Bar = $1.38
Drink = $0.94

49. *What is the purpose of a job cost sheet, and what details does it display?*

The figures for the direct materials, direct labour and overhead costs are all entered onto the job cost sheet for each individual job. The job cost sheet includes the total cost of the job and also the unit cost.

50. *Savage Manufacturing uses the job costing process to calculate cost per unit. The business has been calculating this on a quarterly basis. A new manager has arrived and has suggested that cost per unit should be calculated per annually, rather than quarterly.*

Using the budgeted figures for the upcoming year below, rework the figures to provide the annual: direct materials cost, direct labour cost, manufacturing overhead, total manufacturing cost, number of units to be produced and the estimated cost per unit.

Annual direct materials cost, direct labour cost, manufacturing overhead, total manufacturing cost, number of units to be produced and the estimated cost per unit are shown in the right-hand column.

QUARTER	**FIRST**	**SECOND**	**THIRD**	**FOURTH**	**ANNUAL**
Direct Materials	360 000	180 000	90 000	270 000	900 000
Direct Labour	192 000	96 000	48 000	144 000	480 000
Manufacturing Overhead	450 000	330 000	270 000	390 000	1 440 000
Total manufacturing costs	1 002 000	606 000	408 000	804 000	2 820 000
Number of units to be produced	120 000	60 000	30 000	90 000	300 000
Estimated cost per unit	$8.35	$10.10	$13.60	$8.90	$10.24

51. *Hirst Manufacturing uses the job costing process to calculate cost per unit. The business has been calculating cost per unit on a quarterly basis but would now like to calculate it annually.*

Using the budgeted figures for the upcoming year below rework the figures to provide the annual: direct materials cost, direct labour cost, manufacturing overhead, total manufacturing cost, number of units to be produced and the estimated cost per unit.

In addition, you may need to calculate the quarterly manufacturing costs and the quarterly estimated cost per unit.

QUARTER	FIRST	SECOND	THIRD	FOURTH
Direct Materials	180 000	90 000	45 000	135 000
Direct Labour	96 000	48 000	24 000	72 000
Manufacturing Overhead	225 000	165 000	135 000	195 000
Total manufacturing costs	501 000	303 000	204 000	402 000
Number of units to be produced	60 000	30 000	15 000	45 000
Estimated cost per unit	$8.35	$10.10	$13.60	$8.93

52. *A. Determine the selling price of the following items, given their percentage mark-up.*

COST ($)	PERCENTAGE MARK UP (%)	SELLING PRICE ($)
5.00	5	5.25
6.80	25	8.50
15.00	25	18.75
16.90	50	25.35
19.90	50	29.85
50.00	5	52.50
75.00	25	93.75
90.00	50	135
100.00	50	150

B. *The business Glam Manufacturers manufactures necklaces and sells these to retail stores. It has just received an order for 200 necklaces and has allocated job order number x-93. All the costs associated with the production of this set of necklaces will be recorded on its own job cost sheet. Direct Labour Hours are used as the main cost driver and a 45% mark up is applied to costs.*

Required:

i. *How many direct labour hours are needed for the job?*
ii. *Calculate the overhead recovery rate for Job x-93.*
iii. *What is the total cost of Job x-93?*
iv. *How much will be charged for each necklace?*

Glam Manufacturers

Raw materials – x-93	$5,600.00	Direct labour hours	867
Direct labour – x-93	$4,900.00	Recovery rate	$18.46
Total labour for period	$39,000.00	Labour hours - Job 23	109
Overhead costs for period	$16,000.00	Overhead cost - Job 23	$2,010.26

Total cost – x-93	
Raw materials	$5,600.00
Direct labour	$4,900.00
Overhead costs	$2,010.26
TOTAL	**$12,510.26**
Unit cost	$62.55
Price charged per unit	$90.70

53. The company Hirst Manufacturing produces a putty called Noral. The direct materials and direct labour standards for one unit of Noral are given below:

	SQ or hours	*SP or rate*	*Standard cost*
Direct materials	*4.6 kg*	*$2.50 per kg*	*$11.50*
Direct labour	*0.2 hours*	*$12 per hour*	*$2.40*

During the month of January 2020, the following activity was recorded:

- *20 000 kg of materials were purchased at a cost of $2.35 per kg.*
- *All of the material purchased was used to produce 4 000 units of Noral.*
- *A total of 750 hours of direct labour time was recorded at a total labour cost of $10 425.*

Required:

A. Calculate the direct materials price and quantity variances for January.

Direct materials price variance for January:
Item: Material
Amount: 20 000 kgs
Actual Price: $2.35
Standard Price: $2.50
Difference in Price: $0.15
Total Price Variance: $3 000 F
January has a favourable variance of $3 000.

Direct Materials Quantity Variance for January:
Actual $2.50 x 5 kg = $12.50
Standard $2.50 x 4.6 kg = $11.50
There is an unfavourable variance of $1 per kg.

B. Calculate the direct labour rate and efficiency variances for the month.

Direct Labour Rate
$13.90 - $12 = $1.90
750 hours x $1.90 = $1425 U
There is an unfavourable direct labour rate variance of $1425.
No variance for the efficiency variance. It is assumed that 750 hours was budgeted for.

C. In February the company only produced 3 000 units of Noral using 14 750 kgs of material in the production process. Calculate the direct materials price and quantity variances for February.

Direct Materials Price Variance for February:
Item: Material
Amount: 14 750 kg
Actual Price: $2.35
Standard Price: 2.50
Difference in Price: $0.15
Total Price Variance: $2212.50
There is a favourable variance of $2213.

Direct Materials Quantity Variance for February:
Actual $2.50 x 4.92 kg = $12.29
Standard $2.50 x 4.6 kg = $12.50
There is a favourable variance of $0.21 per kg.

54. Savage Sports produces an inexpensive mini skateboard for toddlers called the Zoomer. The company has established a standard cost system to help control costs and has set the following standards for the Zoomer.

- *Direct materials: 6 pieces per skateboard at a cost of $0.50 per piece.*
- *Direct labour: 1.3 hours per skateboard at $8 per hour.*
- *During January 2020 the company produced 3 000 Zoomers. Production figures for that month were as follows:*
- *Direct materials: 25 000 pieces were purchased for use in production at a cost of $0.48 per piece. Only 20 000 pieces were used for the month.*
- *Direct labour: 4 000 direct labour hours were worked.*

Required:

For January:
A. Calculate direct materials price and quantity variances.

Price Variance:
Item: Skateboard
Amount: 20 000 pieces
Actual Price: $0.48
Standard Price: $0.50
Difference in Price: $0.02
Total Price Variance: $400F
There is a favourable variance of $400.

Direct Materials Quantity Variance:
Actual $0.50 x 6.67 pieces = $3.36
Standard $0.50 x 6 pieces = $3.00
There is an unfavourable variance of $0.36 per skateboard.

B. Calculate direct labour rate and efficiency variances.

Labour rate variance:
No variance as it is assumed the actual rate per labour hour and standard rate are both $8.

Labour Efficiency Variance:
= $8(4000 – 3900)
= $8 x 100
= $800 U
There is an unfavourable variance of $800.

C. List a possible cause for each variance.

Reasons for the unfavourable labour efficiency variance could be inexperienced workers or changes in production methods.

Reasons for the unfavourable materials quantity variance could be that workers are not trained to do their job properly or that some of the material was damaged.

Reasons for the favourable price variance could be sourcing cheaper materials, or better quality material.

55. Sakai Industries produces bicycles for primary school aged children. The seat of the bicycle is moulded from 600 grams of plastic at a cost of $8 per kg. During the quarter ending 30 September the company produced 35 000 bicycles, using 22 500 kg of plastic for the seats. The plastic cost the business $171 000.

Required:

A. Calculate the materials price variance.

Materials price variance:
$9 000 F

B. Calculate the material quantity variance.

Material quantity variance:
1 500 kg

C. What was the cost incurred for the manufacture of the 35 000 plastic seats?

$171 000

D. What cost for plastic should have been incurred?

$180 000

E. List a reason for each variance.

The entity received bonus plastic/a discount for the high volume of plastic they bought;
the entity used an extra 1 500 kgs of plastic due to wastage in the manufacturing process.

56. *The business Keely Enterprises manufactures a toy piano. The labour standards that have been set for one toy piano are:*

Standard Hours	***Standard Rate per Hour***	***Standard Cost***
18 minutes	*$12*	*$3.60*

During January, 5 750 direct labour hours were clocked in the production of 20 000 toy pianos. The direct labour cost was $73 600 for the month.

Required:

A. *Calculate the labour rate variance and the labour efficiency variance.*

Labour rate variance:
$0.80 more per hour

Labour efficiency variance:
0.14 more pianos per hour

B. *What direct labour cost was incurred for the month? By how much does this differ from what the labour cost should have been?*

Direct labour cost:
$73 600 incurred for the month
$1 600 more than the labour cost should have been

57. *Ricciardo and Sons manufacture designer Italian towelling robes. The company uses a standard cost system and has established the following standards for one unit:*

	SQ or hours	***SP or rate***	***Standard cost***	
Direct materials		*2.5 metres*	*$14 per metre*	*$35.00*
Direct labour		*1.6 hours*	*$8 per hour*	*$12.80*

During January the following activity was recorded for the towels:

- *10 000 metres of material was purchased at a cost of $13.80 per metre.*
- *8 000 metres of material was used to produce 3 000 units.*
- *5 000 hours of labour time spent working directly on the towelling robes was recorded at a cost of $43 000.*

Required:

A. *Calculate the direct materials price and quantity variances.*

Direct materials price variance:
– $2 000

Direct materials quantity variance:
500

B. *Calculate the direct labour rate and efficiency variances.*

Direct labour rate variance:
$0.60 more per hour

Direct labour efficiency variance:
0.067 more robes made per hour

Extended answer question 1

How can a business use generic business strategies to achieve a competitive advantage in the marketplace?

Strategic initiatives are initiatives put into place to help the business gain a competitive advantage. A generic business strategy is one which is designed to be used by no specific business or industry sector, but rather can be applied across businesses and industries.

A competitive advantage results from a business choosing cost leadership or differentiation. The business should avoid being ‘stuck’ in between these options with no strategy at all.

Cost leadership

This business strategy focuses on extreme efficiency. It relies on tight cost control so that the company keeps costs to an absolute minimum. Having the lowest possible costs allows the business to pass this on to the consumer and sell a low-cost product, thereby gaining market share. The strategy can be used by companies which produce a high volume of a fairly no frills, standardised product. This allows the business to take advantage of economies of scale. This means the average cost per unit falls the greater the production levels. The aim is for a low cost product being sold to a large customer base. The business is involved with mass production and mass distribution. Due to this, it is a strategy which only large firms can engage in.

Differentiation

This business strategy focuses on making the good/service offered by the business in some way different to that of its competitors. For example, Apple computers are different from IBM compatible computers. This product differentiation allows for a higher price to be charged due to the customer loyalty created in these situations.

The biggest advantage of the differentiation strategy is that the customer tends to remain loyal to the product, buying it because they want the product, without being concerned about the price. Differentiation could occur in areas such as the product, branding, features, customer service, technology used, and/or distribution.

Competitive advantage

This is created by using the businesses’ resources to achieve either lower costs or a differentiated product, thus positioning the business away from competitors.

Extended answer question 2

Why are cost accounting techniques an important element of the decision-making processes in internal management for business?

In your answer, discuss management accounting versus financial accounting, the nature of cost concepts, and the relationship between activity, costs and product.

Cost accounting techniques are an important element of the decision-making processes in internal management for business. Students should discuss setting of prices, budgeting, planning for idle capacity, other management decisions (etc).

Management accounting:

- Internal and confidential to managers and selected outsiders
- Regular production of reports, generated from system
- Responsive to changes.

Financial accounting:

- Often public and reported externally
- Reports based on accumulation of information over time
- Not produced regularly, summarised and lack detail.

Nature of cost concepts:

- Materials, labour and overheads: the elements of product costs, which are the goods manufactured for sale. Students should define each one.
- Cost behaviours: fixed, variable and mixed costs: Students should define each with examples
- Direct and indirect costs: Define each, with examples
- Product and period: Define with examples

Relationship between activity, costs and product:

- As activity increases, fixed costs remain the same and variable costs increase
- Mixed costs can affect – however not expected to be as great an impact as fixed or variable
- Costing is used to enable the business to make decisions about the production of specific items. Students should give a clear example of product mixes, make or buy decisions, accepting or rejecting special order.

CHAPTER 2: COST-VOLUME-PROFIT ANALYSIS

1. *Fill in the table using a fish and chip shop as an example.*

TERM	DEFINITION	EXAMPLE
Variable cost		
Fixed cost		

Variable costs: expenses which increase as production increases. For example raw materials, such as potatoes and fish for a Fish and Chip Shop.

Fixed costs: expenses which remain do not change with the volume of production, such as rent and electricity. All fixed expenses have to be paid regardless of the level of activity. If there were a situation where no services or products were are sold the rent would still need to be paid on the Fish and Chip Shop premises.

2. *What is cost-volume-profit analysis used to determine?*

Cost-volume-profit analysis is used to determine how costs and profits are affected by changes in the volume of production. It examines the relationship between costs, volume, sales, selling price and profit.

3. *How should the owner of a business determine the selling price of their product?*

The selling price generally depends upon the number of items that can be manufactured or sold.

To calculate the number of items required in order to cover costs, or in order to make a particular profit, a business can use break-even analysis. It is essential to calculate the break-even point to ensure that the selling price will cover all costs.

4. *What does it mean to 'break even'?*

Neither a profit nor loss is made. All costs are covered when a business breaks even.

5. *Define the 'break-even point'.*

Break-even point: The number of sales, or the dollar amount of income, where all expenses are covered and neither a profit or a loss will be made.

6. *Define 'contribution margin'.*

Contribution margin: the price at which a firm sells its product less the variable cost of producing the product.

7. *What is the formula for the contribution margin?*

Contribution Margin = Sales – Variable Costs

8.

A. *What does break-even analysis involve?*

Break even analysis involves calculating how many sales of a product are required in order to completely cover all the costs of producing that product. At the 'break even point', the business will make neither a profit or a loss.

B. *List five assumptions behind break-even analysis.*

Assumptions:

- Expenses can be divided neatly into fixed costs and variable costs
- All costs are known
- All costs remain constant without changing
- The selling price for the good or service remains the same
- All goods made can be sold

9.

A. *What are the two main methods of calculating a business' break-even point?*

The two main methods of calculating break-even are the unit contribution method and cost volume profit method.

B. *Under what circumstances would a business use each one?*

The contribution margin is used to calculate how much of the selling price contributes to covering the fixed costs of the business. Managers use cost categorised by behaviour as a decision making device. To help with these decisions, managers prepare the Income Statement in the contribution margin format. This classifies costs by cost behaviour.

10. What is the formula to work out:

A. *The number of units required to break even?*

$$\frac{\text{Fixed costs}}{\text{Contribution margin}}$$

B. *The number of units required to make a specific profit?*

$$\frac{\text{Fixed Cost + Profit}}{\text{Contribution Margin}}$$

11. How do capacity constraints impact on the results of a cost-volume-profit calculation?

The level of capacity can restrict the number of units of product that can be manufactured. If the factory has bottlenecks, or a machine that cannot produce items quickly due to its processes, then this will limit production. For example, one restriction is most factories have one or two eight hour shifts a day, and not continual production from three eight hour shifts a day.

12. Explain the purpose of the contribution margin then respond to these questions.

The contribution margin is the selling price per item, less the variable cost per item.

CM = SP - VC

A. *If the variable cost of manufacturing a product were to increase, what effect would this have on the break-even point?*

The contribution margin would decrease if the variable cost increased.

B. *If the contribution margin for a product were to decrease, what effect would this have on the break-even point?*

The number of units required for break-even will increase.

13.

A. Is it possible for a business to have no fixed costs? How could this affect the calculation of break-even?

Not all fixed costs are actually fixed. The decision to classify them this way can be arbitrary. For example, with changing technology a fixed cost phone line is no longer appropriate and telecommunications cost might be considered variable. In a service business, it is difficult to classify the traditional direct materials and direct labour costs.

B. Horatio Sharp owns a piano making business called Fine Tunes. He is calculating the break-even point for his business. He has the following figures:

i. Explain to Horatio what break-even analysis is.

Break-even analysis involves calculating how many sales of the product are required in order to completely cover all the costs of producing that product. At the 'break even point', the business will make neither a profit or a loss.

ii. Calculate the break-even point in number of pianos for Horatio.

This calculation shows how many pianos per annum need to be sold to break-even.

$$\text{BE} = \frac{\text{Fixed Costs}}{\text{Contribution margin}} \times 52$$

$$\text{F.C.} = 1000 + 1500 + 40 + 50$$
$$= 2590$$

$$\text{BE} = \frac{590 \times 52}{20\,000 - 5\,000}$$
$$= \frac{134\,680}{15\,000}$$
$$= 9$$

9 pianos need to be sold per annum to break even.

C. Roslana is a retired pensioner who operates a card making business from home, called Just a Note. She is interested in the break-even point for her business. She has given you the following figures:

i. Calculate the break-even point for Just a Note.

$$\text{BE} = \frac{\text{Fixed Cost}}{\text{Contribution Margin}}$$
$$= \frac{\$10 + \$160}{\$3.00 - \$1.50}$$
$$= \frac{\$160}{\$1.50}$$

Roslana needs to sell 107 cards per week to break-even.

ii. Roslana, would like to earn \$250 profit per week. How many cards will she need to sell to achieve this?

$$\text{BE} = \frac{\text{Fixed Cost} + \text{Profit}}{\text{Contribution Margin}}$$
$$= \frac{\$160 + \$250}{\$1.50}$$
$$= \frac{\$410}{\$1.50}$$

Roslana needs to sell 274 cards per week to make a \$250 profit.

14. To raise funds, you are going to run a hot chocolate and biscuit day during recess at your school. Students and staff will be able to purchase a drink of hot chocolate for $1, or a chocolate biscuit for $1, or both for $1.50.

A. If advertising and stall decorations cost $10, a packet of 10 biscuits is $2, and cardboard cups 10 cents each, how many sales do you need to make to break even? (Hint: You need to state the cost of your milk and hot chocolate.)

B. Label the break-even graph below with the information from this calculation. Indicate the amounts on each axis, and label the income line, expense line and break-even point.

Discussion question. Student answers will differ according to the milk price and hot chocolate price they use.

15. Consider the following quote:

> 'Internally generated cost-volume-profit data is vital to the owner of a business; however, it is data that should not be provided to external parties under any circumstances because they might gain a competitive advantage.'

Discuss this quote in pairs, considering the point of view of an external and an internal user of the business data.

A. What are the consequences of this action on both users, and on the organisations that they represent?

B. Analyse the value systems and ethical position that have been taken with regard to managerial accounting in the above quote.

Discussion questions. Answers might include:

Comparison of reporting and analysis:

- internally reported management data
- external financial reports
- creation of information that summarises the businesses progress at a point in time
- the use of data for insights in to how to improve the business' performance

16. What is the purpose of calculating the contribution margin? Why are variable costs, and not fixed costs, included in its calculation?

The purpose of the Contribution Margin is to calculate the financial contribution each unit makes to cover fixed costs. Fixed costs are not included in the calculation as the CM is the difference between selling price and variable costs.

17. The business Sarah's Skates manufacture and sell specialist skateboards. Each board sells for $170, and has a variable cost of $120. Three hundred boards have been sold in the past six months. The fixed costs of the business are $3 000 a month.

Complete the following:

A. Calculate the break-even point of the business.

Sarah's Skates

$$BE = \frac{FC}{CM} = \frac{3000}{170-120} = \frac{3000}{50}$$

60 boards need to be sold per month to break-even.

B. Prepare a simplified Income Statement (using a contribution margin layout) for the business.

Income Statement at the end of six months:

Income Statement	**$**
Sales	$51 000
Less: Variable Costs	36 000
Contribution margin	**15 000**
Less: Fixed Costs	18 000
Loss	**$(3 000)**

C. Draw a break-even graph for the business, leaving space to graph information from the sections below.

Graph. NO GRAPH PROVIDED

D. How will the profit or loss of the business change if the selling price is reduced by 10%, and this results in a 15% increase in the volume of sales? Graph the new break-even point.

New BE $= \dfrac{3000}{153-120}$

$= \dfrac{3000}{33}$

91 boards per month now need to be sold per month.

E. Alternatively, how will the profit or loss of the business change if the fixed costs for the next six months increase to $19 000 and the variable cost per unit decreases to $105, with sales unchanged? Graph the alternative break-even point.

New BE $= \dfrac{19\ 000}{170-105}$

$= \dfrac{19\ 000}{65}$

292 boards over the next 6 months, or 49 boards per month, are required with the changes in costs.

18. Fleur's Fine Foods creates and sells takeaway gourmet dinners for a set price. Fleur is expecting that in the first month of business, she will sell 150 dinners each with a variable cost of $15. The cost of power, gas, and kitchen equipment rental for the month is expected to be $3 000.

A. How much must Fleur charge for each dinner to break even?

Sales = Variable expenses + Fixed expenses + Profit
150x = 2250 + 3000 + 0
150x = 5250
x = 35

Fleur will need to charge $35 per dinner.

B. Prepare a simplified Income Statement (using a contribution margin layout) for the business.

Income Statement	**$**
Sales	5 250
Less: Variable costs	2 250
Contribution Margin	**3 000**
Less: Fixed costs	3 000
Profit	**0**

C. *How will the profit or loss of Fleur's business change if the selling price of the dinners is $38 and sales remain the same? Prepare a new simplified Income Statement using a contribution margin layout.*

	Sales	= Variable expenses + Fixed expenses + Profit
	5700	= 2250 + 3000 + x
5700 – 5250		= x
	x	= 450

A profit of $450 will be realised.

Income Statement	**$**
Sales	5 700
Less: Variable costs	2 250
Contribution Margin	**3 450**
Less: Fixed costs	3 000
Profit	**450**

D. *Fleur has underestimated her fixed costs and overestimated her sales. At the end of the first month of business, fixed costs were $3 500 and sales totalled 130 units. Using the break-even sales price, what profit or loss did Fleur make?*

Students must assume the selling price is still $35.

Sales		= Variable expenses + Fixed expenses + profit
4550		= 1950 + 3500 + x
4550 – 5450		= x
	x	= ($900)

A loss of $900 has been made.

E. *In the second month of business, Fleur achieved more positive results. While her fixed costs remained at $3 500, she was able to cut back variable costs and each dinner now only cost $12 to make. Sales rose in response to a reduced sales price of $31, to 190 units. What is Fleur's new profit or loss? Graph the break-even point.*

	Sales	= Variable expenses + Fixed expenses + Profit
	5890	= 2280 + 3500 + x
5890 – 5780		= x
	x	= 110

A profit of $110 was realised.

19. *Kerry's Coffee Shop sells specially brewed coffees. Kerry charges $3.80 a coffee, and each coffee costs $0.50 to make. The rent and wage costs for the shop are $2 000 a week. Kerry is going to offer a special promotion for a week next month, hoping this will entice more customers into the shop. She will give everyone who buys a coffee a voucher for a free coffee. She estimates that she will sell 300 more coffees than usual and give away 400 coffees. She will spend $200 on vouchers and posters for the promotion.*

A. *What is Kerry's break-even point in the week before the promotion? If she usually sells 650 coffees in a week, what is her profit or loss in the week before the promotion?*

	Sales	= VC + FC + Profit
	2470	= 325 + 2000 + x
2470 – 2350		= x
	x	= 120

Profit the week before the promotion is $120. The break-even point is 606 cups of coffee.

B. What is the break-even point for the week of the promotion? Graph the new break-even point.

727 cups of coffee.

C. How would the promotion affect profit or loss during the week of the promotion?

$735 profit is made in total, which is $615 more than usual.

D. Analyse the effect of a large contribution margin (in comparison to variable costs) on the profit or loss made by a business.

The lower the variable cost the higher the contribution margin. The higher the contribution margin the higher the profit.

E. Should the special promotion go ahead? Explain why, and give Kerry at least two alternative courses of action to improve sales.

Yes, the promotion should go ahead because the business will make more profit than what it does normally. Other ways to increase sales could be extra advertising or a loyalty card eg. after buying 9 coffees the customer gets one for free.

20 You have been given the following information in relation to two businesses, both of which have sold 100 items at $34.00 each.

Gorgeous Gifts		*Lazy Loot*	
Contribution Margin Income Statement		*Contribution Margin Income Statement*	
For the quarter ended 1 April 2019		*For the quarter ended 1 April 2019*	
Sales	*$3 400*	*Sales*	*$3 400*
Less: Variable Exp.	*2 000*	*Less: Variable Exp.*	*2 900*
Contribution Margin	*1 400*	*Contribution Margin*	*500*
Less: Fixed Expenses	*900*	*Less: Fixed Expenses*	*800*
Profit (Loss)	*$500*	*Profit (Loss)*	*$(300)*

Required:

A. Calculate the number of units that each business needs to sell in order to break even.

Break-even for Gorgeous Gifts = 64.2 units
Break-even for Lazy Loot = 160 units

B. The two businesses have earned the same sales income, however, their break-even point differs. Explain why.

Gorgeous Gifts has a much higher contribution margin.

C. Calculate the change in the final profit (or loss) for each business if sales and variable expenses both increase by 10%.

Gorgeous Gifts	
Income Statement	**$**
Sales	3 740
Less Variable Costs	2 200
Contribution Margin	1 540
Less Fixed Costs	900
Profit	**640**

Lazy Loot	
Income Statement	**$**
Sales	3 740
Less Variable Costs	3 190
Contribution Margin	550
Less Fixed Costs	900
Loss	**(350)**

D. How has this 10% change affected the two businesses? Identify possible reasons to explain its impact on them.

Gorgeous Gifts now has a profit of $640, a $140 increase. Lazy Loot has a $350 loss.

21. What is the formula for the CVP equation?

Sales – (Variable expenses + Fixed expenses) = Profit

22.

A. The CVP formula can be expressed in many different ways. Why?

The CVP equation is manipulated according to the information known. It can be rearranged mathematically.

B. List five variables that the business might alter when analysing the break-even point using CVP.

The business needs to consider more then one alternative when analysing the break-even point of the business. Management may consider altering any of the following:

- selling price
- fixed costs
- variable costs
- volume
- product mixes.

23. Create a summary table showing how to calculate each of the following:

A. contribution margin
B. contribution margin per unit
C. weighted average contribution per unit
D. margin of safety
E. profit or sales volume
F. break-even point
G. the effect on profit/loss of make or buy decisions
H. the effect on profit/loss of closing a department/dropping a segment product
I. the gain or loss on special order decisions

Students need to come up with their own figures to explain how each of these concepts are calculated such as how part a. is done below.

a) Contribution Margin – If the price is $10 and the VC is $2 then the CM is $8.

Break-even can be expressed as either units or dollars.

24. *Trent Manufacturing makes televisions with a selling price of $200 per unit. The variable expenses are $175 per unit and the fixed costs are $40 000 per month. Using the CVP equation:*

A. *Calculate the break-even point in units.*

$200X = $175X + $40 000 + 0
$25X = $40 000
X = 1 600 televisions per month

B. *Calculate the break-even point in sales dollars.*

1 600 televisions x $200
= $320 000 sales need to be made to break even for the month.

25. *Pinter Manufacturing produces digital radios with a selling price of $350 per unit. The variable expenses are $200 per unit and the fixed costs are $20 000 per month. Using the CVP equation:*

A. *Calculate the break-even point in units.*

$350X = $200X + $20 000
$150X = $20 000
X = 133.33
134 digital radios need to be sold per month to break even.

B. *Calculate the break-even point in sales dollars.*

134 radios x $350
= $46 900 sales need to be made in order to break even.

26. *Brown and Co manufacture microwave ovens with a selling price of $250 per unit. The variable expenses are $150 per unit and the fixed costs are $30 000 per month. Using the CVP equation:*

A. *Calculate the break-even point in units.*

$250X = $150X + $30 000
$100X = $30 000
X = 300
300 microwave ovens need to be sold per month to breakeven.

B. *Calculate the break-even point in sales dollars.*

300 x $250
= $75 000 of sales is required for monthly break-even.

27. *Beepops Inc makes toddler portable DVD players with a selling price of $200 per unit. The variable expenses are $100 per unit and the fixed costs are $20 000 per month.*

Using the CVP equation:

A. *Calculate the break-even point in units.*

$200x = $100x + $20 000
$100x = $20 000
x = 200 units to break even.

B. *Calculate the break-even point in sales dollars.*

200 x $200
= $40 000 sales to break even.

C. If both the fixed costs and the variable costs increase by 5%, what will the new break-even point be in units?

$210x = $105x + $20 000
$105X = $20 000
x = 190.4

191 units need to be sold to break even.

Sales = 191 x $210
$40 110 sales are needed to break even.

28. Hirst Enterprises makes swing sets with a selling price of $400 per unit. The variable expenses are $180 per unit and the fixed costs are $25 000 per month. Using the CVP equation:

A. Calculate the break-even point in units.

$400x = $180x + $25 000
$220x = $25 000
x = 113.6

114 units need to be sold to break even.

B. Calculate the break-even point in sales dollars.

114 x $400
= $45 600

C. If the both the fixed costs and the variable costs increase by 10%, what will the new break-even point be in units?

$440x = $198x + $25 000
$242x = $25 000
x = 103.3

104 swing sets need to be sold to break even.

29 . Soda House makes go-carts with a selling price of $300 per unit. The variable expenses are $200 per unit and the fixed costs are $50 000 per month. Using the CVP equation:

A. Calculate the break-even point in units.

$300x = $200x + $50 000
$100x = $50 000
x = 500 units need to be sold to break even.

B. Calculate the break-even point in sales dollars.

500 x $300
= $150 000 of sales to break even.

C. If the both the fixed costs and the variable costs increase by 15%, what will the new break-even point be in units?

$345x = $230x + $50 000
115x = $50 000
x = 435 go-carts need to be sold to break even.

30 Sports Co manufactures ball machines with a selling price of $600 per unit. The variable expenses are $300 per unit and the fixed costs are $70 000 per month. Using the CVP equation:

A. Calculate the break-even point in units.

$600x = $300x + $70 000
$300x = $70 000
x = 234 units need to be sold to break even.

B. Calculate the break-even point in sales dollars.

234 x $600
= $140 400 of sales to break even.

C. How many ball machines need to be sold if the business would like to achieve a minimum profit of $100 000?

$600x = $300x + $70 000 + $100 000
$300x = $170 000
x = 567 ball machines must be sold to achieve a $100 000 profit.

31. Smith and Sons make playground slides with a selling price of $800 per unit. The variable expenses are $200 per unit and the fixed costs are $60 000 per month. Using the CVP equation:

A. Calculate the break-even point in units.

$800x = $200x + $60 000
$600x = $60 000
x = 100 units need to be sold to break even.

B. Calculate the break-even point in sales dollars.

100 x $800
= $80 000 of sales to break even.

C. How many ball machines need to be sold if the business would like to achieve a minimum profit of $40 000?

$800x = $200x + $60 000 + $40 000
$600x = $100 000
x = 167 slides must be sold to achieve $40 000 profit.

32. Jones and Daughters make a toy house with a selling price of $1 200 per unit. The variable expenses are $400 per unit and the fixed costs are $50 000 per month.

Using the CVP equation:

A. Calculate the break-even point in units.

$1200x = $400x + $50 000
$800x = $50 000
x = 63 units must be sold to break even.

B. Calculate the break-even point in sales dollars.

63 x $1200
= $75 600 of sales to break even.

C. How many toy houses need to be sold if the business would like to achieve a minimum profit of $50 000?

$1200x = $400x + $50 000 + $50 000
$800x = $100 000
x = 125 'Toy Houses' need to be sold to make a $50 000 profit.

33 Define 'margin of safety'.

The margin of safety for a product is the amount by which estimated sales are greater than the break-even point.

34. What is the formula for the margin of safety:

A. In dollars?

The formula to calculate the dollar figure for margin of safety is:

Total sales – Break-even sales = Margin of safety

B. To calculate the margin of safety as a percentage?

The formula to calculate the margin of safety (MS) as a percentage is:

Margin of safety in dollars = MS percentage
Total Sales

35. What is the purpose of calculating the margin of safety?

The business can calculate the percentage by which sales may decrease before the break-even point is reached or a loss is incurred. The higher the margin of safety the better, as there is lowered risk. It shows how much sales can decrease before not meeting the break-even point. If the margin of safety is high, the business might be able to adjust the sales price in order to gain market share, or spend more on expenses such as advertising to increase market reach.

36. ABC and Things sells two types of products. They want to downsize their operation and focus on just the product with the greater margin of safety if it will result in the business being more profitable. An Income Statement extract for the two products is given below:

	Product A Amount	*Product B Amount*
Sales	*$150 000*	*$150 000*
Variable costs	*75 000*	*100 000*
Contribution margin	*75 000*	*50 000*
Fixed costs	*40 000*	*45 000*
Profit	*30 000*	*5 000*

A. Calculate the break-even point for both products.

Break-even = $\frac{\text{Fixed expenses}}{\text{Contribution margin percentage}}$

Product A

$\frac{\$40\ 000}{50\%}$

= $80 000 of sales.

Product B

$\frac{\$45\ 000}{67}$

= $67 164 of sales.

B. Calculate the margin of safety in dollars for both products.

Total sales – Break-even sales = Margin of safety

Product A
$150 000 - $80 000 = $70 000

Product B
$150 000 - $67 164 = $82 836

C. Calculate the margin of safety as a percentage.

The formula to calculate the margin of safety as a percentage is:

$$\frac{\text{Margin of safety in dollars}}{\text{Total Sales}} = \text{MS percentage}$$

Product A

$$\frac{\$70\ 000}{\$150\ 000} = 47\%$$

Product B

$$\frac{\$82\ 836}{\$150\ 000} = 55\%$$

D. What is your recommendation?

It is recommended that *ABC and Things* downsize their operation and focus on Product B, the product with the greater margin of safety.

37. Assume that Bower Corp's break-even point is income of $1 000 000. Fixed costs are $400 000.

A. Calculate the contribution margin as a percentage.

Sales	= Variable Expenses + Fixed Expenses + Profit
1 000 000	= x + 400 000 + 0
1000 000 – 400 000	= x
x	= 600 000

Variable expenses = $600 000

Income Statement in CM Format

Sales	1 000 000	100%
Less Variable Costs	600 000	60%
Contribution Margin	400 000	40%
Less Fixed costs	400 000	
Profit	**0**	

The contribution margin percentage is 40%

B. Calculate the selling price if variable costs are $12 per unit.

$$\frac{\$600\ 000}{\$12} = 50\ 000 \text{ units sold}$$

$$\text{Selling Price} = \frac{\text{Sales}}{\text{Number of units sold}}$$

$$x = \frac{\$1\ 000\ 000}{50\ 000}$$

$$x = \$20$$

Selling price = $20.

C. In the last month, 80 000 units were sold. Calculate the margin of safety in units.

MS = Total Sales – Break-Even Sales
= 80 000 units – 50 000 units
= 30 000 units.

38. Jinx Inc's break-even point is $500 000. Fixed costs are $250 000.

A. Calculate the contribution margin percentage.

Sales	= Variable Expenses + Fixed Expenses + Profit
500 000	= x + 250 000 + 0
500 000 – 250 000	= x
x	= 250 000

Variable expenses are $250 000.

Income Statement in CM Format

Sales	500 000	100%
LESS Variable Costs	250 000	50%
Contribution Margin	250 000	50%
LESS Fixed Costs	250 000	
Profit	**0**	

Contribution Margin Percentage = 50%

B. Calculate the selling price if variable costs are $10 per unit.

$\frac{\$250\,000}{\$10}$ = 25 000 units sold

Selling Price = $\frac{\text{Sales}}{\text{Number of units sold}}$

x = $\frac{\$500\,000}{25\,000}$

x = $20

Selling price = $20.

C. Assume 50 000 units are sold. Calculate the margin of safety in units.

MS = Total Sales – Break-Even Sales
= 50 000 units – 25 000 units
= 25 000 units.

39. Sunrise and Co's break-even point is $200 000. Fixed costs are $80 000.

A. Calculate the contribution margin percentage.

Sales	= Variable Expenses + Fixed Expenses + Profit
200 000	= x + 80 000 + 0
200 000 – 80 000	= x
x	= 120 000

Variable expenses = $120 000

Sales	200 000	100%
Less: Variable Costs	120 000	60%
Contribution Margin	80 000	40%
Less: Fixed Costs	80 000	
Profit	**0**	

Contribution Margin Percentage = 40%

B. *Calculate the selling price if variable costs are $5 per unit.*

$\frac{\$200\ 000}{\$5}$ = 40 000 units sold

Selling Price = $\frac{\text{Sales}}{\text{Number of units sold}}$

x = $\frac{\$200\ 000}{40\ 000}$

x = $5

Selling price = $5.

C. *In the last week, 100 000 units were sold. Calculate the margin of safety in units.*

MS = Total sales – break-even sales
= 100 000 units – 40 000 units
= 60 000 units

40. *The Ronaldo Company has three product lines of shoes – A, B and C with contribution margins of $3, $2 and $1, respectively. Management foresees sales of 200 000 units in the coming accounting period, consisting of 20 000 of unit A, 100 000 of unit B and 80 000 of unit C. The company's fixed costs for the period are $255 000.*

A. *What is the company's break-even point in units, assuming the given sales mix is maintained?*

Step One

CM = $\frac{(\$3 \times 20\ 000) + (\$2 \times 100\ 000) + (\$1 \times 80\ 000)}{200\ 000 \text{ units}}$

= $\frac{(60\ 000) + (200\ 000) + (80\ 000)}{200\ 000 \text{ units}}$

= $\frac{\$340\ 000}{200\ 000 \text{ units}}$

= $1.70 per unit

Step Two

BE = $\frac{\$255\ 000}{1.70}$

= 150 000 units

Break-even is 150 000 units.

B. *If the sales mix is maintained, what is the total contribution margin when 200 000 units are sold? What is the operating income?*

Sales Mix

	A	B	C	TOTAL
Units sold (sales mix)	20 000	100 000	80 000	200 000
Contribution margin $3, $2 and $1 per unit	$60 000	$200 000	$80 000	340 000
Fixed costs				255 000
Profit				85 000

Total Contribution Margin = $340 000

Profit (Operating Income) = $85 000

C. What would the operating income (profit/loss) be if 200 000 units of A, 80 000 units of B and 100 000 units of C were sold?

	A	B	C	TOTAL
Units sold (sales mix)	200 000	80 000	100 000	380 000
Contribution margin \$3, \$2 and \$1 per unit	\$600 000	\$160 000	\$100 000	860 000
Fixed costs				255 000
Profit				605 000

Profit = \$605 000

41. The Bunty Company retails two products: a standard and a deluxe suitcase. The budgeted income statement for the next accounting period is as follows:

Bunty Company
Budgeted Income Statement

	Standard	*Deluxe*	*Total*
Units sold	*150 000*	*50 000*	*200 000*
Income at \$20 and \$30 per unit	*3 000 000*	*1 500 000*	*4 500 000*
Variable costs at \$14 and \$18 per unit	*2 100 000*	*900 000*	*3 000 000*
Contribution margin at \$6 and \$12 per unit	*900 000*	*600 000*	*1 500 000*
Fixed costs			*1 200 000*
Operating income (profit/loss)			*300 000*

A. Calculate the break-even point in units, assuming the planned sales mix is attained.

$$\text{CMPU} = \frac{(\$6 \text{ per unit x } 150\ 000 \text{ units sold}) + (\$12 \text{ per unit x } 50\ 000 \text{ units sold})}{150\ 000 \text{ units} + 50\ 000 \text{ units}}$$

$$= \frac{(\$900\ 000) + (\$600\ 000)}{200\ 000 \text{ units}}$$

$$= \frac{\$1\ 500\ 000}{200\ 000}$$

CMPU = \$75 per unit

$$\text{Break-even} = \frac{1\ 200\ 000}{75}$$

= 16 000 units.

B. Calculate the break-even point in units if only the standard suitcases are sold.

	Standard
Units sold	150 000
Income at \$20	3 000 000
Variable costs at \$14	2 100 000
Contribution margin at \$6	900 000

\$3 000 000 = \$2 100 000 + x + 0
\$3 000 000 – \$2 100 000 = x

$$\text{Break-even in units} = \frac{\$900\ 000}{\$20}$$

= 45 000 units

C. Calculate the break-even point in units if only the deluxe suitcases are sold.

	Deluxe
Units sold	50 000
Income at $30 per unit	1 500 000
Variable costs at $18 per unit	900 000
Contribution margin at $12 per unit	600 000

$1 500 000 = x + $900 000 + 0
$1 500 000 - $900 000 = x
x = $600 000

Break-even in units = $600 000 / $30
= 20 units

D. In the last accounting period, 200 000 units were sold but only 20 000 of them were deluxe. Calculate the profit as well as the break-even point in units.

Sales Mix

	Standard	Deluxe	Total
Units sold	180 000	20 000	200 000
Income at $20 and $30 per unit	3 600 000	600 000	4 200 000
Variable costs at $14 and $18 per unit	2 520 000	360 000	2 880 000
contribution margin at $6 and $12 per unit	1080 000	240 000	1 320 000
Fixed costs			1 020 000
Operating income (profit)			**300 000**

Profit in units

Standard = 89% of profit
= 178 units
Deluxe = 11% of profit
= 22 units

Break-even in units

Standard break-even = 173 550 units
Deluxe break-even = 14 300 units

42. Song World has two departments. One makes stereos and one makes digital radios. The Income Statement for each department is shown here:

Song World
Department Income Statements

	Stereos	*Digital Radios*	*Total*
Sales	*10 000*	*45 000*	*55 000*
Costs:			
Direct materials	*4 000*	*8 500*	*12 500*
Direct labour	*3 500*	*14 000*	*17 500*
Electricity	*500*	*1 500*	*2000*
Supplies	*500*	*2 500*	*3 000*
Rental	*2 500*	*3 000*	*5 500*
Share of site costs	*1 500*	*3 500*	*5 000*
Profit/Loss	*(2 500)*	*12 000*	*9 500*

The business is concerned that the Income Statement shows a loss is being made on stereos. Management are wondering if they should close down this department. The rental cost total and the share of site costs total would not alter if one department closed. All other costs are directly associated with the products and would disappear if the relevant department closed.

A. Should the business close down the stereo department? Justify your decision.

	Digital radios
	$
Sales	45 000
Costs	
Direct materials	8 500
Direct labour	14 000
Electricity	1 500
Supplies	2 500
Rental	5 500
Share of site costs	5 000
Profit	**8 000**

With the stereo department and the digital radios being manufactured simultaneously the overall profit is $9 500. If the stereo department was closed and only the digital radios were sold, then the profit would be $8 000 – a decrease of $1 500. Therefore, although the stereo department makes a loss, because of the shared costs it helps contribute to a higher overall profit and thus should remain open.

B. What are avoidable costs? Give an example.

Avoidable costs are those that would not be incurred if a certain course of action was taken, ie. they are costs that belong to a product/service/department and would disappear if the product disappeared.

C. What are unavoidable costs? Give an example.

Unavoidable costs are those that will be incurred whether a product is kept or not.

43. *Tempa Lines Ltd. manufactures wooden rowing boats. The following information shows the costs associated with producing these boats:*

Direct materials	Each boat requires 4 kg of materials. The materials cost $3 per kg.
Direct labour	An employee takes two hours to complete each boat. Employees are paid $7 per hour.
Machine time	Each boat requires 1 hour of machine time. Machine time costs $3 per hour.
Sales commission	Sales staff receive $5 commission for every boat they sell.
Fixed costs	$240 000
Selling price	$50

Tempa Lines Ltd is currently manufacturing 18,400 boats, but has the capacity to manufacture 20,000 per year. A national sporting goods retailer has contacted Tempa Lines Ltd and would like to purchase 3,700 boats and has offered to pay $42 for each boat.

Required

A. *Determine whether this offer is acceptable.*

Determine whether this offer is acceptable.

Maximum capacity = 20000 – 18400

Current production = 1600 units

To produce the special order of 3700 units:
= 3 700 – 1 600
= 2 100 units of normal production would need to cease

Normal contribution margin = SP $50 – VC $34
= $16 CM per unit

Income	(3 700 x $42)	155 400
Less: Variable Costs	(3 700 x $34)	(125 800)
Less: Opportunity Costs	(2 100 x $16)	(33 600)
Less: Additional Fixed Costs		0
Gain/Loss		**(4 000)**

B. *Would the offer be acceptable if the sporting goods retailer ordered 2 650 products?*

Would the offer be acceptable if the sporting retailer ordered 2 650 products?

Units of normal production needing to cease = 2 650 – 1 600
= 1 050

Income	(2,650 x $42)	111 300
Less: Variable Costs	(2,650 x $34)	(90 100)
Less: Opportunity Costs	(1,050 x $16)	(16 800)
Less: Any Additional Fixed Costs		0
Gain/Loss		**4 400**

Student answer should discuss questions such as:

- Is it wise to stop production of 1050 units of normal production?
- Will these customers come back in the future?

C. What is the minimum price Tempa Lines Ltd could accept if the order was for 2 950 products?

What is the minimum price Tempa Lines Ltd could accept if the order was for 2 950 products?

Gain/Loss		0
Add any Additional Fixed Cost		0
Add Opportunity Costs	(1 350 x $16)	21 600
Add Variable Costs	(2 950 x $34)	100 300
Income		**$121 900**

Minimum Price = $121 900 / 2 950
= $41.32

44. Bancroft Ltd make music players. One of the parts, the outer machine cover, could be made and purchased from an overseas supplier. The cost charged by the overseas supplier would be $130.

For the upcoming year, Bancroft Ltd has budgeted to make 15 000 music players. The cost to make the outer machine cover would be as follows:

Direct materials	*$90 per outer machine cover*
Direct labour	*$50 outer machine cover*
Variable manufacturing overhead	*$35 per outer machine cover*
Fixed manufacturing costs (allocated)	*$140000 for the year*

If the outer machine cover were made and purchased from an overseas supplier, $20000 of the fixed manufacturing costs allocated to the outer machine cover would be eliminated.

Required:

Determine if the business should make or buy the hard drive. Justify your answer.

	Make the outer machine cover	**Buy the outer machine cover**	**Differential analysis**
Direct material	$90 X 15000 units = $1350000	Nil	$1350000
Direct labour	$50 X 15000 units = $750000	Nil	$750000
Variable manufacturing overhead	$35 X 15000 units = $525000	Nil	$525000
Fixed manufacturing overhead	$140000	$120000	$20000
Purchase from overseas supplier		$130 X 15000 = $1950000	($1950000)
Total costs	$2765000	$2070000	$695000

The business should buy the outer machine cover from the overseas supplier because it will lead to a gain of $695000 in cost savings.

Savings per unit = $695000 / 15000 units
= $46.33 savings per cover.

45. *Jolimont Ltd is considering the profitability of its three products: tennis racquets, squash racquets and badminton racquets. The CEO would like to know whether the business should close down its production of badminton racquets due to the loss reported below. Sales in badminton racquets have been in decline for a number of years.*

The following data relates to these three products for the last financial year.

Details	Tennis racquets $	Squash racquets $	Badminton racquets $	Total $
Sales	800000	950000	600000	2350000
Variable costs:				
Manufacturing	(460000)	(560000)	(430000)	(1450000)
Selling	(65000)	(95000)	(89000)	(249000)
Fixed costs	(100000)	(110000)	(90000)	(300000)
Profit (Loss)	175000	185000	(9000)	351000

70% of fixed costs are allocated based on the proportions:

Tennis racquets – 33%
Squash racquets – 37%
Badminton racquets – 30%

If the Badminton racquets are dropped, then the proportions would be:

Tennis racquets – 47%
Squash racquets – 53%

The other 30% of fixed costs are discretionary costs, and these would be eliminated if manufacture of badminton racquets were closed down.

In addition, if the badminton racquets are not produced, the factory space could be rented out to earn revenue of $30000 per year.

Required:

Comment on whether the business should close down production of badminton racquets.

Jolimont Ltd

Badminton racquet fixed costs = $90000 x 30%
= $27000 discretionary costs to be saved.

Therefore $90000 – 27000 = $63000 to be re-apportioned to the tennis racquets and squash racquets as follows:

Tennis racquets: = $63000 x 47%
= $29610 + 100000
= 129610

Squash racquets: = $63000 x 53%
= $33390 + 110000
= 143390

Details	Tennis racquets $	Squash racquets $	Total $
Sales	800000	950000	1750000
Variable costs: Manufacturing Selling	 (460000) (65000)	 (560000) (95000)	 (1020000) (160000)
Fixed costs	(129610)	(143390)	(273000)
Profit (Loss)	145390	151610	297000

Loss of profit:

Previous profit = $351000 - $297000
= $(54000)
Offset by the opportunity cost of rent to be gained of $30000:
Therefore the overall loss of income from dropping the badminton racquet production is:
= ($54000) + 30000
= $24000

46. *Eager Enterprises manufacture cameras. The business has two products in its camera lens category – Product A and Product B. The management of Eager Enterprises has recently compiled separate estimated Income Statements for the two products and these are shown below.*

Eager Enterprises

Income Statement – Estimate
For the month of May 2020

	PRODUCT A	*PRODUCT B*
Sales	*64 000*	*65 000*
Less Variable costs	*32 000*	*30 000*
Contribution Margin	*32 000*	*35 000*
Less Fixed costs	*30 000*	*30 000*
Profit/Loss	*2 000*	*5 000*
Number of units sold	*160*	*250*

A. *What is the dollar value of the margin of safety for each product?*

Units required to break even = $\frac{\text{Fixed costs}}{\text{Contribution margin}}$
Margin of safety = Estimated total sales – Break even sales

	PRODUCT A	**PRODUCT B**
Number of units sold	160	250
Sale price	$400	$260
Variable cost per unit	$200	$120
Breakeven units	150	214
Margin of safety	4000	9286

B. Explain to the managers how they can use the information obtained from the margin of safety.

Students should discuss the concept that by comparing estimated sales with the break-even point required, managers can consider how much sales can decline before a loss is incurred. A higher margin of safety is preferred, therefore Product B is the better option.

C. Assuming estimated sales remain consistent, what level of sales of Product A and Product B does the business need to earn in August 2020 in order to break even across sales for the two products?

Weighted average contribution margin (WACM):

$$= \frac{(\text{Contribution margin Product A x Units Product A}) + (\text{Contribution margin Product B x Units Product B})}{(\text{Units Product A + Units Product B})}$$

$$= \frac{(\$200 \text{ x } 160) + (\$140 \text{ x } 250)}{410}$$

= $163.41 per unit

$$\text{Units required to break even} = \frac{\text{Total fixed costs}}{\text{WACM}} = \frac{60\ 000}{163.41} = 367 \text{ units}$$

Product mix = 39% Product A, 61% Product B

Sales mix to break even = 143 units of Product A, 224 units of Product B

D. The business has idle capacity. If the business were approached with a request to custom manufacture an additional 50 units of Product A in August, at a sale price of $300 per unit, should it accept or reject this special order? Justify your answer.

Special order	
Sales	15 000
Less Variable Costs	10 000
Contribution margin	**5 000**

Yes, the special order will add to the profits of the business (especially as there is idle capacity – no effect on fixed costs) and should be accepted.

E. Explain to the managers the meaning of the term "opportunity cost" and how this could have affected their profit if the business was at capacity when the request for the custom manufacture in Part D was made.

Opportunity cost is having to forgo other alternatives (opportunities) when one alternative is chosen. For example the opportunity cost of not accepting the special order is $5 000.

47. Amity's Fitness manufactures specialty fitness equipment for the Australian and overseas markets. Amity has given you the business results for the past financial year presented in a contribution margin format. The business manufactured and sold 6 000 pieces of fitness equipment in the year. Amity is concerned about the overall results for the year.

Amity's Fitness
Income Statement
(Contribution margin format)
For the period ending 30 June 2021

Sales	*$1 500 000*
LESS: Variable Costs	
Direct materials	*900 000*
Direct labour	*360 000*
Contribution Margin	*240 000*
LESS: Fixed Costs	*300 000*
Loss	*(60 000)*

A. What is the selling price per item and the variable cost per item?

Selling price $= \frac{1\ 500\ 000}{6\ 000}$
= $250 each

Variable costs per item $= \frac{900\ 000 + 360\ 000}{6\ 000}$
= $210 each

B. How many units does the business need to manufacture in order to break even in the next financial year?

Units required to break even $= \frac{\text{Fixed costs}}{\text{Contribution margin per unit}}$
$= \frac{300\ 000}{(250\text{–}210)}$
= 7 500 cameras.

C. If a reduction in the selling price of 10% was to result in a 20% increase in sales, with relevant adjustments to variable costs, would the business make a profit or a loss?

New sale price = 250 x 0.9
= $225 each

Volume of sales (increase of 20%) = 6 000 x 1.20
= 7 200 units of fitness equipment

New sales amount = 225 x 7200
= $ 1 620 000

Revised contribution margin

Sales	$1 620 000
Less: Variable Costs	
Direct materials	1 080 000
Direct labour	432 000
Contribution Margin	108 000
Less: Fixed costs	300 000
Loss	**(192 000)**

Unfortunately the adjustment to the selling price would not improve the situation. In fact the business would make a worse loss if the predicted sales were to occur.

D. Amity has been able to obtain a component of the fitness equipment for a reduced cost. This means that the fixed cost will reduce to $200 000. Based on this change and the information from the financial year ending June 2021, respond to these questions:

i. What effect will the change in fixed costs have on the profit or loss of the business?

Revised contribution margin:

Sales	$1 500 000
Less: Variable Costs	
Direct materials	900 000
Direct labour	360 000
Contribution Margin	240 000
Less: Fixed costs	200 000
Profit	**40 000**

ii. What effect will this change in fixed costs have on the break even point?

$$\text{New breakeven} = \frac{\text{Fixed costs}}{\text{Contribution margin per unit}} = \frac{200\ 000}{(250–210)} = 5\ 000 \text{ units of fitness equipment.}$$

Extended answer question 1

1. *Write an essay either supporting, or disagreeing with, the statement below:*

'CVP is a powerful management tool.'

Students should start by defining CVP.

They should list and explain the main advantages of a business using CVP analysis such as:

This type of analysis gives a business manager the information needed to make the right choices and avoid costly mistakes such as:

- the most profitable product or service to offer
- which products or services should be emphasised
- what sales volumes must be met in order to stay profitable
- sales goals the business will need to meet in order to cover any increase in fixed costs (ie. an increase in rent)
- the increase in sales the business will need to compensate for any discounting.

There are many more advantages which the student can choose from.

After discussing the advantages the students should discuss a few disadvantages such as:

CVP analysis is generally made under certain limitations and with certain assumed conditions, some of which may not occur in practice.

It is assumed that the production facilities anticipated for the purpose of cost-volume-profit analysis do not undergo any change. Such analysis gives misleading results if expansion or reduction of capacity takes place.

- In case where a variety of products with varying margins of profit are manufactured, it is difficult to forecast with reasonable accuracy the volume of sales mix which would optimize the profit.
- The analysis will be correct only if input price and selling price remain fairly constant which in reality is difficulty to find. Thus, if a cost reduction program is undertaken or selling price is changed, the relationship between cost and profit will not be accurately depicted.
- In cost-volume-profit analysis, it is assumed that variable costs are perfectly and completely variable at all levels of activity and fixed cost remains constant throughout the range of volume being considered. However, such situations may not arise in practical situations.

The student should then conclude that even though there are some disadvantages the advantages of CVP analysis outweigh these and it is indeed a vital tool for management.

Extended answer question 2

2. *Outline how a manager can use the data available within their business to make decisions about any two of the following issues:*

- *changing cost behaviours*
- *break even point*
- *margin of safety*
- *capacity constraints.*

CVP analysis is vital to decision making processes because it:

- identifies how managerial assumptions impact on financial plans
- allows planning for future needs
- determines how costs and profits are affected by changes in the volume of production

Data is used to make decisions about issues in the following ways.

Changing cost behaviours

- the product mix, given listed resources
- changes in fixed and variable costs
- changes in the per unit cost

Break even point

- decisions about selling price
- the effect of changes in costs
- cost behaviour analysis

Margin of safety

- level of sales needed for s specific profit
- percentage changes in sales that will be sustainable
- product mixes

Capacity constraints

- accepting or rejecting a special order
- whether to introduce a new product/service
- whether to close down production of a product
- whether to make or buy a product

CHAPTER 3: WHAT IS BUDGETING?

Questions

1. *What is budgeting?*

Budgeting is a means of planning ahead, in order to try to control the financial situation of a business, to achieve a specific financial objective.

2.

A. *Describe the budgeting process.*

Budgeting involves the owner or the management of the business analysing the current business situation, then making an estimate based on past experience, of the goals they plan to achieve within the next financial year. Goals can be related to the money (or finances) of the business, or they can be non-financial.

B. *What is the role of accrual accounting in cash budgets?*

With accrual accounting, expenses and income are recognised when the transaction occurs and not when cash is paid or received. In cash budgets only cash coming in or going out is recorded.

3. *What question does the Financial Budget try to answer?*

The financial budget aims to answer the question, 'How will all the plans of the business be funded'?

4. *List one of the most important aspects of budgeting.*

One of the most important aspects of budgeting is being able to analyse the estimated budget with the actual budget to see where changes have occurred and to investigate the reasons for this by preparing budget variance reports.

5. *Explain one of the ways in which management can try to overcome budget estimates being incorrect.*

As the budgeting process involves management making 'educated guesses', these guesses or estimates can turn out to be inaccurate. Therefore the budgeting process should always be reviewed and altered if required.

6. *List some of the areas on which the operating budget focuses.*

The operating budget focuses on plans for activities which make up the everyday operations of the business e.g. budgeted figures for sales, administration, marketing, production and distribution and the budgeted Income Statement.

7. *What is the difference between the financial budget and the operating budget?*

The operating budget focuses on financing everyday operations. The financial budget looks at how all the plans of the business will be financed, projecting cash inflow and outflows, and income and expenses over the period.

8. *What role does the master budget play in a business?*

The master budget is the overall budget for a business. It consists of all the individual budgets. In other words it is an amalgamation of the operating budget, capital expenditure, and the financial budget.

9. *List three budgeted documents that may be included in a master budget.*

For example: Budgeted Income Statement, Budgeted Balance Sheet, Sales Budget.

10. *What does the cash budget aim to predict?*

A Cash Budget predicts the future estimated cash receipts and cash payments of the business.

11. *What knowledge does a business hope to gain by preparing a cash budget?*

The cash budget will allow management to see when their cash payment commitments must be made. They can make sure the business has sufficient funds to meet these obligations when they fall due.

The budget will show when the business may have periods where it has surplus cash not being used. The business will be able to investigate ways of investing this money (short-term) to earn a return so that it is not idle, as this is a wasted opportunity.

The budget may reveal periods when a shortage of funds may occur. In this case the business will need to investigate ways that this can be overcome such as negotiating a longer period of credit with creditors, or borrowing funds from the bank.

The budget will show management how long it is taking for debtors to pay. The longer a debtor takes to pay their account the more likely they are to become a bad debt. If debtors are taking too long then management will need to take steps to rectify the situation, such as offering a discount for early payment or charging interest on overdue accounts.

12. *Jack has recently commenced a small business. His bank manager asks him if he has been preparing regular budgets, to which he replies: 'No'. Jack has no idea of the advantages that preparing a budget would deliver.*

A. *Explain to Jack why he should prepare regular budgets.*

Jack should prepare regular budgets for the reasons listed in the answer to question 11.

B. *Why would the bank manager need Jack to prepare budgets?*

One reason the bank manager would want Jack to prepare this is because the budget may reveal periods when a shortage of funds may occur. In this case the business will need to investigate ways that this can be overcome, such as negotiating a longer period of credit with creditors, or borrowing funds from the bank.

C. *After preparing a cash budget, Jack notices that his business has an excess of cash. What are three things his business could do with the surplus cash?*

Jack can use the surplus cash to pay off extra on loans, invest in a cash management account, or to pay any outstanding accounts due.

13. *Molly has paid her accountant to prepare a budget variance report for her business. When the report is posted to her she cannot understand some of it. Explain to Molly the following:*

A *Why is a budget variance report prepared?*

The budget variance report compares the budget estimates with the actual results.

B. *What is a variance?*

A variance is a difference between the estimated result and the actual result.

C. Summarise the difference between a favourable variance and an unfavourable variance., using an example.

A favourable variance (F) occurs when the actual result is better than the estimated amount. For example if Molly estimated sales for October to be $50 000 and the actual figure was $60 000, then this is viewed as a $10 000 favourable variance. An unfavourable variance (U) is where the actual result is worse than the estimated amount.

14. Is budgeting a waste of time for a business? Justify your response.

No. Budgeting is not a waste of time for the simple reason that many businesses have had to close due to a lack of liquidity through poor planning. The budgeting process helps to reduce this.

15. Julie is the owner of Tasty Teas, a business that manufactures specialty herbal teas. She is applying for a business loan. Julie has been asked by her bank manager to prepare a cash budget for the next year of business, showing how she plans to repay her bank loan. She completes the cash budget but forgets to estimate the likely cost of paying her new administrative assistant their wages.

A. What are the consequences of this omission from Julie's cash budget?

Her cash budget will be unfavourable by the amount of the assistant's wages.

B. What effect might this have on the bank manager's decision?

The bank manager will view the figures as being more favourable than they actually are.

C. What should Julie do? Why?

Julie should redo the budget with the correct figures.

16. Cheryl owns the business Pots and Pitchers selling pottery to retail stores around Perth. She recently went to a talk presented by the Small Business Development Corporation on budgets. She has asked you to prepare a cash budget for her. She has supplied the following information:

Cash at bank as at 1 May 2019	*$ 1 445*
Estimates of the transactions for May 2019:	
Advertising	*$ 1 020*
Drawings	*680*
Office expenses	*2 040*
Cost of sales	*3 400*
Cash sales	*10 200*
Receipts from accounts receivable	*1 700*
Credit sales	*3 400*
Payment to accounts payable	*6 120*
Credit purchases	*6 800*

A. Prepare a cash budget for May 2019.

Pots and Pitchers
Cash budget
for the month of May 2019

	$
Receipts	11 900
Payments	13 260
Estimated deficit for May	(1 360)
Opening bank balance	1 445
Estimated closing bank balance	85

B. Comment on Cheryl's cash position.

Cheryl has more funds going out of the business than coming into the business during May.

C. What can Cheryl do if she wants to improve the situation?

Cheryl needs to determine why this has happened. Is it a 'one off' or a trend? She needs to find ways to rectify the situation. For example: she may be able to reduce one of her expenses, such as advertising or office expenses. She could take less drawings.

17. On 30 June 2019 the business Vaughan Enterprises has a bank balance of $12 700. Vaughan estimates the following receipts and payments for July, August and September.

	July	*August*	*September*
Estimated cash fees	*21 050*	*21 050*	*22 900*
Payments from accounts receivable	*10 000*	*8 000*	*10 000*
Estimated expenses			
Wages	*2 040*	*2 040*	*2 040*
Advertising	*544*	*544*	*544*
Cleaning	*300*	*300*	*300*
Office expenses	*5 525*	*5 525*	*5 950*
Payments to accounts payable	*1 000*	*1 200*	*1 000*
Drawings	*6 000*	*6 000*	*6 000*

A. Prepare a cash budget for Vaughan Enterprises for the three months ending 30 September 2019.

Vaughan Enterprises - Cash budget
for the month of:

July:

	$
Opening Bank	12 700
Receipts	31 050
Payments	15 409
Surplus	15 641
Ending Bank balance	28 341

August:

	$
Opening Bank	28 341
Receipts	29 050
Payments	15 609
Surplus	13 441
Closing Bank Balance	41 782

September:

	$
Opening Bank	41 782
Receipts	32 900
Payments	15 834
Surplus	17 066
Ending Bank Balance	58 848

B. What is the bank balance at 30 September 2019?

$58 848

18. Below is the estimated quarterly budget for Patty's Party Accessories.

Patty's Party Accessories
Estimated cash budget

	October $	November $	December $
Estimated receipts			
Cash fees	*50 000*	*50 000*	*55 000*
LESS: Estimated payments			
Cost of sales	*6 000*	*6 000*	*6 000*
Insurance	*500*	*500*	*500*
Wages	*6 500*	*6 500*	*6 500*
Electricity	*100*	*100*	*100*
Telephone	*200*	*200*	*200*
Postage	*250*	*250*	*250*
Drawings	*2 500*	*2 500*	*2 500*
Total payments	*16 050*	*16 050*	*16 050*
Estimated surplus for month	*33 950*	*33 950*	*38 950*
Bank balance start of month	*200 000*	*233 950*	*267 900*
Estimated bank balance end of month	*233 950*	*267 900*	*306 850*

Patty's accountant has discovered the following errors in the estimated budget:

- *Cost of sales is $15 000 for October, November and December.*
- *Insurance is $800 per month for October, November and December.*
- *Drawings are $8 500 per month for October, November and December.*
- *The cash fees for October were $25 000.*
- *The cash fees for November were $35 000.*
- *The cash fees for December were $45 000.*
- *Wages for October, November and December were $12 000 per month.*

A. Correct the errors in the budget.
B. Rewrite the budget for October, November and December.

A and B.
Patty's Party Accessories
Corrected cash budget

	October $	**November $**	**December $**
Estimated receipts			
Cash fees	25 000	35 000	45 000
Less estimated payments			
Cost of sales	15 000	15 000	15 000
Insurance	800	800	800
Wages	12 000	12 000	12 000
Electricity	100	100	100
Telephone	200	200	200
Postage	250	250	250
Drawings	8 500	8 500	8 500
Total payments	36 850	36 850	36 850
Estimated deficit/surplus for month	(11 850)	(1 850)	8 150
Bank balance start of month	200 000	188 150	186 300
Estimated bank balance end of month	188 150	186 300	194 450

C. Explain the impact the errors had on the estimated budget.

Initially the business estimated a surplus for October and November, however it actually ended up with a deficit for both months. Overall there was an unfavourable variance of $112 400 in the final bank balance.

19. *Tim prepared a cash budget for the first time in July 2021. His budget estimated that he would have a cash balance of $5 000 at the end of the month. However, his bank statement shows he has a bank overdraft of $3 660. Tim would like you to assist him in comparing the original estimated budget below with the actual cash flows.*

	$ Budget	$ Actual
Receipts		
Cash fees	*36 000*	*39 000*
Collections from accounts receivable	*18 000*	*7 200*
Total receipts	*54 000*	*46 200*
Payments		
Wages	*15 600*	*7 800*
Rent	*7 200*	*7 200*
Payments to accounts payable	*19 800*	*20 400*
Advertising	*3 300*	*1 200*
Car expenses	*1 200*	*1 260*
Office expenses	*1 800*	*2 100*
Purchase of photocopier		*9 000*
Drawings	*3 600*	*5 400*
Total payments	*52 500*	*54 360*
Excess receipts over payments	*500*	*(8 160)*
Bank balance as at 30 June 2021	*4 500*	*4 500*
Bank balance as at 31 July 2021	*5 000*	*(3 660)*

A. *Prepare a budget variance report that shows the variances in both dollar amounts and percentages.*

Budget variance report for Tim

	$ Budget	$ Actual	$ Variance	
Receipts				
Cash fees	36 000	39 000	$3 000	F
Collections from accounts receivable	18 000	7 200	$10 800	U
Total receipts	**54 000**	**46 200**	**$7 800**	**U**
Payments				
Wages	15 600	7 800	$7 800	F
Rent	7 200	7 200	Nil	
Payments to accounts payable	19 800	20 400	$600	U
Advertising	3 300	1 200	$2 100	F
Car expenses	1 200	1 260	$60	U
Office expenses	1 800	2 100	$300	U
Purchase of photocopier	-	9 000	$9 000	U
Drawings	3 600	5 400	$1 800	U
Total payments	**52 500**	**54 360**	**$1 860**	**U**
Excess receipts over payments	500	(8 160)		
Bank balance as at 30 June 2021	4 500	4 500		
Bank balance as at 31 July 2021	5 000	(3 660)		

B. *Write a performance report, explaining why the projected cash figure was not achieved. Include both the negative and the positive reasons.*

Performance report for Tim

Positives:
Favourable variance in cash fees of $3 000. Favourable variance in wages as they were $7 800 less than estimated. Favourable variance in advertising which was $2 100 less than estimated.

Negatives:
There was a large unfavourable variance in payments from accounts receivable. Also unfavourable variances in the majority of expenses and in the owner's drawings.

Overall:
The main reason for the overdraft is that the photocopier cost $9 000 and was it was a payment that had not been budgeted for. Had this item not been purchased the business would have had a surplus of $5 340. Although there were some unfavourable variances in payments and drawings, they were not the main reason for the overdraft.

20. Slawko owns a courier service, Dashing Deliveries, which delivers flowers and other fragile items throughout the suburbs of Perth. She estimates the following receipts and payments for July, August and September. As of 30 June 2019 the business has a bank balance of $2 720.

Dashing Deliveries
Estimate of Receipts and Payments

	July	August	September
	$	$	$
Estimated cash fees	*11 050*	*11 050*	*11 900*
Estimated expenses			
Wages	*2 040*	*2 040*	*2 040*
Advertising	*544*	*544*	*544*
Cleaning	*300*	*300*	*300*
Office expenses	*5 525*	*5 525*	*5 950*

In addition, Slawko has to pay:

- *Annual business insurance premium of $2 295 on 15 July.*
- *Annual registration for her four delivery vans, which in total costs $2 800, on 15 August.*
- *Each month, she withdraws $2 500 for her own use.*

Required:
A. Prepare a cash budget for Dashing Deliveries for the three months ending 30 September 2019.

Dashing Deliveries
Cash budget
for the month of:

July

	$
Receipts	11 050
Payments	13 204
Bank balance 1/07/19	2 720
Bank balance 31/07/19	566

August

	$
Receipts	11 050
Payments	13 709
Bank balance 1/08/19	566
Bank balance 31/08/19	(2 093)

September

	$
Receipts	11 900
Payments	11 334
Bank balance 1/09/19	(2 093)
Bank balance 31/09/19	(1 527)

B. Write a performance report to Slawko commenting on the liquidity situation revealed by her cash budget.

Slawko's budget reveals that the business liquidity is very poor. The business has no surplus cash for both August and September. The business has a deficit at the end of September. The business will not be able to pay short term debt.

C. What action should Slawko take?

Slawko needs to look at ways to lower business expenses, or could stop drawing income out the business, until the liquidity has improved.

21. *Jett Printer runs a business servicing and fixing computers and printers. He would like to purchase some new equipment at a cost of $15 000 in July 2020. He is unsure whether the business has enough cash to pay for the purchase or whether he will need to take out a bank loan to cover the costs.*

Jett has estimated the following monthly costs for July.

- *Bank balance as at 1 July $3 000*
- *Cash fees $22 500*
- *Direct cost of providing the service $11 700*
- *Wages $1 200*
- *Drawings $225*

Required:

A. *From Jett's July estimates, prepare a cash budget. Use the correct title, headings and terminology throughout.*

Jett Printer
Cash budget
for July 2030

	$
Receipts	22 500
Payments	13 125
Surplus	**9 375**
Bank balance at 1/07/30	3 000
Bank balance at 31/07/30	12 375

B. *Should Jett purchase the new equipment in July? Justify your answer.*

The business is not in a position to pay the full amount of the equipment cost in July. The business has $12 375 in its bank account at the end of July. The equipment costs $15 000. Jett could pay part of the equipment cost and finance part of it through a loan which he should aim to pay off as quickly as possible.

C. *If Jett had estimated the cash fees to be $30 000, would the business be in a better position to purchase the equipment? Explain the impact this would have.*

Yes the business would be in a better position. The bank balance at the end of the month would have been $19 875 instead of $12 375. This means that the $15 000 cost of the equipment could have been paid up front.

22. Brittany Gibson and Mel Spears are wedding singers. Based on past experience, Brittany and Mel have found that 60% of accounts receivable pay their accounts in the month following the service being conducted, 25% in the second month, and 15% in the third month.

They have supplied you with the following information about their credit fees:

January	*$60 000*
February	*$90 000*
March	*$40 000*
April	*$120 000*
May	*$110 000*
June	*$80 000*

Required:

A. Prepare a schedule of estimated receipts from accounts receivable for the months from April to June.

Brittany Gibson and Mel Spears
Schedule of estimated receipts

	$
April	55 500
May	95 500
June	102 000

B. Outline the purpose of the debtors' schedule.

The debtors' schedule enables the business to divide up expected receipts from accounts receivable (or debtors) into the months in which payment is expected to be received. This can be tallied and the total estimated receipts can be complied.

23. Based on past experience, Pokey Leonard has found that 90% of his accounts receivable pay their accounts in the month following the service being conducted, 5% in the second month and 5% in the third month. He has supplied you with the following information about credit sales:

January	*$100 000*
February	*$95 000*
March	*$80 000*
April	*$1 150 000*
May	*$100 000*
June	*$80 000*

Required:

A. Prepare a schedule of estimated receipts from accounts receivable for the months from April to June.

Pokey Leonard
Schedule of estimated receipts
for the April-June Quarter

	$
April	81 750
May	1 043 750
June	1 515 000

B. Is Pokey in a position where he has any surplus funds?

Having the schedule of estimated receipts from accounts receivable does not give enough information to work out if Pokey has any surplus funds. To calculate this, all estimated receipts and all estimated payments need to be presented.

C. What do you recommend Pokey does with any surplus funds?

If Pokey is in a situation where he has surplus funds he could:

- Pay current or non-current liabilities
- Purchase non-current assets
- Expand the business
- Invest the funds outside the business
- Place the surplus funds in a high interest earning cash account
- Leave the funds in the business.

24. The owner of South West Tours has asked you to prepare estimates of the future cash inflows of the business. The business sells tours on both a cash and credit basis, with cash fees usually being 70% of total sales. Based on his years of experience, he informs you that debtors usually pay in the following way:

- *80% pay their fees in the month following the sale.*
- *15% pay their fees in the second month following the sale.*
- *5% pay their fees in the third month.*

The owner has supplied you with the following sales figures:

Actual sales
January - $20 000
February - $20 000
March - $30 000

Estimated sales
April - $30 000
May - $40 000
June - $40 000

Required:

A. Prepare a table showing the breakdown between the credit and cash sales for the six months from January to June.

Cash and credit sales breakdown
for the six months January-June

	Cash	**Credit**
	$	**$**
January	14 000	6 000
February	14 000	6 000
March	21 000	9 000
April	21 000	9 000
May	28 000	12 000
June	28 000	12 000

B. Prepare a schedule of collections from debtors for the quarter ending 30 June.

South West Tours
Schedule of collections from debtors

	$
February	4 800
March	5 700
April	8 400
May	8 850
June	11 400

C. Using your calculations from (A) and (B), prepare a cash budget extract, showing the estimated cash receipts for South West Tours for the months of April, May and June.

South West Tours
Cash budget (extract)

APRIL: Cash $21 000 Credit $8 400 Total receipts $29 400
MAY: Cash $28 000 Credit $8 850 Total receipts $36 850
JUNE: Cash $28 000 Credit $11 400 Total receipts $39 400.

D. Is the owner in any position to look at alternative investments? Justify your answer.

Having the schedule of estimated receipts from accounts receivable does not present enough information to work out if the business has any surplus funds. To calculate this all estimated receipts and all estimated payments need to have been presented.

25. Thomas Newton is an undergraduate science student. Thomas is so passionate about science that he owns and runs a business that visits primary and secondary schools conducting fun science shows for students. He also provides lots of science materials so that students can attempt experiments in addition to watching the show.

Thomas has become concerned about the liquidity of the business, which, in addition to being fun, is an extra source of income. Currently there is only $92 in the business bank account. Thomas gives his friend Dave, an accounting student, the following information, in the hope that Dave will be able to prepare a cash budget for him.

	Fees earned	*Materials used*
	$	*$*
Actual		
February	*5 600*	*2 400*
March	*4 800*	*2 400*
April (less shows booked, due to school holidays)	*3 000*	*1 200*
Estimated		
May 7 200	*3 600*	
June	*7 200*	*4 000*
July (less shows booked, due to school holidays)	*3 000*	*1 200*

Thomas purchases the science materials needed for the shows from SciTech. He pays SciTech for the materials the month following purchase. All the schools that book science shows pay on credit terms in the following manner:

- *70% pay in the month after the show.*
- *25% pay in the second month after the show.*
- *5% pay in the third month after the show.*

In addition to the materials used for each show, Thomas has the following monthly expenses:

- *Advertising to schools $50*
- *Postage $100*
- *Wages of assistant $500*
- *Telephone $200*
- *Depreciation of motor vehicle $1000*
- *Depreciation of science equipment $350*
- *Motor vehicle expenses $250*
- *Drawings $1750*

Although Thomas has a helper to whom he pays $500 a month and he withdraws $1 750 for personal use, he doesn't mind reducing the amount he withdraws and he doesn't really mind not having the help of an assistant.

Required:

A. Prepare the appropriate schedules and calculate the anticipated payments to SciTech and estimated collections from the schools.

Receipts from Shows (from schools)

March	$3 920	
April	$1 400 + $3 360	= $4 760
May	$280 + $1 200 + $2 100	= $3 580
June	$240 + $750 + $5 040	= $6 030
July	$150 + $1800 + $5 040	= $6 990

Payments for Science Materials (to SciTech)

March	$2 400
April	$2 400
May	$1 200
June	$3 600
July	$4 000

B. Prepare a cash budget for the quarter ending 31 July 2020. Inform Thomas about the estimated bank balance at the end of each month.

Thomas Newton
Cash Budget
For the Quarter ending 31 July 2020

	$ MAY	$ JUNE	$ JULY
Receipts	3 580	6 030	6 990
Less Payments	4 050	6 450	6 850
Balance	(470)	(420)	140
Bank Balance start of month	92	(378)	(798)
Bank Balance end of month	(378)	(798)	(658)

C. Address the following:

- *Should Thomas be concerned about the liquidity of the business? Justify your answer.*
- *Suggest steps that Thomas can take to improve the liquidity.*
- *If Thomas implements the steps you have suggested, what will be the impact on the cash balance at the end of May, June and July?*

Yes, Thomas should be concerned about the liquidity of the business as his estimated bank balance will be in overdraft for May, June and July. However, as Thomas can work without an assistant he should reduce or remove this expense as it will save an extra $500 per month - almost the amount of his monthly shortfall. If Thomas does not have the assistant for May he will have a surplus of $30 instead of a $470 deficit. In June he would have a surplus $80 instead of a deficit of $420 and in July he would have a surplus of $640 instead of $140.

D. Thomas is thinking of investing in some new equipment that costs $4 000. He predicts that his business would increase 20% due to the new experiments he could offer. He is unsure if it would be a wise move to make this investment could take. Advise Thomas on the following:

- *Should he take out a bank loan in order to buy the equipment? The loan would need to be paid back at a cost of $250 per month.*
- *Do you recommend that he buys the capital equipment or not? Fully explain your answer using data.*

This answer assumes that Thomas no longer has an assistant and is paying the loan off at $250 a month. It also assumes that Thomas' expenses remain the same and have not increased due to the increase in business.

The 20% increase in business would result in the following new figures for May – July.

Thomas Newton
Revised cash budget
For the Quarter ending 31 July 2020

	$ MAY	$ JUNE	$ JULY
Receipts	4 296	7 236	8 388
Less Payments	3 800	6 200	6 600
Balance	496	1 036	1 788
Bank Balance at start of month	92	588	1 624
Bank Balance at end of month	588	1 624	5 036

As can be seen from the revised cash budget, without the expense of an assistant and with a 20% increase in business, Thomas can afford to pay back the equipment loan at a cost of $250 per month.

Yes, Thomas should invest in the capital equipment because it is expected to significantly increase business receipts. By the end of July Thomas is predicting he should have enough in the bank to pay the balance owing on the equipment, due to the increase in business.

26. Ashton Company

You have been asked to prepare a cash budget for December 2015 for Ashton Company. The following information is available about the company's operations:

i. The cash balance on 1 December will be $40 000.

ii. Actual sales for October and November and expected sales for December are as follows:

	October	November	December
Cash sales	*$65 000*	*$70 000*	*$83 000*
Credit sales	*$400 000*	*$525 000*	*$600 000*

Credit sales are collected over a three month period in the following ratio: 20% collected in the month of sale, 60% collected in the month following sale, and 20% collected in the second month following sale.

iii. Purchases of inventory will total $280 000 for December. Thirty per cent of a month's inventory purchases are paid during the month of purchase. The accounts payable remaining from November's inventory purchases total $161 000 all of which will be paid in December.

iv. Selling and administration expenses are budgeted at $430 000 for December ($50 000 of which is for depreciation).

v. Equipment costing $85 000 will be purchased for cash during December.

vi. The company must maintain a minimum cash balance of $20 000. An open line of credit is available from the company's bank to bolster the cash position as needed.

Required:
A. Prepare a schedule of expected cash collections for December.

Receipts for December
$83 000 + $120 000 + $315 000 + $80 000 = $598 000

B. Prepare a schedule of expected cash payments during December to suppliers for inventory purchases.

Payments to suppliers for December
$84 000 + $161 000 = $245 000

C. Prepare a cash budget for December. Indicate in the financing section any borrowing that will be needed during the month.

Ashton Company
Cash budget
for December 2015

Opening bank balance 01/12/15	40 000
Add Receipts	
Cash sales	83 000
Collections from customers (for Dec)	120 000
Collections from customers (for Nov)	315 000
Collections from customers (for Oct)	80 000
TOTAL RECEIPTS	638 000
Less Payments	
Inventory	245 000
Selling and administration expenses	380 000
Equipment	85 000
TOTAL PAYMENTS	710 000
Deficit	(72 000)
Borrowing required	92 000
Closing bank balance 31/12/15	20 000

27. *The opening cash balance of Graeme's Golf Suppliers at 1 May 2019 is $9 000. Over the next three months the business expects to have monthly wages of $3 000 and monthly utilities expenses of $700. The June quarterly bills will be office running costs of $1 500 and rent of $6 000.*

Sales at the beginning of the year were as follows:

- *January $13 000*
- *February $12 000*
- *March $15 000*
- *April $ 8 000*

Estimated sales are $12 000 per month. Analysis of the results from the beginning of the year has revealed that 60% of sales are for cash. Of the credit sales, 50% are paid the month following sale, 30% two months after sale and the remainder in the third month after sale.

Estimated purchases for the next three months are as follows:

- *May $ 8 000*
- *June $12 000*
- *July $ 9 000*

Inventory purchases are made on credit and are paid the month after. This attracts a 3% discount. In the first four months of the year, $6 000 was purchased each month.

The business is planning to purchase office furniture for $5 500 cash on 1 June and this is to be depreciated at 20% straight line.

Graeme has come to you for advice on the budgeting process.

Required:

A. Prepare a debtors' schedule and a creditors' schedule for Graeme's Golf Suppliers for the quarter.

Collections from debtors	$ **May**	$ **June**	$ **July**
February	960		
March	1 800	1 200	
April	1 600	960	640
May		2 400	1 440
June			2 400
TOTALS	4 360	4 560	4 480

Creditors' schedule	$ **May**	$ **June**	$ **July**
April	5 820		
May		7 760	
June			11 640
	5 820	7 760	11 640

B. Prepare a cash budget for the business, showing separately the months of May, June and July.

Quarterly Cash Budget
For the months May – July 2019

	May	June	July
Receipts			
Cash sales	7 200	7 200	7 200
Collections from debtors	4 360	4 560	4 480
TOTAL RECEIPTS	11 560	11 760	11 680
Payments			
Payments to creditors	5 820	7 760	11 640
Wages	3 000	3 000	3 000
Utilities	700	700	700
Office running costs		1 500	
Rent		6 000	
Furniture		5 500	
TOTAL PAYMENTS	9 520	24 460	15 340
Net Inflow/Outflow	**2 040**	**(12 700)**	**(3 660)**
BALANCE AT BEGINNING	**$9 000**	**$11 040**	**$(1 660)**
BALANCE AT END	**$11 040**	**$(1 660)**	**$(5 320)**

C. What advice can you give to the owner of Graeme's Golf Suppliers about the purchase of the office furniture in June?

The business will have a negative outflow of cash in June due to the purchase of the furniture and the other quarterly payments in that month. Advice for Graeme is to consider if any of these payments can be delayed as this would lessen the impact, or to consider some short term finance.

28. The following information was provided by Monsoon Retail at the start of 2022.

Monsoon Retail Unclassified Balance Sheet as at 30 June 2022

Assets		Liabilities and equity	
Cash at Bank	21 000	Loan	6 000
Investments	31 000	Credit Card	3 000
Inventory	33 000	Capital	76 000
	$85 000		$85 000

The following transactions were expected to take place during the year ending 30 June 2019:

- *Sales are expected to be $243 000. An amount of $9 000 should be owing from debtors on 30 June 2023.*
- *Cash paid for inventory purchases should be $84 000. Cost of sales is expected to be $90 000.*
- *Wages expense will be $57 000. Wages paid will be $51 000*
- *Office equipment depreciation will be $1 800*
- *Electricity will be $3 000, including $900 accrued electricity expenses on 30 June 2023.*
- *Rent expense is expected to be $21 000 with the balance of prepaid rent on 30 June 2023 at $600.*
- *A computer was purchased on 1 May 2023 for $4 000 cash.*

The following information was provided at the end of the 2022 financial year.

Monsoon Retail Cash Receipts and Payments for the year ended 30 June 2023

Opening Cash at Bank	21 000
RECEIPTS	
Receipts from Customers	202 000
PAYMENTS	
Payments to Creditors	95 500
Wages Paid	56 000
Electricity Paid	4 400
Rent Paid	33 300
Purchase of Computer	5 000
Closing Cash at Bank	$28 800

Monsoon Retail Income Statement for the year ended 30 June 2023

INCOME	
Sales	204 000
LESS: Cost of Sales	103 500
EXPENSES	
Wages	56 000
Depreciation	4 000
Electricity	4 000
Rent	32 000
PROFIT	$4 500

Required:

A. Complete the cash budget performance report and the budgeted Income Statement performance report for the year ended 30 June 2023.

Monsoon Retail

**Cash budget performance report
for the year ended 30 June 2023**

	BUDGET	ACTUAL	VARIANCE	
Opening Cash at Bank	21 000	21 000	**0**	
RECEIPTS				
Receipts from customers	234 000	202 000	**32 000**	**U**
PAYMENTS				
Payments to creditors	84 000	95 500	**11 500**	**U**
Wages paid	51 000	56 000	**5 000**	**U**
Electricity paid	2 100	4 400	**2 300**	**U**
Rent paid	21 600	33 300	**11 700**	**U**
Purchase of computer	4 000	5 000	**1 000**	**U**
Closing Cash at Bank	92 300	28 800	**63 500**	**U**

Monsoon Retail

**Budgeted Income Statement performance report
for the year ended 30 June 2023**

	BUDGET	ACTUAL	VARIANCE	
INCOME				
Sales	243 000	204 000	**39 000**	**U**
Less: Cost of sales	90 000	103 500	**13 500**	**U**
EXPENSES				
Wages	57 000	56 000	**1 000**	**F**
Depreciation	1 800	4 000	**2 200**	**-**
Electricity	3 000	4 000	**1 000**	**U**
Rent	21 000	32 000	**11 000**	**U**
PROFIT/LOSS	70 200	4 500	**65 700**	**U**

B. Using the 'Steps in appraising budget performance', interpret the budget information.

The business has performed poorly, with many unfavourable variances from budget. The profit is $65 700 less than expected. The main reason for this has been the $39 000 lower than expected sales and the $11 500 increase in payments to creditors along with the increases in wages, electricity and rent paid.

29. The following information was provided by ABC Sales at the start of 2016.

ABC Sales Unclassified Balance Sheet as at 30 June 2016

Assets		Liabilities and equity	
Cash at Bank	3 500	Creditors	1 500
Investments	40 000	Credit card	500
Inventory	5 500	Capital	47 000
	$49 000		
$49 000			

The following transactions are expected to take place during the year ending 30 June 2016:

- Sales are expected to be $40 500. An amount of $1 500 should be owing from debtors on 30 June.
- Inventory purchases should be $14 000 cash. Cost of sales is planned at $15 000
- Wages expense will be $9 500. Wages paid will be $8 500
- Vehicle depreciation will be $4 500
- Telephone expenses will be $500, with $100 in accrued telephone expenses on 30 June.
- Rates are expected to be $3 500 and are always paid on the 30 June.
- Depreciation of office equipment is $200.
- Other expenses should total $300.

The following information was provided at the end of the 2016 financial year.

ABC Sales Cash Receipts and Payments for the year ended 30 June 2016

Opening Cash at Bank	3 500
RECEIPTS	
Receipts from Customers	43 000
PAYMENTS	
Payments for Inventory	12 000
Wages Paid	8 500
Telephone	600
Rates	3 500
Other Expenses	5 000
Closing Cash at Bank	$16 900

ABC Sales Income Statement for the year ended 30 June 2016

INCOME	
Sales	42 000
LESS: Cost of Sales	15 000
Gross Profit	27 000
EXPENSES	
Wages	9 500
Depreciation	1 800
Telephone	600
Rates	3 500
Other	5 000
PROFIT/LOSS	$6 600

Required:

A. Complete the following:

i. cash budget performance report for the year ended 30 June 2016.

ABC Sales

Cash budget performance report
for the year ended 30 June 2016

	BUDGET	ACTUAL	VARIANCE	
Opening Cash at Bank	3 500	3 500	**0**	**-**
RECEIPTS				
Receipts from customers	39 000	43 000	**4000**	**F**
PAYMENTS				
Payments for inventory	14 000	12 000	**2000**	**F**
Wages paid	8 500	8 500	**0**	
Telephone	400	600	**200**	**U**
Rates	3 500	3 500	**0**	
Other expenses	300	5 000	**4700**	**U**
Closing Cash at Bank	15 800	16 900	**1100**	**F**

ii. budgeted Income Statement performance report for the year ended 30 June 2016.

ABC Sales

Budgeted Income Statement performance report
for the year ended 30 June 2016

	BUDGET	ACTUAL	VARIANCE	
INCOME				
Sales	40 500	42 000	**1500**	**F**
Less: Cost of sales	15 000	15 000	**0**	
EXPENSES				
Wages	9 500	9 500	**0**	
Depreciation	1 800	1 800	**0**	
Telephone	500	600	**100**	**U**
Rates	3 500	3 500	**0**	
Other	300	5 000	**4700**	**U**
PROFIT/LOSS	7 000	6 600	**400**	**U**

B. Interpret the performance reports.

The overall profit is an unfavourable result, being $400 less than expected. This is mainly due to the unfavourable result for the other expenses which will require investigation.

The final balance in cash at bank was higher than expected, due in part to the higher than predicated receipts from customers. The other expenses, however, had a significant impact on cash flow for the period.

30. Birkland Enterprise has supplied you with the following information.

Birkland Enterprise
Unclassified Balance Sheet
as at 30 June 2018

Assets		Liabilities and equity	
Cash at Bank	40 000	Loan	20 000
Investments	1 000	Credit Card	0
Vehicles	24 000	Capital	45 000
	$65 000		$65 000

The following transactions are expected to take place over the following year ending 30 June 2019:

- *Sales are expected to be $400 000. They are expected to be half cash and half credit sales. It is expected that 99% of credit sales should be collected by the end of the accounting period.*
- *Purchases of inventory for the year are estimated to be $164 000. Purchases are paid for in the month after purchase. The cash purchases made in June should be $28 000.*
- *Marketing costs are estimated to be $32 000, with $800 marketing being prepaid at 30 June 2019.*
- *Wages expense for the year should be $99 200, with accrued wages at 30 June 2019 being $1 200.*
- *The owner will withdraw $68 000 throughout the year.*
- *Other expenses paid are estimated to total $84 000.*
- *Depreciation is $3 600.*

The actual results achieved were as follows, with all other transactions remaining the same as above.

	$
Cash sales	256 000
Collections from debtors	132 560
Sales income	396 000
Cost of sales	180 000
Wages expense	100 800
Wages paid	96 400
Marketing incurred	32 400
Marketing paid	36 000
Other expenses paid	80 000
Other expenses incurred	80 000
Drawings	64 000
Loss on sale of vehicle	14 000

Required:

A. *Prepare a cash budget for Birkland Enterprise for the year ended 30 June 2019.*

Birkland Enterprises

Cash budget performance report
for the year ended 30 June 2019

	BUDGET	ACTUAL	VARIANCE	
Opening Cash at Bank	40 000	40 000	**0**	
RECEIPTS				
Receipts from customers	398 000	388 560	**9440**	**U**
PAYMENTS				
Payments for inventory	136 000	180 000	**44000**	**U**
Marketing	32 000	36 000	**4000**	**U**
Wages	98 000	96 400	**1600**	**F**
Drawings	68 000	64 000	**4000**	**F**
Other expenses	84 000	80 000	**4000**	**F**
Closing Cash at Bank	$20 000	(27 840)	**47840**	**U**

B. *Prepare a budgeted Income Statement for Birkland Enterprise for the year ended 30 June 2019.*

Birkland Enterprise

Budgeted Income Statement performance report

	BUDGET	ACTUAL	VARIANCE	
INCOME				
Sales	400 000	396 000	**4000**	**U**
Less: Cost of sales	164 000	180 000	**16000**	**U**
EXPENSES				
Marketing	31 200	32 400	**1200**	**U**
Wages	99 200	100 800	**1600**	**U**
Loss on sale	0	14 000	**14000**	**U**
Depreciation	3 600	3 600	**0**	**-**
Other	84 000	80 000	**4000**	**F**
PROFIT/LOSS	18 000	(14 800)	**32800**	**U**

31. *Michelle and Jason own Mish's Mighty Muffins, with two retail outlets. These are located in your local area, and so their surroundings and customer base are quite familiar to you. The current concerns that Michelle has relate to increasing raw material prices; flour and milk are becoming more expensive due to increased petrol prices. Michelle is also planning to renovate the shop in May. The current benefits include their location, new recipes and packaging they are developing, and improved interest rates. They want to decrease their loans and purchase a new computer for cash in June.*

Shown below is the cash budget of Mish's Mighty Muffins for the next four months:

	March	April	M ay	June
	$	$	$	$
Cash and cash equivalents at beginning of period	400	3 920	4 490	2 270
CASH RECEIPTS				
Cash receipts from customers	58 300	59 666	58 700	61 234
Proceeds from sale of computer	80	0	0	0
Interest received	880	880	880	900
Proceeds from long-term borrowings	1 000	1 200	1 000	1 000
CASH PAYMENTS				
Cash paid to suppliers and employees	(52 900)	(57 976)	(54 100)	(57 666)
Interest paid	(740)	(800)	(700)	(1 500)
Purchase of fittings	(700)	0	(5 700)	0
Payment of liabilities	(1 800)	(1 600)	(1 600)	(1 800)
GST payment	(600)	(800)	(700)	(800)
NET INCREASE/DECREASE IN CASH AND CASH EQUIVALENTS	3 520	570	(2 220)	1 368
Cash and cash equivalents at end of period	3 920	4 490	2 270	3 638

Required:

A. *Prioritise the cash flow needs of Michelle and Jason, giving reasons for your answer.*

B. *Complete a performance report for the business.*

C. *Compare your analysis of the data with your initial expectations, and outline an action plan for Michelle and Jason.*

Using the questions contained in *'Analysis of the cash budget'* students should complete a *Performance Report* which discusses issues such as, but not limited to, the following:

- Why have cash receipts been gradually increasing? It appears that receipts from customers is the main account affecting this section of the statement – what has occurred for this positivevariance to result?
- Cash payments to suppliers and employees have increased at a greater rate than receipts. What has affected this? Should creditor terms be reviewed? Are there some unexpected cash expense being paid to suppliers?
- We know that raw materials and petrol prices are increasing. How can receipts from customers be adjusted or expenses decreased to allow for this increase?
- Why has interest paid doubled in June?
- Can the May purchase of fittings be reconsidered – either a loan may not be advisable as interest is already doubling in the following month – this asset purchase is for a shop renovation – is this required? Can it be delayed? It might be part of the plan to increase sales due to the increase in raw materials costs.
- The computer purchase is possible based on the final balance of $4638 at the end of June, however.

32. *Cricket Creations. Shown below are the Cash Flow Statement and the Income Statement for Cricket Creations, a cricket equipment retail store run by Shane. The business is located in East Perth, and supplies specialist cricket equipment and clothing to the Western Australian public, as well as to the state cricket team. Shane has asked you to prepare some budgets for the upcoming year.*

Cricket Creations
Cash Flow Statement
For the year ended 31 December 2018

	$
Cash and cash equivalents at beginning of period	*(12 340)*
Cash Receipts	
Cash receipts from customers	*297 100*
Proceeds from sale of computer	*1 000*
Interest received	*490*
Cash Payments	
Cash paid to suppliers and employees	*(236 000)*
Interest paid	*(2 000)*
Purchase of new computer	*(3 350)*
Payment of bank loan	*(32 000)*
Net Increase in Cash and Cash Equivalents	*25 240*
CASH AND CASH EQUIVALENTS AT END OF PERIOD	***12 900***

Cricket Creations
Income Statement
For the year ended 31 December 2018

	$
Income	
Net sales	*324 600*
LESS: Cost of Sales	*247 890*
GROSS PROFIT	*76 710*
ADD: Other Income	
Gain on sale of computer	*500*
Discount received	*8 400*
	85 610
LESS: Expenses	
Selling Expenses	
Advertising	*(3 400)*
Delivery costs	*(2 300)*
Wages of sales staff	*(65 000)*
	(70 700)
Administration Expenses	
Depreciation of equipment	*(1 300)*
Electricity	*(2 000)*
Telephone and internet	*(800)*
Office supplies	*(7 000)*
	(11 100)
Financial expenses	
Interest	*(2 200)*
Bad debts	*(560)*
	(2 760)
Total Expenses	***(84 560)***
PROFIT	***1 050***

Required:

A. Prepare a cash budget, taking into account the following forecasts made by Shane for the next 12 months:

- *Customer repayments are predicted to rise by 4%.*
- *The business will commence giving a discount of 3% to customers who buy in bulk. It is estimated that a quarter of customers will take advantage of this offer.*
- *The loan will be paid off halfway though the year and interest will therefore halve.*
- *The payments to suppliers and employees will be affected by a 5% wage increase and a 1% electricity increase. At present, wages are 40% of these payments, and electricity is 10%.*

Cricket Creations
Cash budget
For the year ended 31 December 2019

	$
Cash and cash equivalents at beginning of period	12 900
Cash Receipts	
Cash receipts from customers	306 666
Interest received*	490
Cash Payments	
Cash paid to suppliers and employees	(240 956)
Interest paid	(1 000)
Payment of bank loan*	(16 000)
Net Increase In Cash And Cash Equivalents	49 200
CASH AND CASH EQUIVALENTS AT END OF PERIOD	**62 100**

* Students may have decided to leave these amounts out and should have explained their reasoning

B. Prepare a budgeted Income Statement, taking into account the following forecasts:

- *Cash and credit sales are expected to increase by 5%.*
- *The cost of sales will also increase, by 4%.*
- *There will not be any sale of computers, and discount received is generally 5% of purchases, because the business always pays creditors on time.*
- *The business has decided to increase spending on advertising.*
- *Wages will increase 5% and electricity 1%.*
- *All other income and expenses will be unchanged.*

Workings:
Cost of Sales = 257 806 – 12 890 = $244 916

Cricket Creations
Budgeted Income Statement
For the year ended 31 December 2019

	$
Income	
Sales	340 830
Less: Cost Of Sales	244 916
GROSS PROFIT	95 914
Less: Expenses	
<u>Selling Expenses</u>	
Advertising #	(8 800)
Delivery costs	(2 300)
Bad debts	560
Wages of sales staff	(68 250)
<u>Administration Expenses</u>	
Depreciation of equipment	(1 300)
Electricity	(2 020)
Telephone and internet	(800)
Office supplies	(7 000)
<u>Financial Expenses</u>	
Interest	(2 200)
BUDGETED PROFIT	**2 684**

\# Students should justify their choice of an amount here

C. Using correct accounting language and terminology, interpret the information contained in the budgets for Shane.

Cash Budget:

– Opening positive cash balance, different to previous period

– Slightly elevated receipts from customers, though cash payments to suppliers also increasing

– No cash payments for assets

– Much lower payment of loan planned.

Should result in an overall much more positive closing cash balance and improved liquidity position.

Budgeted Income Statement:

– Expecting sales to increase
– Cost of sales predicted to remain almost the same
– Increased advertising cost will result in overall increase in expenses.

Overall predicting a slight improvement in profitability.

33. *Shown here is the Cash Flow Statement for Zen Delights, a yoga equipment shop run by Amy and Duncan, at the end of the 2019 financial year. The budgeted figures for the following year at shown to the right.*

	Cash Flow Statement for 2019 $	**Cash Budget for 2020** $
Cash and cash equivalents at beginning of period	34 600	34 600
CASH RECEIPTS		
Cash receipts from customers	229 200	242 600
Proceeds from sale of vehicle	5 600	0
Interest received	5 690	5 690
CASH PAYMENTS		
Cash paid to suppliers and employees	(260 450)	(340 670)
Interest paid	(370)	(670)
Purchase of fittings	(6 350)	0
Payment of bank loan	(2 900)	0
NET DECREASE IN CASH AND CASH EQUIVALENTS	(29 580)	(93 050)
Cash and cash equivalents at end of period	5 020	(58 450)

The Income Statement for 2019 and the budget for the following year are included below.

	Actual for 2019 $	**Budget for 2020** $
INCOME		
Net sales	237 925	249 821
LESS: COST OF SALES	120 560	124 177
GROSS PROFIT (LOSS)	117 365	125 644
ADD: OTHER INCOME		
Gain on sale of equipment	340	0
Discount received	898	900
	118 603	126 544
LESS: EXPENSES		
Selling Expenses		
Advertising	(1 500)	0
Delivery costs	(800)	(1 200)
Depreciation of delivery vehicles	(6 300)	(6 300)
Wages of delivery staff	(23 000)	(24 000)
	(31 600)	(31 500)
Administration expenses		
Depreciation of equipment	(2 300)	(2 300)
Loss on disposal of computer	(120)	0
Salaries of office staff	(52 300)	(52 000)
Office supplies	(7 802)	(7 500)
	(62 520)	(61 800)

	Actual for 2019 $	Budget for 2020 $
Financial expenses		
Interest	(9 632)	(9700)
Bad debts	(562)	(560)
	(10 194)	(10 260)
TOTAL EXPENSES	(104 314)	(103 560)
PROFIT FOR THE PERIOD	**14 289**	**22 984**

Required:

A. *Summarise the liquidity and profitability position of the business.*

B. *Interpret these two sets of budget information.*

C. *Comment on the predicted variance between the actual results for 2019 and the budget for 2020.*

D. *What changes should Amy and Duncan make to reverse any potential problems for the next financial year?*

Discussion questions. Answers might include:

Responses to the 'analysis of the cash budget' and 'analysis of the budgeted income statement' Performance Report questions.

Student responses should note serious concerns about the liquidity position of the business, as revealed in the Budgeted Cash Flow Statement and should isolate concerning data such as the large increase in cash payments to suppliers and employees.

Responses should analyse the strong predicted profitability of the business as predicted by the Budgeted Profit and Loss Statement, with predicted increases in sales – potentially these are merely credit sales – and a predicted decline in several expense items.

Responses should show that the business could potentially become insolvent through not having sufficient funds for the day to day running.

Show an understanding that the Cash Budget will allow Amy and Duncan to see when their cash payment commitments must be made. They can make sure the business has sufficient funds to meet these obligations when they fall due. The budget will show when the business might have surplus cash not being used. The business will be able to investigate ways of investing this money so that it is not idle, as this is a wasted opportunity.

For the shortage of funds the business will need to investigate ways that this can be overcome such as negotiating a longer period of credit with creditors, or borrowing funds from the bank.

The longer a debtor takes to pay their account the more likely they are to become a bad debt. If debtors are taking too long to pay their account then Amy and Duncan will need to take steps to rectify the situation such as offering a discount for early payment or charging for late payment.

CHAPTER 4: CAPITAL INVESTMENT

Questions

1. *Define capital budgeting.*

Capital budgeting is concerned with the investment of capital and analysing whether a project being considered is good investment or not. It deals with long term investment decisions. For example: replacing old machinery, buying new machinery, starting a new product line.

2. *Why is capital budgeting such an important management tool?*

Businesses usually have unlimited investment opportunities but only limited capital. Due to this and the fact that firms exist to make a profit they have to be careful that they are making the right decision. Capital budgeting helps the business manager analyse the investment and hopeful make a wise decision that will yield a good return and increase the profitability of the business.

3. *What are the main characteristics of capital budgeting decisions?*

Capital budgeting needs to answer questions such as:

- Would Machine A or Machine B be more cost effective?
- Should new equipment be purchased to reduce costs?
- Should the equipment be bought, leased or hire purchased?
- Should the equipment be replaced now or at a later stage?
- Would the investment increase sales?
- Would it provide a decent return?
- Would the investment increase capacity or sales?
- Should the plant be modernised now or at a later stage?
- Would it provide a decent return on the investment?

4. *What are the most common cash inflows considered in a capital budgeting decision? What is the most common cash outflow?*

A. Return on the investment.
B. The cash outflow to pay for the investment.

5. *What is meant by the time value of money'? Why is this concept important for capital budgeting?*

A dollar in the business (hand) now is better than in the future. Business managers usually prefer investments which will yield a return as soon as possible rather than at some time in the future. For example: $200 to be received in 5 years time is not as valuable as $200 in my hand right now as I can use the $200 to invest or earn interest on it.

6. *Distinguish between the future value of money and the present value of money. Which of the two is the more important in capital budgeting? Why?*

The future value of money is integral to capital budgeting. A dollar now is worth more than a dollar in five years time. Capital budgeting takes this factor into account. By using compound interest tables, a business manager can determine whether a cash outlay made now in an investment project can be justified in terms of expected cash receipts from the project in future years.

7. *Is the net present value method always positive in a capital budgeting decision?*

No NPV is not always positive. If it is negative, the value of the cash outflows is greater than the cash inflows.

8. *Harper Adams Inc is considering an investment proposal. Staff have made the following estimates with respect to the proposal:*

Cash outlay required immediately	$100 000
Total cash receipts per annum.	15 000
A final cash receipt 6 years from now	80 000

Harper Adams Inc sets a target rate of return of 10% for all of its investment proposals.

Required: Using net present value analysis, state if the business should accept the investment proposal. Justify your answer.

The present value of expected future net cash receipts should be compared with the outlay of $100 000 which is already expressed at its present value. The future net cash receipts from the proposal can be considered in two parts:

1. The receipt of $80 000 six years from now. From looking at Table 3 (Present value of $1) in the chapter appendix we can see that the present value of $1 in 6 periods time at 10% is 0.5645.

   Therefore the present value of $80 000 in 6 years time at 10% per annum
   = $80 000 x 0.5645
   = $45 160.

2. The receipt of **an annuity** of $15 000 for each of the next 5 years. From Table 4 (Present value of an Annuity of $1) we can see that the present value of an annuity of $1 for each of the next 5 years at 10% is 3.7908.

   Therefore the present value of an annuity of $15 000 for each of the next 5 years
   = $15 000 x 3.7908
   = $56 862.

Overall, the net present value of the proposal
= ($45 160 + $56 862) - $100 000
= $2 022.
The net present value of the proposal is positive, therefore the proposal is acceptable.

9. *If the net present value of an investment is zero, does this mean that no profit will be earned from the investment?*

Zero means that the project equals the cost of the capital.

10. *Regents Park is considering an investment proposal. Its required rate of return is 12%. The project requires a $40 000 investment and would provide an estimated lump sum return of $68 000 at the end of four years.*

The present value of $1 in 4 periods from now at 12% is $0.6355.
Therefore the present value of $68 000 in 4 years time = $68 000 x 0.6355
= $43 214.

NPV = $43 214 - $40 000
= $3 214.
As the NPV is positive the investment is acceptable.

11. *Why is the dollar today generally worth more than a dollar at some future date? How can we approach the problem of estimating how-much more?*

An amount of money to be received in 5 years time is not as valuable as that same amount right now as the business can use the money by investing it or collecting interest on it.

The time value of money has been integrated into capital budgeting by means of compound interest relationships.

12. *Traders Online likes to receive a minimum of 14% return on its investments. It is considering an investment costing $75 000 which would bring annual net cash inflows of $20 000 for six years and an additional residual return of $10 000 at the end of the sixth year. Is this proposal acceptable? Show your calculations and justify your answer.*

Discussion question. Students should show an understanding that as the NPV is positive the investment should be acceptable.

13. *Jolly Barnyard* is considering a proposal that costs $40 000 and will earn an estimated annual net cash flow of $12 500 over the next five years. It likes a 14% per annum return on all investments. Should it accept this proposal?

From Table 4 (Present value of an annuity of $1) for 5 periods at 14% is 3.433.
Therefore the present value of an annuity of $12 500 for 5 years at 14%
= $12 500 x 3.433
= $42 913.
NPV = $42 913 - $40 000
= $2 913.
As the NPV is positive the investment is acceptable.

14. *Highflyers* is considering an investment project that costs $75 000 and has a rate of return of $22 500 per annum over the next five years. It likes a rate of return of 10%. Should it accept the proposal?

From Table 4 (Present value of an annuity of $1) for 5 periods at 10% is 3.791.
Therefore the present value of an annuity of $22 500 for 5 years at 10%
= $22 500 x 3.791
= $85 298.
NPV = $85 298 - $75 000
= $10 298.
The investment is acceptable.

15. *Raiders and Co* is investigating an investment proposal that costs $60 000 and would yield a rate of return of $19 500 per annum for the next five years. The business likes a minimum rate of return of at least 12%. Should it accept the proposal?

The present value of an annuity of $1 for 5 years at 12% is 3.605.
$19 500 for 5 years at 12% = $19 500 x 3.605
= $70 298.
The NPV = $70 298 - $60 000
= $10 298 and the proposal can be accepted.

16. *Sakai Trading* has a fixed amount of money to invest. It can invest the money and receive either a $20 000 lump sum amount at the end of 10 years or receive $1 400 per annum at the end of each year for 10 years. If the minimum desired rate of return is 12%, which alternative should *Sakai Trading* accept? Justify your answer.

Option 1: $20 000 x 0.322 = $6 440
Option 2: $1 400 x 5.650 = $7 910
Having $1 400 per year for 10 years is a better option than the $20 000 lump sum.

17. *Blinko Lighting* is looking at an investment proposal that would have an eight-year life and require a $1 600 000 investment in equipment. At the end of eight years, when the project ends, the equipment would have a zero salvage value. The project would provide net income each year as follows:

Sales	$3 000 000	
LESS: Variable expenses	1 800 000	
Contribution Margin	1 200 000	
LESS: Fixed expenses:		
Advertising, wages and other expenses		700 000
Depreciation		200 000
Total fixed expenses		900 000
Net income		$300 000

The company's cost of capital is 18%.

Required:

Calculate the project's net present value. Is the investment acceptable? Show your calculations and justify your answer.

Cost of equipment = $(1 600 000) x 1.00
= $(1 600 000)
Net annual cash flow inflow = $500 000 x 4.078
= $2 039 000
NPV = $(1 600 000) - $2 039 000
= $439 000
The project is acceptable as it has a positive NPV.

18. *An investment proposal is expected to yield a net annual cash flow of $5 000 for the next six years. What is the present value of that investment now, given a target rate of return of 12% per annum?*

The present value of an annuity of $1 for 6 periods at 12% is 4.114. Therefore the present value of an annuity of $5 000 for 6 years is $5 000 x 4.114 = $20 570.

19. *What is the future value of $3 000 invested for five years at 12% per annum compounded annually?*

The future value of $1 for 5 periods at 12% is $1.7623. Therefore the future value of $3 000 for five years at 12% is $3 000 x 1.7623 = $5 286.90.

20. *A sum of $8 000 is due to be paid in four years from now. How much would need to be invested now at 14% per annum compounded annually to yield the sum due?*

The present value of $1 in 4 periods time at 14% is $0.5921.
Therefore the present value of $8 000 in four years at 14% = $8 000 x 0.5921
= $4 736.80.

21. *Keely Enterprises is considering purchasing a new machine that will cost $33 540 and have no residual value. Annual net cash flows for each of the next 10 years are expected to be $8 000. The related annual net income is expected to be $4 696. The company has a cost of capital of 12%. You are required to work out the payback period.*

Annual cash inflow = $8 000 + $4 696
= $12 696

Payback period = $33 540 / $12 696
= 2.6 years

22. *Hirst and Son is considering the purchase of a new machine that will cost $70 000. The machine has a useful life of seven years and no residual value. Annual cash savings from better productivity are expected to be $24 000. The business has a cost of capital of 12%. What is the payback period for the investment?*

Payback period = $70 000 / $24 000
= 2.9 years

23. *Calculate the payback period for the following investment with an initial cost of $54 000.*

Year	Annual Net Cash Flows
1	$13 250
2	15 000
3	25 750
4	15 250
5	23 940
6	57 060

The payback period is 2 years.

To calculate this, it is necessary to balance off the cash inflows against the investment. This is done by adding the cash inflows year by year basis until the investment outlay has been realised.

24. *Calculate the payback period for the following investments considering the business has a cost of capital of 12%.*

Investment	1	2	3	4
Initial cost	$10 000	$50 000	$75 000	$60 000
Expected life in years	3	4	5	6
Total net cash flows over the useful life of the investment	$15 000	$80 000	$125 000	$96 000

Investment 1:	$10 000 / $15 000	=	0.67 years
Investment 2:	$50 000 / $80 000	=	0.63 years
Investment 3:	$75 000 / $125 000	=	0.6 years
Investment 4:	$60 000 / $96 000	=	0.63 years

25. *Collins Inc is looking at an investment proposal that would have an eight-year life and require a $1 600 000 investment in equipment. At the end of eight years, when the project would end, the equipment would have a zero salvage value. The project would provide net income each year as follows:*

Sales		$3 000 000
LESS: Variable expenses		1 800 000
Contribution margin		1 200 000
LESS: Fixed expenses:		
Advertising, wages and other expenses	$700 000	
Depreciation	200 000	
Total fixed expenses		900 000
Net income		$300 000

The company's cost of capital is 18%.

Required:
Calculate the project's payback period. If the business requires a maximum payback of three years, is the project acceptable?

Payback period = Investment required / Net annual cash inflow
= $1 600 000 / $500 000
= 3.2 years

No, the project is not acceptable when measured using the payback method. The 3.2 years is greater than the maximum three years set by the business.

26. *What is meant by the term 'payback period'?*

An alternative approach to capital budgeting instead of using NVP analysis is the payback method. This method looks at the period of time needed for an investment to pay for itself. The shorter the payback period the better.

When the annual net cash flows from an investment are equal each year the following formula is used:

Payback period = Initial cost of the investment / Annual net cash flows

When the annual net cash flows are uneven the simple formula shown above cannot be used. To obtain the payback period it is necessary to balance off the cash inflows against the investment outflows on a year by year basis.

27.

A. Thomas Brothers estimates that if the business invests $160 000 in new production equipment it can save $60 000 in annual cash operating costs. The system has an expected useful life of five years and no salvage value. The required rate of return is 12%. Calculate both the payback period and the net present value. Comment on your findings.

Payback period - $160 000 / $60 000 = 2.7 years
NPV - $60 000 x 3.605 = $216 300
$216 300 - $160 000 = 56 300

The investment is acceptable as the payback period is less than the useful life of the equipment and the NPV is a positive figure. Both the payback period and the NPV indicate the investment should go ahead.

B. Fabian-Hunt Dentistry estimates it can save $28 000 a year in cash operating costs for the next 10 years if it buys a special purpose x-ray machine at a cost of $110 000. No salvage value is expected. Fabian-Hunt's required rate of return is 14%. Calculate both the net present value and the payback period. Comment on your findings.

Payback period - $110 000 / $28 000 = 3.9 years
NPV - $28 000 x 5.216 = $146 048
$146 048 - $110 000 = $136 048

The investment is acceptable as the payback period is less than the useful life of the x-ray machine and the NPV is a positive figure. Both the payback period and the NPV indicate the investment should go ahead.

28. A biscuit manufacturing company, Big Bikkies, is planning for the possible expansion of its plant. The purchase of new processing machinery will allow Big Bikkies to double its product line from five to ten types of biscuit. The new equipment will cost $58 000, with a scrap value of $8 000 and a useful life of five years. The cost of capital is to be 20%. The supplier of the new equipment has agreed that the business can pay a deposit of 40%, with the remaining amount payable in two years' time.

The managing director of Big Bikkies has calculated that the new equipment will generate the following cash flows for the subsequent five years:

Year	Cash inflow $	Cash outflow $
1	70 000	55 000
2	68 000	56 000
3	73 000	58 000
4	78 000	60 000
5	80 000	61 000

A. Calculate the net present value of purchasing the equipment.

Net present value calculation

Annual cash flows

Year	Cash inflow	Cash outflow	Net cash flow	20% factor	NPV
1	70 000	55 000	15 000	0.8333	12 499.50
2	68 000	56 000	12 000	0.6944	8 332.80
3	73 000	58 000	15 000	0.5787	8 680.50
4	78 000	60 000	18 000	0.4823	8 681.40
5	80 000	61 000	19 000	0.4019	7 636.10
TOTAL					**45 830.30**

Initial investment and scrap value

Year	Cash inflow	Cash outflow	Net cash flow	20% factor	NPV
0	0	23 200	(23 200)	1	(23 200.00)
2	0	34 800	(34 800)	0.6944	(24 165.12)
5	8 000	0	8 000	0.4019	3 215.20
TOTAL					**(44 149.92)**
NPV of proposal					**1 680.38**

B. *Big Bikkies would only like to invest in the equipment if it can make back its investment within four years. Calculate the payback period of the equipment to the nearest month and recommend if it should proceed with the investment decision.*

Payback period

Year	Net cash flow	Cumulative
1	15 000	15 000
2	12 000	27 000
3	15 000	42 000
4	18 000	60 000
5	19 000	79 000

Payback occurs at some stage of Year 3.

Payback period $= 3 \text{ years} + \dfrac{(58\,000 - 42\,000)}{18\,000} \times 12 \text{ months}$

$= 3$ years and 11 months.

The net present value calculation indicates that the business will make a small positive return over the life of the project. The payback period is only just under the period required by the business so this is acceptable. Overall, the proposal is acceptable to the business because the net wealth of the business will be improved in the time period specified. The managing director needs to be cautious however because the NPV is quite small and the payback period is only met by one month.

29. *Scotty Jackets is considering the purchase of a special buttoning machine for $23 000. It is expected to have a useful life of four years, with no salvage value. The business manager estimates the following savings in operating costs:*

Year	Amount
1	$10 000
2	8 000
3	6 000
4	5 000
Total	$29 000

Calculate the payback period.

Payback period is 3 years. To get this figure it is necessary to balance off the cash inflows against the investment. This is done by adding the cash inflows on a year by year basis until the investment outlay has been realised.

30. In what way can consumer preferences affect capital budgeting decisions?

Capital budgeting decisions

The limitations of Capital Budgeting are that the assumption of a perfect world. That these large investments can be decided by a quick and easy calculation. The reality is that the world of business is a far more complicated place. Many factors can make what looked like a good investment on paper turn bad. For example; if a business introduces a new product line but does no market research in addition to the capital budgeting research, they could come unstuck because the business might have made the product blue when the target market wanted a pink product. Or the business could price the product incorrectly, losing market share. Or that economic climate might force consumers to prefer to save rather then spend. It is extremely important that the business is aware of the current preferences of its target market, and the economic climate, to help predict capital budget decisions.

31. Why does a business need to be aware of government regulations?

Taxes and required insurances reduce the profit on any investment so it is important for the business to know exactly what taxes and insurance or fees the government will require the business to pay on the investment and on any profit realised. In addition the business needs to be aware of any other government regulations which affect its line of business. For example: if the business chose to build a new warehouse in their grounds but did not get planning and council approval first they would have to face the consequences if they were found out like a fine or having to pull down what had been illegally built. Companies need to be very aware of all the business regulations facing the business they are in right down to the smallest detail. For example: using paint that is lead free on childrens' toys.

32. Explain two short-term investment options.

Two short-term investment options are (for example):

1. **Cash Management Trusts:** this is an investment portfolio. It is a managed option in the short term money market that tends to yield a higher rate of return than a savings account. It is a situation where the fund operator pools the money together of a collective amount of investors and invests the funds in a wide range of investments. Regarded as a safe investment option.
2. **Money market:** this is the market for short term funds. People use it as it is safe. It is used for short term purposes with maturities of less than a year and often only a month. Returns are fairly low but it is a safe option but will be higher than bank interest. Investors often use the money market as a place to store cash until they have decided how to use it.

33. Discuss three long-term investment options managed by Financial Institutions.

Three long-term investment options are (For example):

1. **Shares:** Companies can sell Ordinary Shares and Preference Shares.
   A. Ordinary Shares: the majority of share capital will be raised from these shares. Ordinary Shareholders are entitled to full shareholder voting rights at meetings. They also receive a share of any profits, which are made in the form of dividends. Even if the business makes a profit sometimes it will be retained in the business rather than being used to pay dividends.

   B. Preference Shares: these are shares, which can be purchased if the shareholder wants a guaranteed dividend. Preference Shareholders have limited voting rights.
2. **Debentures:** This is when a company offers existing investors the chance to invest in the company through the purchase of debentures. The debenture holders are really loaning the company money for a set period of time at a set interest rate. They do not become owners of the company, instead they become creditors waiting to be paid back in full by an agreed date.

Extended answer question

1. *The owner of a small soft drink manufacturing firm has asked you to explain why her business should be concerned about capital investment decisions. She says to you:* ***'I find it difficult enough to plan for next week; planning for years in advance doesn't seem worth the effort.'***

The owner of the business has asked you to prepare a report outlining:

- *what a capital investment decision is, from the perspective of the owner of this business*
- *different techniques for making capital investment decisions*
- *rhe factors affecting capital investment decisions.*

Apply your discussion to the business.

What a capital investment decision is, from the perspective of the owner of this business:

- Definition: Long term decision about the investment of business money
- Types of decision: purchase asset, acquire new building, expand product line, upgrade machinery, update technology (etc)
- Requires decision about the allocation of limited capital in the investment market, with consideration of potential returns
- Often there is a high level of risk due to the amount of money and length of time

Different techniques for making capital investment decisions:

- **Discounted cash flows:** compares the present value of cash inflow with present value of outflows. A positive NPV results in the project being likely to go ahead. Main advantage of NPV: considers time value of money.
- **Payback period:** how long it takes for investment cash flows to exceed initial outflow. Business decides on time period required and calculates of project will meet this. Advantages: simple and may provide more certainty, considers liquidity of business.
- **Return on average investment:** uses an average rate of return by measuring profitability. Higher return would make project more likely to proceed. Advantages: easy to understand and considers profits.

The factors affecting capital investment decisions:

- Consumer preferences
  - Customers might not want the product which the investment is being made to produce.
  - Marketing must be completed and market research to determine suitability for consumers
  - Changes can occur at a later date and affect the business
  - The economic or social climate can change (etc).
- Competition
  - Other businesses can enter or leave the market, driving price up or down
  - Changes in technology and the environment can affect a competitor
  - Constant awareness of competitors required
  - Awareness and reminding a step ahead.
- Government regulation
  - Laws such as environmental, OHS etc
  - Taxation, and other government fees and charges
  - Approval from planning authorities for expansion and upgrading decisions
  - Consumer laws and safety of product.

CHAPTER 5: THE WIDER COMMUNITY

Questions

1. *What is the main difference between an internal user and an external user of accounting information?*

Internal user: someone within the organisation who uses the information to manage the business.

External user: someone outside the organisation who uses the information to make decisions about the business.

2. *What are some of the ways in which a manager will use accounting information?*

Questions which an owner or shareholder would expect management to be able to answer, include:

- What short-term plans are being implemented?
- What long term plans need to be made?
- Has the business made a profit?
- In comparison to the previous year, has the profit increased or decreased or remained the same?
- If the profit has decreased what are the reasons for this?
- If the profit has increased what was this due to? And will this trend continue?
- Is the business able to repay all its liabilities?
- Can the owner withdraw more money from the business or should he/she be withdrawing less? (Or, can a company alter dividends?)
- Are customers paying their bills on time?
- Should the business offer more services or reduce the number currently offered?
- Can the business expand?

3. *Explain what an auditor does.*

An auditor is a person who is trained to examine and verify that the accounts of a business are true and fair. An auditor could be both an internal and an external user of financial information.

Internal auditors analyse the business processes, procedures and activities to investigate if there are any problems which are causing the business to not operate as efficiently as it is capable of.

The **external auditor's** primary role is to decide whether the company's annual financial statements:

1 conform with the generally accepted accounting principles (GAAP)
2. fairly present the financial position of the organisation
3. accurately represent the result of operations for the given time period and
4. are free of material misstatement.

4. *List four users of external accounting information, and describe the way in which each will use financial information.*

- **Lenders** use information to decide if loans and interest will be paid.
- **Employees** use information to decide if they are financially stable and profitable.
- **Customers** use information to decide on long-term business relationships.
- **Governments** use information to regulate and enforce legal requirements.

5. *What are accounting standards?*

Accounting standards are technical documents that outline how a business should complete specific elements of financial records in relation to the transactions that take place in the business. These requirements impact on the final preparation and presentation of the businesses financial statements.

6. *List the three main accounting statements used by companies.*

1. Balance Sheet
2. Statement of Profit or Loss and Other Comprehensive Income
3. Cash Flow Statement

7. *What is the purpose of a Balance Sheet?*

Balance Sheet: a list of all the assets, liabilities and equity of a business at a particular point in time. The financial position.

8. *What is the difference between the Statement of Profit or Loss and Other Comprehensive Income and the Cash Flow Statement?*

The Statement of Profit or Loss and Other Comprehensive Income details the various income and expenses incurred in an accounting period in order to calculate the profit or loss a business has made in an accounting period and includes non-cash items.

The Cash Flow Statement gives the users of financial information a detailed look at the cash inflows and outflows in specific categories, which no other financial report is able to provide. It helps users of financial information answer two important questions: where did the cash come from in the financial year and what was it spent on. It also enables analysis of the businesses liquidity position.

9. *What is the purpose of an internal audit?*

Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.

10. *List three items on which an internal audit might focus.*

There are many things that an internal auditor may be asked to investigate. Specifically, they might focus on the following:

- Investigating any fraud or the possibility of it occurring.
- The reliability of the financial reports being produced.
- Safeguarding assets.
- Whether the business is complying with the necessary laws and regulations pertaining to their industry sector.
- The efficiency of the business operations.

11. *Define 'internal control', and give four reasons why a business uses internal control procedures.*

Internal control, at the simplest level, means adopting good business practices to ensure that the assets of the business are safeguarded and that the effectiveness and efficiency of business operations are improved whenever they can be.

To ensure that:

- assets are safeguarded
- correct procedures, policies, regulations and laws are adhered to
- financial reports and records are valid
- continual improvement of the effectiveness and efficiency of business operations is achieved.

12. *The Financial Services Reform Act outlines many requirements that must be followed by accounting and finance professionals who provide financial advice. What does it mean to act 'efficiently, honestly and fairly'?*

Accounting and finance professionals must act *efficiently honestly and fairly* in providing financial services, be competent to provide financial services, ensure that representatives are sufficiently trained to provide financial services that they are authorised to provide, and have a dispute resolution system in place as approved by the Australian Securities and Investments Commission.

13. *What are accounting controls?*

An accounting control is anything (ie. methods or procedures) that aims to limit the possibility of a transaction being manipulated.

14. *Why do accounting controls exist?*

Accounting controls exist to make sure that:

- errors do not accidently occur
- errors do not deliberately occur through manipulation
- records are kept accurately
- transactions are authorized correctly
- set procedures are followed
- assets are safeguarded
- wherever possible efficiency is maximized
- waste is minimised.

15. *What is internal control over cash primarily concerned with?*

Internal control over cash is concerned with ensuring that cash does not go missing either intentionally or by accident.

16. List and explain three accounting controls over cash a business may wish to adopt.

Some (but by no means all) of the controls that can be adopted are:

- Different employees should be responsible for receiving and recording cash collections, balancing daily cash receipts to related cash recordings and verifying that the deposit amounts reflected in the general ledger match the departmental records. If the business is too small to allow for this role segregation then the senior management must be aware of this shortcoming and periodically do additional checks to ensure that the cash funds are being adequately protected.
- Separate, lockable containers available for every person collecting cash. The money should be locked and keys to the cash box be limited to the cashier and a manager. The cash should be locked in a drawer or safe overnight.
- If cash is kept in a safe the safe combination should be changed regularly.
- Cash should be counted in a secure area where the person is free from interruptions.
- Cash should be banked either at the end of each day or weekly depending on how large the amounts are.
- There should be a chain of accountability immediately upon receipt of the initial cash. Transfers between two people should be jointly verified and documented.
- All cash receipts should be recorded on a cash receipt form, cash register or a properly controlled computer database at the time of receipt.

17. Sally Harper operates an advertising agency as a small company. She currently has one employee, a receptionist. Every now and then, Sally allows high school, TAFE or university students to complete two-week-long work experience stints in her office. As Sally has a small company she cannot see any point in adopting any internal controls over cash. The receptionist sometimes lets the work experience student attend to customers who come in to pay their bill in person with cash.

Discuss the following:

A. Why should Sally adopt internal controls over cash?

Yes Sally must adopt internal control measures over cash. Cash is vital to the business so it must be protected.

B. What are some controls that Sally could implement?

Sally could adopt some of the following controls over cash:

1. Different employees should be responsible for receiving and recording cash collections, balancing daily cash receipts to related cash recordings and verifying that the deposit amounts reflected in the general ledger match the departmental records. As the business only has two employees these duties will be split between Sally and the receptionist. As the business is too small to allow for proper role segregation then Sally must be aware of this shortcoming and periodically do additional checks to ensure that the cash funds are being adequately protected.
2. Separate, lockable containers should be available for Sally and the receptionist. The money should be locked and keys to the cash box be limited to the receptionist and Sally. The work experience student should not have access to this. The cash should be locked in a drawer or safe overnight.
3. If cash is kept in a safe the safe combination should be changed regularly.
4. Cash should be counted in a secure area where the person is free from interruptions.
5. Cash should be banked either at the end of each day or weekly depending on how large the amounts are.

6. All cash receipts should be recorded on a cash receipt form, cash register or a properly controlled computer database at the time of receipt.
7. If the work experience student does the banking then Sally must fill in the amount and check when the student arrives back at the office that it was all banked.

18. What is internal control over inventory primarily concerned with?

Internal control is concerned with ensuring that the assets of the business are protected and managed in the most ideal manner possible. In relation to inventory, this means that the owners of a manufacturing or retail business need to ensure that stock is not spoilt, wasted, accidentally broken, stolen or incorrectly stored.

19. List and explain TWO controls over inventory a jewelry business should use.

Possible inventory control methods that a jewelry business could use:

- Writing guidelines as to the correct manner to show customers the jewelry and to lock the display cabinet straight away once a customer has viewed the item.
- Locking display cabinets for valuable items at all times unless showing a customer an item.
- Printing receipts and daily stock totals from the electronic inventory system.

20. Jeremy Wright has a business manufacturing surfboards. Once the surfboards have been made they are usually transported by friends in their cars, to Jeremy's retail outlet. The surfboards are displayed inside the shop, though sometimes a display is placed outside the shop. Jeremy usually has one employee working in the shop. If the employee is serving a customer inside the shop, there is no one to watch what is happening elsewhere.

A. What are some inventory control problems that Jeremy may experience?

Jeremy may have some of the surfboards which are outside the shop stolen as they are not always being watched. Also some of the surfboards outside may fade due to the exposure to the outside elements, for example wind, rain sun. As Jeremy get different friends to deliver the surfboards to the shop some may get damaged as not all the cars will be suitable for transporting surfboards.

B. What inventory control procedures could Jeremy implement?

Possible inventory control methods Jeremy could make use of are to:

- protect surfboards from sun damage by not displaying them outside the shop
- use protective bags to transport surfboards
- use a reputable transport company for delivering the surfboards to the shop
- if he wants to display stock outside then lock it
- install security cameras to prevent theft by customers.

21. Claire is a shopping entrepreneur, who has recently purchased part ownership in her local grocery store. This is part of a large Australia wide franchise, and the store of which she is now part owner is quite large, with ten checkouts, eighty part-time employees and a range of more than a thousand items on the shelves.

Claire has asked you to advise her on setting up a loss prevention system within the store, and to explain how the different elements will interact to produce the most beneficial inventory control system for the business.

Claire would like to ensure that you consider all elements of inventory control, including:
- *accidents*
- *employee errors*
- *customer theft*
- *employee theft*
- *spoilage*

Working with a partner, devise a system that will meet Claire's requirements. In a written report and using diagrams, illustrate how all these elements will interact.

Students will have different responses. They must include a proposal for the internal control of each of the items: accidents, errors, theft and spoilage.

22.
A. What is internal control over accounts receivable mainly concerned with?

Making sure that accounts receivable pay their invoices and that bad debts are kept to an absolute minimum.

B. Clearly explain three controls that a large legal firm could implement to ensure better control over accounts receivable.

A legal firm can segregate duties related to accounts receivable by:

- locating the office for receiving and opening mail away from the office for billing and the office that handles incoming payments
- having different individuals in charge of recording the receipt of cheques or credit card payments and in charge of preparing and sending out invoices
- reconciling all individual customer accounts with the accounts receivable control account on a weekly basis.

C. Name two specific strategies that a company could use to enable control of customer credit accounts.

A company can enable control of customer credit accounts through consistent monitoring of the customer credit policy, using aged analysis of receivables and calculation of the receivables turnover ratio.

23. List and explain three internal control measures over accounts receivable which every business should follow.

The management of accounts receivable may include some of the following:
- Invoices should be issued on a timely basis.
- Invoices should be issued in numerical sequence.
- Different people should be responsible for billing and maintaining accounts receivable records, receiving or handling incoming payments and reconciling receivable records to the general ledger.
- Delinquent accounts should be followed up regularly to facilitate payment.
- The business must set up and follow a specific set of procedures for determining bad debts and collection actions.

24. Bobbi Miller operates the dry cleaning business Breath of Fresh Air. He has been operating the business for two years. Two per cent of his customers never pick up their dry cleaning; therefore, he is not paid for these items. Bobbi is still assuming that at some stage the client will return and pick up their dry cleaning, so he refuses to write them off as bad debts.

What are some simple steps Bobbi could implement to have a greater control over accounts receivable?

Some of the things Bobbi could do to help with the management of accounts receivable could include:

- Keeping contact details of customers so the can be rung up if they have forgotten to pick up their dry cleaning. Delinquent accounts should be followed up regularly to facilitate payment.
- Setting up and following a specific set of procedures for the business to determine bad debts and collection actions.
- Making customers pay for their dry cleaning when they bring it in rather than when they pick it up.

25. What is the biggest advantage of supplying credit to customers?

Extending credit facilities to customers can increase business, as customers want to purchase from the company, however they may not have the funds to pay up front. This is particularly important for high cost items that can be repaid over time.

26. What is the biggest disadvantage of supplying credit to customers? Explain your answer.

The downside of extending credit is that the business has to make sure all customers pay, and keep track of the debts that are owed to the company. There is a risk that some customers will not pay and will become a bad debt.

27. List and explain FOUR items every business should consider before extending credit to a customer.

As part of their internal control systems over accounts receivable, management will have to consider their policy for supplying credit to customers. Items to consider:

1. **Credit history:** this is a record of the prospective customers' past borrowing and repaying history. It will include all personal and business information, credit lines currently being utilised, and the two biggest risk factors: whether the prospective client makes late payments or has been bankrupt in the last seven years. It is relatively simple to obtain a credit history on someone in Australia.
2. **Employment history:** if credit is to be extended it helps to know whether that customer is employed and how long they have been employed for. A person with a good employment history is less likely to default on paying their bill.
3. **Security:** this is an asset that can be seized if a business is unable to pay. A company should rarely lend large amounts money without this. If a client does not have enough of his or her own assets to offer as collateral/security then the business may accept someone acting as a guarantor for the extended line of credit. This means that if the client cannot pay, the person who has acted as the guarantor will have to make the payments.
4. **Bad debts:** the company needs to consider the likelihood that the customer could become a bad debt and if so to what extent this would affect the business.

Businesses exist to make a profit and spending time collecting money will be an added administration cost. Management will need to assess what this cost is and if it warrants extending credit or if it is easier to expect all customers to pay cash up front. If management decides that financially it will be beneficial to extend credit as more business will be generated then they need to put some policies in place, to make sure the amounts of money they are owed will be paid back to them.

28. Winfred Higgin is just about to open a business leasing luxury cars. He plans to lease Porsches, BMWs, Audis and SAABs. To attract new customers, he will offer a line of credit to customers.

A. Should Winfred extend a line of credit to every potential customer?

Extending credit facilities to customers can increase business, as some people want to take advantage of buying a luxury car but are unable to pay up front. However the downside of extending credit is that Winfred has to make sure all customers pay. There is a risk that some customers will not pay and will become a bad debt. Winfred should therefore not extend credit to all customers, rather only those who have a good credit history and the regular income which will allow them to meet their repayments.

B. What must Winfred consider before extending a line of credit to a customer?

As part of internal control systems over accounts receivable Winfred need a policy on supplying credit to customers, and should consider:

1. **Credit history:** this is a record of past borrowing and repayment history. It will list all personal and business information, credit lines currently being utilised and the two biggest risk factors: late payments or recent bankruptcy. It is relatively simple to obtain. Specifically, Winfred can call REVS to determine if anything is owing on a secondhand car.
2. **Employment history:** where the customer is employed and how long they have been employed. A person with a good employment history is less likely to default on paying their bill. Winfred can ask the customer to provide this information when they apply for credit.
3. **Security:** if the customer does not have enough of his or her own assets to offer as collateral/ security then the business may accept someone acting as a guarantor. If the client cannot pay the guarantor will have to make the payments.
4. **Bad debts:** Winfred needs to consider the likelihood that the customer could become a bad debt based on the information gathered. If Winfred decides that financially it will be beneficial to extend credit he needs to put policies in place, to make sure the money owing is tracked and paid back to his business.

29. Monty Casino operates a business selling designer coats to major retailers. Currently, his business has no internal controls in place. After attending a seminar on the benefits of internal control, Monty hires an expensive consultant to implement internal control policies in the business. The business associate is unhappy with the amount of money that the consultant is charging. He mumbles to Monty, 'I hope this doesn't end up a failure'. Monty is surprised that anyone could think that internal control may not work.

Explain to Monty three ways in which internal control is limited.

No internal control system is perfect, some of the reasons why are discussed below:

1. Staff size – if the business does not have enough staff these limitations may prevent the workplace from implementing a system of segregating duties properly.
2. Humans can and do make errors, this inaccuracy may lead to a seemingly perfect internal control system being not as effective as it was designed to be.
3. If two or more people conspire together to falsely report an activity to protect themselves then the internal control system will probably not pick up on this.
4. Most internal control systems are designed to monitor the usual everyday transactions of the business and will not pick up on the unusual, out of the ordinary transactions.
5. People in management can override a control making the overall system vulnerable.
6. The controls may need to be reviewed and changed if the business grows or changes the way it currently operates, without new changes the existing system could be ineffective and irrelevant. This is a limitation if management does not constantly review the system.
7. Businesses design internal control systems to be cost effective, this objective means that some errors may never be detected.

30. *Ingrid Murphy is about to open a shop selling computer hardware and software. The shop is in a large retail complex. The equipment ranges in size from large to very small items. Inside the shop Ingrid will have one salesperson and one till operator. In the back of the shop, has an administration person who signs for deliveries, opens the post, answers the phone, counts the daily takings and does the banking. The stock for the business is all kept in the back of the shop next to a window that does not shut properly. When it rains, water sometimes drips down onto the stock.*

A. Write a report highlighting the internal control issues that Ingrid faces.

B. What are some measures that can be taken to address these control issues?

A. and B. Students will have different responses. They could highlight examples such as:

- Security such as tags, beeper at the exit, video surveillance camera, a security guard.
- Stock in reserve being secure and locked.
- Stock needs to be protected from the elements so the window needs to be fixed straight away. This is ruining stock and a burglar could get into the storage area.
- Rotation of duties among the three staff regarding checking and banking the daily takings.

31. *Explain the role of an external auditor.*

The external auditor's primary role is to decide whether the company's annual financial statements:

- conform with the generally accepted accounting principles (GAAP).
- fairly present the financial position of the organisation
- accurately represent the result of operations for the given time period and
- are free of material misstatement.

32. *Discuss the role an accountant plays in an organisation.*

Accounting professionals have a range of roles from fostering economic growth to ensuring sustainable business development, and to assist with decision making for a variety of business needs.

Accountants are needed to interpret information, develop policies and enable risk management. An accountant might develop the accounting system for a specific business in response to its unique needs.

The *Australian Financial Service Reform Act (2001)* outlines the expected role to be taken by accountants and financial advisors. The Act outlines licensing rules and disclosure requirements, and is aimed at ensuring that the user of the financial information is fully knowledgeable and can make informed decisions.

An accountant may specialise in a particular field, and offer business advice or financial planning to customers who have particular needs. Specialist areas include:

- information and communication technology
- auditing
- insolvency
- project management accounting
- financial planning
- taxation and treasury
- strategic support
- business strategy

In large corporations there are many accountants specialising in different areas. However, in small businesses there may only be one accountant who has to focus on all of the following:

- financial management and accounts
- budgeting and forecasting
- analysis and interpretation
- decision making and advising
- internal auditing and upholding the code of ethics.

33. Define the term 'insolvency' and discuss the role of the liquidator.

Insolvency means not being able to pay debts when they are due and payable. To be insolvent the company is not able to pay all debts in full. People or businesses who are insolvent may be able to get themselves out of the situation by refinancing the debt and paying it off gradually.

This will occur if the creditor agrees.

Insolvent companies cannot declare bankruptcy, instead they can:

- enter into a deed of arrangement with their creditors
- go into receivership
- be wound up (liquidated) – voluntarily or forcibly.

It is the role of the liquidator to take care of the following:

- Investigate what assets the company owns
- Find out who is owed money and pay them
- Once the creditors have been paid, whatever assets remain will be distributed to the shareholders
- Organise to have the company deregistered.

34.

A. Reorganise the following list of creditors in to priority order of repayment upon declaration of bankruptcy of a shared debtor:

- *Retrenchment payments*
- *Creditor – raw materials supplier*
- *Secured creditor – charge over machinery.*
- *Unsecured creditor – liquidator or administrator*
- *Creditor who obtained the winding-up order*
- *Secured creditor – mortgage*
- *Liquidator costs*
- *Employee pay*

PRIORITY ORDER:

Liquidator costs (provided that secured creditors have elected not to enforce their charge)

Secured creditors – mortgage and charge over machinery.

Unsecured creditors:

- Liquidator or administrator
- Creditor who obtained the winding up order
- Employee pay
- Retrenchment payments

Creditor – raw materials supplier

B. Write a summary explaining the differences between voluntary administration, liquidation, receivership and insolvency.

Voluntary administration is an insolvency procedure where the directors of a financially troubled company, or a secured creditor with a charge over most of the company's assets, appoint a voluntary administrator. The effect of the appointment of a voluntary administrator is to provide the company with time to resolve the company's future.

Liquidation is the orderly winding up of a company's affairs. It involves realising the company's assets, ending or selling its operations, distributing the proceeds among creditors, and distributing any surplus among shareholders. The three types of liquidation are court, creditors' voluntary, and members' voluntary.

Receivership occurs when a secured creditor who holds security over some or all of the company's assets appoints a receiver. The receiver's primary role is to collect and sell enough assets to repay the debt owed to the secured creditor.

C. List the main indicators of an insolvency problem and explain what a business owner or company director should do when they notice these.

Indicators of an insolvency problem:

- Poor cash flow and problems paying creditors on time.
- An inability to obtain credit from financial institutions.
- Demand letters for payment from suppliers.
- Poor results for key ratios such as profit margin and debtors turnover.
- Management not using financial information in a timely manner.

D. Choose a business that you believe demonstrates its corporate social responsibility and explain the benefits to the business and the community.

Discussion question

Explain detail of a business that demonstrates its corporate social responsibility.

Benefits to business and community might include:

- becoming an employer of choice
- buy-in and commitment from staff
- an increased ability to attract and retain staff leading to lower employee turnover
- saving employing new staff.
- increased customer loyalty
- positive community impact
- support public shared values

35. Helping Hand

Tabitha Jenkins has opened up her own employment agency, Helping Hand. She has heard the term 'Corporate Social Responsibility' and would like to know how she can make her workplace more responsible in the following areas:

- *environmental friendliness*
- *community awareness*
- *employee support.*

Write a report for Tabitha outlining how she can respond to these concerns.

Discussion question. Answers might include:

A. Analysis of the concerns and challenges faced by companies when adopting CSR practices. These are as follows:

   - Lack of finance
   - Lack of knowledge and expertise
   - Lack of resources
   - Lack of time
   - Sourcing environmentally friendly products.
   - Having to train employees.

36. Delia Hammond runs a wholesale business, Funky Furniture, which sells household furniture manufactured from recycled materials. Delia is overworked. Financially, the business only just breaks even each month after paying the bills and wages. The local business council has approached Delia her, asking her to adopt some CSR initiatives.

A. Discuss some of the costs (challenges) that Delia may face when adopting CSR initiatives.

Challenges and costs include money, time, knowledge, resourcing and training.

B. What are the potential benefits?

Benefits include morale, retention, healthy competition, motivation, appreciation, connection, increased productivity and potentially increased profits.

37. Hugh Tavener runs a chain of restaurants which, although they make money, have a large employee turnover. He has heard that engaging in CSR can lead to a happier workplace.

A. Discuss the benefits of CSR for businesses.

There are several benefits for Hugh's restaurants of engaging in CSR:

- Increased ability to attract and retain staff leading to lower employee turnover, which in turn means less money being spent on employing new staff. This is a bonus as staff recruitment can be costly due to the expenses associated with advertising, interviewing and training.
- Increased customer loyalty as customers see the business doing the 'right thing' therefore they are willing to support the business. This can lead to increased business and thus revenue.

B. What are some CSR initiatives which Hugh could undertake to retain staff?

For example: providing employees with incentives, staff dinners, time off when asked for in advance.

C. Outline some possible ethical issues that could arise from Hugh's financial dealings with staff.

Ethical concerns include staff using the benefits in the wrong way, or not all staff being able to access the same CSR initiatives equally.

38. What is a code of ethics?

A code of ethics is a document outlining the company's core mission and values, and explaining how the organisation and its employees are expected to conduct themselves and uphold company values.

39. List four items a business may include in a code of ethics.

For example:

- Not to deliberately do anything illegal.
- To only do business with other ethical businesses.
- To treat customers and suppliers in the manner that the business owners would like to be treated.
- To not exploit customers, suppliers or employees.

40. List the ethical issues encountered in financial dealings between business owners and their:

A. Clients

B. Investors.

a. Clients – may have been given incorrect quotes or there may be a fee dispute.

b. Investors – may use information illegally such as inside trading.

41. What is the risk for a business that is engaging in unethical practices?

- Risk of consumers boycotting the product in favour of a product from a business which operates in a more ethical manner.
- Decrease in productivity leading to lower profits
- Internal conflict and disagreement within the company, leading to lower performance from staff
- Employees leaving the business and staff turnover increasing

42. What is the risk for a business trying to be overly ethical?

Given that the goal of business is to make a profit most businesses want to source the least expensive goods at the lowest possible price. They also may want to source the lowest possible cost of labour as well. Essentially there is nothing wrong with this if it is still done in a legal, ethical manner. The problem with not trying to source the lowest cost is that a business can be so ethical their costs are unsustainably high, resulting in investors losing money and employees being laid off. This implies that to keep workers employed and investors making a profit, a happy medium needs to be struck.

However, at the same time management needs to be aware that any unethical malpractice could result in a loss of public trust, a loss of support and then in lower sales and profits. This would also result in workers losing jobs and investors losing money. The job of management is to strike the balance between being ethical and at the same time making a profit, keeping employees employed and investors happy because the business is performing well.

Extended answer question

1. *How do users of financial reports rely on information from auditors?*

   Discuss this question using an essay format. In your answer, ensure that you explain the difference between internal and external reporting for a business in relation to the users of reports, and outline the purpose of internal audit and its relationship to the external audit process.

Internal vs external reporting

- Internal is for management and efficiency purposes. External is for users of information who are removed from the business and not able to make decisions about the business unless they have access to this information.

Internal vs external users of reports – to be discussed in detail:

- Internal:
  - Owner
  - Managers
  - Auditors
- External:
  - Lenders
  - Consumers
  - Government
  - Employees
  - Suppliers

Users of financial information are making decisions about the management of the business (internal) or the allocation of their resources (external).

Internal audit and its purpose:

- Definition: systematically tracking and checking the effectiveness of the businesses internal risk management, financial and other controls, internal control and governance
- Examples
- Purpose: review polices, revise procedures, correct errors, fix deficiency
- Closely related to internal control: check reliability of reports, ensure assets safe, compliance with regulations, improvements in efficiency.

Relationship to external auditing:

- An external audit is independent of any internal audit processes
- It requires the examination of the external financial statements which are produced for the external users
- Discuss the difference between an external and internal auditor and their focus
- An external auditor checks the financial information of the business meets the requirements of Accounting Standards, is a faithful representation of the financial position and performance, accurate and free from bias.

Marking Guide for Chapter Questions

Selected marking guide for Unit 4 ATAR. NOTE : The following are suggested methods only. There is no intention to outline any 'one' method of responding to questions.

UNIT FOUR ATAR

CHAPTER 6: THE CORPORATE ENVIRONMENT

Questions

1. *The majority shareholder of a large Australian public company has recently passed away. What affect will this have on the company, if any, and which characteristic of a company comes into play in this situation?*

Students should discuss the implications for continuity of existence of the company. Its ability to carry on business is unaffected by a change in shareholding. Compare this with other types of business such as a partnership where the business would have to be re-formed.

2. *One of your acquaintances owns shares in an Australian proprietary limited company. They have recently told you that they need some cash and plan to sell their shares on the share market. What incorrect assumptions have they made in this situation? Clearly explain the issues of transferability of ownership for public and proprietary companies.*

Most proprietary limited companies have restrictions on the sale of shares. Generally shares are held in a family or employee group and the company Constitution either does not allow sale, allows it with the approval of others or allows it to particular people eg. Other family members.

3. *Create a table summarising the six main characteristics of companies, and showing the differences between public and large proprietary companies.*

Characteristics of public and large proprietary companies

CHARACTERISTIC	PUBLIC COMPANY	LARGE PROPRIETARY COMPANY
Liability of owners	Limited by shares, limited by guarantee, unlimited or no liability	Must be limited by shares or an unlimited company with a share capital
Number of members or directors	At least three directors, no limit on number of shareholders	At least one director and no more than 50 non-employee shareholders
Continuity of existence	Yes	Yes
Legal entity	Separate legal entity	Separate legal entity
Transferability of shares	Minimal restriction	Always some type of restriction
Separation of ownership and control	Yes	Usually

4. *One of the directors of Sunnie Ltd has recently stated: 'As one of the shareholders of the business, I also have a stake in the results of this company. It is important for the owners of a company to be very involved in the day to day running of the business.' What is incorrect about this statement?*

The owners of the company are not always the managers. While some companies have members who are also directors' or employees not all of them do. It is often the case that ownership is separate from management.

5. *Explain the concept of 'transferability of ownership' in relation to public companies.*

Ownership in an Australian public company can easily be transferred, through the sale of shares on the Australian Securities Exchange.

6. *The members of a small partnership business are considering changing their business structure and forming a company. Create a table summarising at least SEVEN differences between public and large proprietary companies to assist them in making their decision. Under what circumstances would the formation of a proprietary company be recommended?*

Differences and similarities between public companies and large proprietary companies

COMPARE:	PUBLIC COMPANY	LARGE PROPRIETARY COMPANY
Abbreviations in name	Co	Pty Co
Directors	At least 3	At least one
Secretary	At least one	Not required
Display of name	Every place open to public and Registered Office	Every place open to public
Financial reporting	Formal reports required	Formal reports required
Audit requirements	Yes	Yes
Annual General Meeting (AGM)	Required	Not required
ASIC	Must lodge	Must lodge

Students should discuss that the formation of a proprietary company would be recommended if the owners would like more control over the transfer of shares and more involvement in running the company (relate discussion to the characteristics of the two types of companies).

7. *Clearly explain the three main purposes of accounting standards.*

Accounting standards have three main purposes:

i. To provide information that:

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

ii. To facilitate the operation of the Australian economy by:

- reducing the cost of capital
- enabling Australian entities to compete effectively overseas
- having Accounting Standards that are clearly stated and easy to understand.

iii. To maintain investor confidence in the Australian economy, including its capital markets.

8. Under what circumstances is a company required to comply with accounting standards?

Companies preparing reports for external reporting purposes and/or classified as public companies or large proprietary companies. External users of financial reports include shareholders, investors, creditors, regulators and business analysts.

9. How are Australian Accounting Standards informed and influenced by International Accounting Standards?

International accounting standards must be adopted and used for the external reporting done by companies. International standards are only aimed at for-profit entities so they have been adapted to develop Australian standards to be used by not-for-profit and public entities. The set of Australian accounting standards meets the requirements of international accounting standards and differ only in that they can have more stringent requirements than the international standards.

10. Why has the Framework been developed, and what is its main purpose?

The Framework sets out concepts that underlie the preparation and presentation of financial reports for external users. Its purpose is to:

- assist the AASB in the development of future Australian Accounting Standards and in the review of existing Australian Accounting Standards
- assist the AASB in promoting harmonisation of regulations, accounting standards and procedures relating to the presentation of financial information
- assist preparers of financial reports in applying Australian Accounting Standards and in dealing with new financial reporting issues not already covered by a standard
- assist auditors in deciding if financial reports conform with Australian Accounting Standards
- assist users of financial reports in interpreting the information contained in financial reports prepared in conformity with Australian Accounting Standards
- provide individuals who are interested with information about the AASB's approach to the formulation of Australian Accounting Standards.

11. Define 'reporting entity', and give examples of such an entity.

An entity is a reporting entity if it is reasonable to expect the existence of users of financial reports who are dependent upon the entity's reports for information which will be useful for making and evaluating decisions about the allocation of scarce resources. Entities that have a high level of separation between owners and managers are more likely to be reporting entities because the external users of the information have less ability to obtain information about the financial position and performance of the entity. If the entity has a lot of influence in the community, then there is more likely to be users of information who are reliant on the financial statements. Large entities with complex financial systems can have a greater likelihood of requiring useful external reporting mechanisms. For example: large public companies.

12. *Name FIVE users of financial reports, and explain for each one the main information needs they have in relation to company reporting.*

Users of financial information

USER	INFORMATION NEEDS
employees	Confidence in financial stability of employer
lenders	Loan and interest repayment
suppliers and trade creditors	Short-term debt repayment
governments and their agencies	Regulation and taxation
public and customers	Future prospects, community and environmental impact, profitability and stability

13. *What is the main objective of general purpose financial reports, and how is this related to the user of the information?*

GPFSs (or GPFRs) are prepared with the aim of assisting the user of the financial reports to make decisions about the allocation of their scarce resources, or in other words their investment in the company.

14. *Define the enhancing qualitative characteristic "understandability", and give one example that applies this characteristic to a business transaction.*

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

For example: a company can include information about depreciation in the reports without defining it or explaining the calculations used to determine the amount. It is reasonable to assume that the user of the report knows what depreciation is.

15. *Define the fundamental qualitative characteristics of 'relevance' and 'faithful representation', and explain how budgets can be a relevant method of preparing financial information.*

Relevance: Information is relevant when it influences the economic decisions of users by helping them evaluate events or to confirm or correct their evaluations of the situation. Users should be able to both predict and confirm. The relevance of information is also affected by its nature and materiality.

A budget is relevant because it is used to predict and plan the future direction of the company.

16. *Define 'the enhancing qualitative characteristics of 'verifiability' and 'timeliness', and explain the difference between direct and indirect verification of information.*

Verifiability: different users of the financial information can agree (or reach consensus) that a particular representation of information is faithful. Direct verification occurs when the user of information can directly observe the information, for example by counting cash to verify the Cash in Hand amount. Indirect verification occurs when input and outputs can be used to check a methodology.

Timeliness: Information should be made available to users in time to be able to influence their decision making process. Information that is old and out of date is generally not useful for decision making.

17. Use an example to explain how a user of accounting information might rely on the enhancing qualitative concept of 'comparability' when reading accounting reports.

Comparability: Users must be able to compare the financial reports of an entity through time in order to be able to identify trends. They also need to be able to compare different entities in order to be able to evaluate their relative financial position, financial performance, and cash flow.

For example: if the company decides to change the method of valuing inventory the changes and its impact on the interpretation of the reports must be included in the notes to the accounts.

18. Are each of the following considered liabilities, and can they be recognised in a company's financial statements?:

A. Provision for warranties expense

B. Provision for long service leave

C. Provision for environmental damages

Liability recognition

Students should discuss the definition of a liability.

Liabilities to be recognised in a company's financial statements:

A. **Provision for warranties expense:** yes, it is likely that future costs will rise from customers returning the goods to make a warranty claim. The likelihood of this occurring is based on past experience where customers have returned goods within the warranty period.

B. **Provision for long service leave:** yes, future costs will arise from employees who have remained in the company for the length of time required to qualify for long service leave. Past experience is likely to show that a percentage of employees remain for long enough to claim, or to be paid out this entitlement, so this can be used as basis for the provision calculation.

C. **Provision for environmental damages:** assuming that the company carries on a business that could potentially harm the environment then there will be future costs incurred in this period to be expensed or a later accounting period to be planned for as a liability.

19. Are each of the following assets? Justify your answer using the definition of an asset.

A. Pine plantation trees

B. Exploration costs for a new gold mine

C. A patent that is at a 50% stage of development

Asset definition

Students should discuss the definition of an asset.

A. **Pine plantation**

- Control by the entity – the plantation would be fenced in and managed.
- Existence of a past transaction or event – purchase of the immature trees.
- The inflow of future economic benefits – cash can be earned from the sale of the trees upon maturity.

B. **Exploration costs for gold mine**

- Control by the entity – if the land being explored is owned by the company, or some form of written agreement to enable it to excavate any site exits, otherwise no control exists.
- Existence of a past transaction or event – if there is an agreement with the company about the use of the land, or ownership from purchase of the land.
- The inflow of future economic benefits –difficult to prove. There will be an inflow if gold is found – however if the probability is low this cannot be shown to be an asset.

C. **Patent at 50% stage of developmen**t

- Control by the entity – the patent would be owned by the company.
- Existence of a past transaction or event – there will be a record of ownership of the patent intellectual property
- The inflow of future economic benefits – at only 50% completion the company will have to establish the potential for cash to be earned from the items produced by the patent.

20. Clearly explain if each of the following is an asset or an expense, justify your answer using examples.

A. Laboratory research

B. Electricity

C. Upgrade of delivery van engine

Asset or expense:

Students need to show an understanding of the two definitions and be able to explain differences between the two.

A. **Laboratory research:** the question is whether future economic benefits are to arise from the research. This is dependent upon how clearly there is a link between future earnings and the research. If it cannot be shown that a particular item will result that can earn benefits then it is likely that the research should be expensed in the period that it is incurred.

B. **Electricity:** this meets all criteria for an expense. There is a decrease in economic benefits in the form of a cash payment for the use of the electricity, which will decrease equity through a lessening of profits and this is not a distribution of equity. The company does not control the electricity resource or sell it for the gain of future economic benefits.

C. **Upgrade of delivery van engine:** this is dependent upon the nature and extent of the upgrade. A permanent upgrade of a significant part of the van such as the engine or body would be a permanent addition to the van expected to earn future economic benefits in the form of income for the company over a period of time. This would therefore be an asset.

21. *For each of the following elements of financial statements, give a definition, and then decide, based on the probability and recognition criteria, if it should be included in the Statement of Financial Position and/or the Statement of Profit or Loss and Other Comprehensive Income of a company.*

Elements of financial statements

ELEMENT	DEFINITION A, L, I, Ex?	PROBABLE?	RELIABLE?
Telephone and internet	Expense	Yes – telephone and internet system has been used.	Yes – a detailed bill will have been received.
Vehicle	Asset	If the business has possession and use of the vehicle.	Yes – a purchase price would have been paid, or market valuation can be used.
Royalties	Income	Yes – money would have been received.	Yes – a measurable dollar amount.
Research and development costs	Asset or expense	An asset only if it is considered probable that the economic benefits will result with a large degree of certainty – unlikely.	May not be able to apply to specific assets.
Office supplies	Asset	Yes - Benefits have resulted from the office.	Yes – a purchase price.
Warranties	Liability	Only if it is probable that an outflow of resources will be required.	Based on past results, an amount may be possible to measure.
Doubtful debts	Expense	Yes – based on past history of the business.	Yes – should be possible to estimate from businesses past results.
Donations	Income	Yes – a form of asset has been received.	Yes – will have a written record.
Depreciation	Expense	Yes – a decrease in future economic benefits that is related to an asset.	Yes – the allocation of the asset cost.
Cost of sales	Expense	Yes – benefits from the sale of the stock.	Yes – sale amounts.
Inventory	Asset	Yes – cash or debtors.	Yes – sales.
Livestock	Asset	If the livestock is able to be sold.	Dependent on market.
Computer upgrade	Asset	Economic benefits will flow as long as the business has use of this asset.	Yes – purchase price.

22. *The directors of a mining company have decided that the 20km-long access road is an asset to the business. The road connects the main site with the highway leading to the local town.*

Asset recognition:

A. *Do you agree that the road is an asset? Why or why not?*

- Resource controlled by the entity: If this is owned only by company, it is controlled by the business.
- As a result of past events: The agreement with the builders of the road is a past event.
- From which future economic benefits are expected to flow to the entity: the business would receive economic benefits in the form of mining sales to customers.

B. *Should the road be recognised in the Statement of Financial Position? Under what specific circumstances?*

It is probable that the economic benefits associated with an exclusive access road will flow to the business, and it is likely that the amount can be measured with reliability. It is possible to gauge the exact amount of cost of the access road if the company has to pay for it themselves. It would be more difficult if the local council was paying for part of the road.

23. *Define 'income'. Clearly distinguish between 'revenue' and 'gains', giving examples.*

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

The definition of income encompasses both revenue and gains. Revenue arises in the course of the ordinary activities of an entity and is referred to by a variety of different names including sales, fees, interest, dividends, royalties and rent. Gains represent other items that meet the definition of income and may, or may not, arise in the course of the ordinary activities of an entity. Gains represent increases in economic benefits and as such are no different in nature from revenue. Hence, they are not regarded as constituting a separate element.

24. *What are the income recognition criteria, and how are they applied?*

Income is recognised in the Statement of Profit or Loss and Other Comprehensive Income when an increase in future economic benefits has arisen and the increase can be measured reliably. Revenue arises in the ordinary course of business and can include sales, fees, interest, dividends, and rent. Gains may not arise in the ordinary course of business, and may include gains from the disposal of non-current assets. For most businesses the majority of income will result from the provision of goods or services and there will be certainty, as the firm will have received the cash.

Income (or revenue) arising from the *sale of goods* must be recognised when the entity has transferred to the buyer the significant risks and rewards of ownership, the entity does not retain ownership or effective control over the goods, the amount of revenue can be measured reliably, it is probable that future economic benefits will flow to the entity and costs incurred in respect to the sale can be measured reliably.

25. Define each of the following types of shares:

A. Ordinary shares

Ordinary shares: shares which are fully paid and rank after preference shares for dividend payments. They entitle the share owner to a share of company profits and or voting power.

B. Preferences shares

Preference shares: give shareholders some right or preference such as priority payment of dividends over other share classes.

C. Bonus shares

Bonus shares: issued with no amount payable to the company and when the issue does not require any increase to the company's share capital.

D. Redeemable shares

Redeemable preference shares: shares that according to their terms of issue, may be redeemed at the company's option, the members' option, or at a fixed time or specified date.

26. What is the difference between the recognition of preliminary expenses and the recognition of share issue costs in the accounts of a company?

Recognition of preliminary expenses: The costs that the company must pay in order to set up the business and commence trading are known as the formation costs or *preliminary expenses*. These start up costs include fees paid to ASIC, the cost of printing the prospectus, legal consultation fees, and any other expenses associated with the commencement of the company. These are treated as expenses as it is difficult to define the future economic benefits arising from their payment.

Share issue costs: The costs the company must pay in *order to issue shares* include costs that are incurred directly in connection with the issue of the shares which would not have been incurred had the shares not been issued. This includes items such as stamp duties, taxes, professional advisors' fees, underwriting costs and brokerage fees directly related to the issue. These are not either an asset or an expense but rather are a deduction from equity.

The cost of the share issue is therefore deducted from the share capital amount and it is the gross proceeds from the issue of the shares that is recognised in the accounts.

27. Are redeemable preference shares equity or a liability? Under what terms or conditions of issue could it be argued that they are a liability to the company?

Students should discuss the definitions of redeemable preference shares, equity and liabilities.

Non-redeemable preference shares are classified as equity and redeemable preference shares as liabilities.

28. Define and explain the differences between each of the following types of dividends:

A. Ordinary

Ordinary: paid on ordinary share. Preference shareholders are usually entitled to the payment of a dividend before ordinary shareholder.

B. Preference

Preference: these can be cumulative, non-cumulative or participating dividends. Payment of a dividend is not guaranteed as the company may not have made enough money for a dividend to be distributed.

C. Cumulative

Cumulative: if a dividend is not able to be paid in one year, it accumulates until a year in which the company can pay it. These are called dividends in arrears.

D. Non-cumulative

Non-cumulative: if dividends on these shares are not paid in one year, then they do not carry over into subsequent years.

E. Participating

Participating: These are shares that can participate in the receipt of extra dividends once their initial dividend plus all ordinary dividends have been paid.

29. A shareholder has complained to the directors of a public company because a dividend was not declared at the last AGM. The shareholder has said: 'Divdends must always be declared by the directors at every annual meeting.' Is this correct? Explain.

This is dependent upon the provisions of the company Constitution and on the operating results for the year. Dividends can only be paid if they are provided for and in some cases the company may not be able to afford these. There is no requirement for a company to always pay a dividend.

30. Complete the General Journal and General Ledger entries required to recognise the following issues of shares:

A. Newtimes Ltd invited potential members to invest in 1 000 000 $6 ordinary shares through its prospectus issued on 1 January 2020. Subscriptions closed, fully paid, on 1 February. Fees for the share issue came to a total of $80 000. All the shares were allotted by the directors on 13 February. At the end of 2020, the directors allowed a 1 for 100 bonus share issue to be paid from the general reserve on 31 December. A final ordinary dividend of 3c per share was declared on 30 December, and this dividend was paid to members on the 7 January 2021 after ratification at the AGM Annual General Meeting.

Calculations

Bonus shares $= \frac{1}{100} \times 1\,000\,000 \times \$6$

$= \$60\,000$

Dividends $= \$0.03 \times 1\,010\,000$

$= \$30\,300$

General Journal (extract)

DATE	DETAILS	DEBIT $	CREDIT $
2020			
1 Feb	Share Trust Fund	6 000 000	
	Application		6 000 000
	Receipt of application money for 1 000 000 $6 shares.		
13 Feb	Cash at Bank	6 000 000	
	Share Trust Fund		6 000 000
	Transfer of application money for 1 000 000 $6 shares into cash at bank.		
13 Feb	Application	6 000 000	
	Share Capital		6 000 000
	Transfer from application into share capital.		
13 Feb	Share Capital	80 000	
	Cash at Bank		80 000
	Writing off share issue costs to equity.		
30 Dec	General Reserve	30 300	
	Dividend Payable - Final		30 300
	Declaration of 3c dividend on 1010000 shares		
31 Dec	General Reserve	60 000	
	Share Capital		60 000
	Bonus share issue from general reserve.		
2021			
7 Jan	Dividend Payable - Final	30 300	
	Cash at Bank		30 300
	Payment of 3c dividend on 1010000 shares.		

General Ledger (extract)

Dr — Share Trust Fund — Cr

1 Feb	Application	6 000 000	13 Feb	Cash at Bank	6 000 000

Dr — Application — Cr

13 Feb	Share Capital	6 000 000	1 Feb	Share Trust Fund	6 000 000

Dr — Share Capital — Cr

13 Feb	Cash at Bank	80 000	13 Feb	Application	6 000 000
			31 Dec	General Reserve	60 000

Dr — Cash at Bank — Cr

13 Feb	Share Trust Fund	6 000 000	13 Feb	Share Capital	80 000
			2021		
			7 Jan	Dividend Payable - Final	30 300

Dr — General Reserve — Cr

30 Dec	Dividend Payable - Final	30 300			
31 Dec	Share Capital	60 000			

Dr — Dividend Payable – Final — Cr

2021			30 Dec	General Reserve	30 300
7 Jan	Cash at Bank	30 3000			

B. *Blacklands Ltd invited potential members to invest in 2 000 000 $3 ordinary shares on 6 August 2025. Subscriptions closed, fully paid, on 30 August with a total of $60 000 being paid for share issue costs. Directors allotted all shares on 20 September. An interim dividend of 2% was declared and paid on 24 November, and on 2 December the directors allowed a 2 for 100 bonus share issue to be paid from the general reserve.*

Calculations

Bonus shares $= \frac{2}{100} \times 2\ 000\ 000 \times \$3$

$= \$120\ 000$

Dividend $= 0.02 \times 2\ 000\ 000 \times \$3$

$= \$120\ 000$

General Journal (extract)

DATE	DETAILS	DEBIT $	CREDIT $
2025			
30 Aug	Share Trust Fund	6 000 000	
	Application		6 000 000
	Receipt of application money for 2 000 000 $3 shares.		
20 Sept	Cash at Bank	6 000 000	
	Share Trust Fund		6 000 000
	Transfer of application money for 2 000 000 $3 shares into cash at bank.		
20 Sept	Application	6 000 000	
	Share Capital		6 000 000
	Transfer from application into share capital.		
20 Sept	Share Capital	60 000	
	Cash at Bank		60 000
	Writing off share issue costs to equity.		
24 Nov	Retained Earnings	120 000	
	Dividend Payable - Interim		120 000
	Declaration of 2% dividend on 2 000 000 shares		
24 Nov	Dividend Payable - Interim	120 000	
	Cash at Bank		120 000
	Payment of 2% dividend on 2 000 000 shares.		
2 Dec	General Reserve	120 000	
	Share Capital		120 000
	Bonus share issue from general reserve.		

General Ledger (extract)

Share Trust Fund

Dr					Cr
30 Aug	Application	6 000 000	20 Sept	Cash at Bank	6 000 000

Application

Dr					Cr
20 Sept	Share Capital	6 000 000	30 Aug	Share Trust Fund	6 000 000

Share Capital

Dr					Cr
20 Sept	Cash at Bank	60 000	20 Sept	Application	6 000 000
			2 Dec	General Reserve	120 000

Cash at Bank

Dr					Cr
20 Sept	Share Trust Fund	6 000 000	20 Sept	Share Capital	60 000
			24 Nov	Dividend Payable - Interim	120 000

General Reserve

Dr					Cr
2 Dec	Share Capital	120 000			

Dividend Payable - Interim

Dr					Cr
24 Nov	Cash at Bank	120 000	24 Nov	Retained Earnings	120 000

Retained Earnings

Dr					Cr
24 Nov	Dividend Payable - Interim	120 000			

31. *ASIC registered the company Baileys Ltd in April 2020. The following events occurred over the next few years:*

May 2020

A prospectus was issued on 10 May offering 500,000 fully paid $2.40 ordinary shares to the public. The share issue closed fully subscribed on 30 May.

July 2020

On 5 July, all the shares were allotted. The company incurred expenses of $50 000 which included the fee to ASIC, legal expenses and the cost of printing the prospectus. Additional costs relating to stamp duties, professional advisors' fees and underwriting costs came to a total of $60 000.

September 2020

The shares were listed on the Australian Securities Exchange on 15 September. One month later they were trading at $3.00 per share.

2021

The directors declared and paid a 5% interim dividend to the ordinary shareholders on 10 February. At the AGM a resolution was passed to give a bonus share allocation in the ratio of 1: 100 from the general reserve.

Required:
Complete the General Journal and General Ledger entries for the above transactions.

Calculations

Dividend = 0.05 x 500 000 x $3
= $75 000

Bonus shares = $\frac{1}{100}$ x 500 000 x $3
= $15 000

General Journal (extract)

DATE	DETAILS	DEBIT $	CREDIT $
2010			
30 May	Share Trust Fund	1 200 000	
	Application		1 200 000
	Receipt of application money for 500 000 $2.40 shares.		
5 July	Cash at Bank	1 200 000	
	Share Trust Fund		1 200 000
	Transfer of application money for 500 000 $2.40 shares into cash at bank.		
5 July	Application	1 200 000	
	Share Capital		1 200 000
	Transfer from application into share capital.		
5 July	Share Capital	60 000	
	Cash at Bank		60 000
	Writing off share issue costs to equity.		
2011			
10 Feb	Dividend Payable - Interim	75 000	
	Cash at Bank		75 000
	Payment of 5% dividend on 500 000 shares.		
10 Feb	Retained Earnings	75 000	
	Dividend Payable - Interim		75 000
	Declaration of 5% dividend on 500 000 shares		
30 Jun	General Reserve	15 000	
	Share Capital		15 000
	Bonus share issue from general reserve.		

General Journal (extract)

Dr — Share Trust Fund — Cr

30 May	Application	1 200 000	5 July	Cash at Bank	1 200 000

Dr — Application — Cr

5 July	Share Capital	1 200 000	30 May	Share Trust Fund	1 200 000

Share Capital

Dr					Cr
5 July	Cash at Bank	60 000	5 July	Application	1 200 000
			30 June	General Reserve	15 000

Cash at Bank

Dr					Cr
5 July	Share Trust Fund	1 200 000	5 July	Share Capital	60 000
			10 Nov	Dividend Payable - Final	75 000

General Reserve

Dr					Cr
30 June	Share Capital	15 000			

Dividend Payable – Interim

Dr					Cr
10 Feb	Cash at Bank	75 000	10 Feb	Retained Earnings	75 000

Retained Earnings

Dr					Cr
10 Feb	Dividend Payable - Interim	75 000	10 Feb	Retained Earnings	75 000

Extended answer questions

1. *Arthur and Yui are starting an internet consultancy business and plan to form either a public company or proprietary limited company. Produce a report that explains each type of company, distinguishing between public and large proprietary companies, and describe the procedures that must be followed to establish the new company. Also explain the accounting standards to be followed in relation to each type of company.*

In the conclusion to your report, clearly state the type of company you recommend to be formed giving reasons for your choice.

Students should discuss:

- The differences between public and proprietary companies.
- Differences between small and large proprietary companies
- The characteristics of ONE of these that would best suit this scenario (eg. a small proprietary company because the two owners will retain more control...). A clear argument is required.
- Procedures to establish the chosen company.
- Requirements in relation to ASIC, ASX, accounting standards, etc. (as relevant, with an explanation of why they are relevant).

2. *What is the purpose of accounting standards in the corporate world?*

In your answer, discuss issues such as the reasons why companies must follow accounting standards, the impact of general purpose financial statement requirements, and the relationship between Australian and international standards.

Define accounting standards: technical documents that outline the company should complete specific elements of financial records in relation to the transactions that take place in the business.

Companies must follow standards to ensure they:

i. Provide information that:

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

ii. Facilitate the operation of the Australian economy by:

- reducing the cost of capital
- enabling Australian entities to compete effectively overseas
- having Accounting Standards that are clearly stated and easy to understand.

iii. Maintain investor confidence in the Australian economy, including its capital markets.

General purpose financial statements:

- Required for public companies
- Follow Accounting Standards
- Guidelines for correct presentation of company financial performance, financial position and cash flow situation
- Require explanatory notes to the statements
- To assist the user of the financial reports to make decisions about the allocation of their scarce resources
- Enable 'arms length' investors to decide what is best for their investment in the company.

Users of company financial reports can include shareholders (owners), investors, creditors, employees, regulators and business analysts.

Users of the company financial reports should be able to compare the company's results over time and with other like companies if the company has correctly followed the requirements of Accounting Standards.

International accounting standards:

- to be adopted and used by companies
- adapted to Australian standards to be used by not-for-profit and public entities
- Australian accounting standards fulfill the requirements of international accounting standards
- Australian standards differ in that they can have more stringent requirements, asking the company to provide more information than required under an international standard.

3. *'Stakeholders can advise the AASB of issues that in their view should be considered by the AASB or an international standard-setter.*

   For example, issues may be raised in the context of improving the relevance and reliability of financial information or reducing the costs of financial reporting.'[8]

What is the role of lobby groups in relation to the standard setting process in Australia? In your answer, outline the role of the Framework and standard setting processes in Australia. Include a discussion of the reporting entities that are subject to these standards, the qualitative characteristics that they must adhere to and the objectives of general purpose financial reporting.

Lobby groups can:

- Identify technical issues
- Propose research items
- Give input into consultation groups
- Comment on Exposure Drafts, Discussion Papers and other related documents
- Participate in round table discussion, focus groups, and advisory panels

Role of The Framework and standard setting processes is to enable technical accounting issues to be identified, then researched and considered, so that revised standards and interpretations can be issued. The Framework provides the concepts that underlie the preparation and presentation of financial statements for external users. It is not an Australian Accounting Standard so does not define standards for any particular measurement or disclosure - it cannot override any specific Accounting Standard. The Framework assists the AASB in the development of future Accounting Standards and in its review of existing Australian Accounting Standards, including evaluating proposed International Accounting Standards Board pronouncements.

Reporting entities are all entities (including economic entities) that have users dependent on general purpose financial reports for information which will be useful for making and evaluating decisions about the allocation of scarce resources. For example, private sector companies where there is significant separation of ownership/membership and management.

Qualitative characteristics of financial information are qualities the information should have in order for it to be useful for economic decision making by users of the information. The aim of defining the qualitative characteristics of financial information is to ensure that the information reported by the company in the financial reports is useful to the users of the information. The objective of applying qualitative characteristics is to produce financial reports that convey a true and fair view of the financial position, performance and cash flow of the company. The Framework defines the four main qualitative characteristics to be **understandability, relevance, reliability and comparability**.

Reporting entities prepare **general purpose financial reports** in accordance with Accounting Standards. A general purpose financial report is a financial report intended to meet the information needs common to users who are unable to require the preparation of reports tailored to satisfy all of their information needs.

8 www.aasb.gov.au

CHAPTER 7: POSITION AND PERFORMANCE

Questions

1. *Define 'equity' and explain the difference between share capital and reserves.*

Equity is the owner's portion of a business. Retained earnings, other reserves and share capital together make up the equity of a company.

Share capital is the total shares issued to all shareholders of the company. A company with share capital must record all the shares issued.

Reserves are amounts set aside, or reserved, for use in the company. The most important type of reserve account is the cumulative profits or losses that the company makes. These cumulative amounts are held in the business and are referred to as the retained earnings.

2. *What is the purpose of:*

A. *The Statement of Changes in Equity?*

The Statement of Changes in Equity shows income and expense amounts that accounting standards do not define as income and expense for reporting in the Statement of Profit or Loss and Other Comprehensive Income. These are instead seen as direct adjustments to the equity of the company.

B. *The Statement of Financial Position?*

The Statement of Financial Position itemises the final balance in each asset, liability and equity account for the company at a point in time.

3. *Summarise the content usually found in the three main sections of the Statement of Changes in Equity.*

Statement of Changes in Equity

- **Share capital:** The total paid up capital of the company, split into each type of share.
- **Other reserves:** All reserves other than retained earnings. These show the opening amount, any changes in the reserve, and the closing amount at the end of the period.
- **Retained earnings:** A reconciliation of the opening balance in retained earnings at the start of the period, with the addition of any profit and any transfers into the reserve, then the subtraction of any loss and any transfers out and any dividends.

4. *Clearly outline the main uses for each of the following reserves:*

A. *Retained profits*

The retained profits account can be used to:

- transfer amounts to reserve accounts, such as the General Reserve
- pay out cash dividends or share dividends
- offset losses in future years

B. General reserve

The general reserve can be used to:

- pay a cash dividend
- pay a bonus share dividend
- transfer back to retained profits

C. Asset revaluation reserve.

The asset revaluation reserve can be used to:

- Transfer back to retained profits
- Pay a cash dividend
- Pay a share dividend or bonus share issue
- Record a subsequent write-down of the same class of assets which had been revalued upwards previously.

5. Compare and contrast the current/non-current presentation and the liquidity presentation for a Statement of Financial Position. Under what circumstances is the liquidity presentation used?

Students should discuss the differences in layout between the two and give an example of a company that is in liquidation, using the liquidity presentation.

The liquidity presentation is used when the Statement of Financial Position is prepared based on the order of liquidity of each account if the company is being sold, or selling several assets. Accounting standards require the entity to present the Statement of Financial Position using the current/non-current presentation except in circumstances where a liquidity presentation would make the financial information more relevant and reliable.

6. Define each of the following and give THREE examples for each:

A. Current assets

Current assets: assets that the company expects to turn into cash (such as accounts receivable) or consume (such as cash at bank) within a 12 month period. For example; cash and cash equivalents, trade and other receivables and inventories

B. Non-current assets

Non-current assets: assets which do not fit the current asset criteria and that the company intends to have the use of for a period longer than 12 months to help generate income. For example; trade and other receivables not included as current assets, long term investments such as government bonds, stock and pension funds, and property, plant and equipment.

C. Current liabilities

Current liabilities: obligations which fall due within the next months or will be paid off during the next operating cycle of the company. For example; a bank overdraft, trade and other payables, and provisions.

D. Non-current liabilities

Non-current liabilities: obligations which do not fit the current liability criteria and which the business will be committed to for a period longer than 12 months. For example; employee benefits, long term loans and borrowings, and mortgages.

7. What is the relationship between the equity section of a company Statement of Financial Position and the Statement of Changes in Equity?

The equity section of the Statement of Financial Position is a summary of the final balances shown in the Statement of Changes in Equity. (See the comprehensive example in the text).

8. Summarise the purpose of each of the following notes to the Statement of Financial Position, giving examples of how to present each section:

A. Share capital and reserves

B. Property, plant and equipment

C. Dividends recommended by directors.

Students should summarise each note with an example.

9. What is the relationship between a company Statement of Profit or Loss and the Statement of Changes in Equity?

The final profit or loss in the Statement of Profit or Loss is shown in the retained earnings section of the Statement of Changes in Equity. (See the comprehensive example in the text).

10. What are the two main methods of classifying expenses in the Statement of Comprehensive Income?

Classification of expenses:

- **Function :** The functions of a business are the main activities required to support the manufacturing and retailing of the business. When classification by function is used the company should disclose additional information on the nature of expenses such as depreciation and employee benefits.
- **Nature:** Expenses can be grouped in relation to the type of cost.

11. Summarise the main balance day adjustments.

The main balance day adjustments that students should summarise with an example:

- Prepaid Expense
- Accrued Expense
- Unearned income
- Accrued income
- Inventory adjustment

12. *Following is a current/non-current presentation of the Statement of Financial* Position for Educators Incorporated *at the end of the last financial period.*

Educators Incorporated
BALANCE SHEET
AS AT 30 JUNE 2021

	$
CURRENT ASSETS	
Cash and cash equivalents	15 000
Inventory	148 600
Trade receivables	21 800
Current Assets	**185 400**
NON-CURRENT ASSETS	
Investments	91 600
Machinery and equipment	459 200
Intangibles	29 800
Buildings	2 400 000
Non-Current Assets	**2 980 600**
Total Assets	3 166 000
EQUITIES	
CURRENT LIABILITIES	
Tax payable	600
Trade payables	87 400
Short-term loan	46 200
Current Liabilities	**134 200**
NON-CURRENT LIABILITIES	
Long-term borrowings	690 000
Mortgage	1 600 000
Total Non-Current Liabilities	**2 290 000**
Total Liabilities	2 424 200
Net Assets	741 800
EQUITY	
Share capital	741 800
Total Equity	**741 800**

The directors have asked you to rewrite the Statement of Financial Position using the liquidity presentation format.

Educators Incorporated
STATEMENT OF FINANCIAL POSITION – IN LIQUIDITY FORMAT
AS AT 30 JUNE 2021

	$
EQUITY	
Share capital	741 800
Total Equity	**741 800**
ASSETS	
Cash and cash equivalents	15 000
Inventory	148 600
Trade receivables	21 800
Investments	91 600
Machinery and equipment	459 200
Intangibles	29 800
Buildings	2 400 000
Total Assets	**3 166 000**
LIABILITIES	
Tax payable	600
Trade payables	87 400
Short term loan	46 200
Long term borrowings	690 000
Mortgage	1 600 000
Total Liabilities	**2 424 200**
Net Assets	741 800

13. *Consider the information in the following Trial Balance.*

Cars R Us Ltd
Trial Balance (internal)
As at 30 June 2025

	DEBIT $000	CREDIT $000's
Accumulated depreciation – tools and equipment		600
Loan – due 2027		2 880
Accrued wages		600
Prepaid advertising	300	
Interest	1 600	
Retained earnings		2 040
General reserve		2 000
Investments	1 200	
Computer	2 000	
Gain on sale of computer		1 360
Sales returns and allowances	800	
Cost of sales	52 000	
Mortgage		5 000
Current tax liability		1 000
Magazine advertising	1 000	
Letter box flyers	1 200	
Cartage inward	1 600	
Share capital at 1 January 2024		11 500
Computer ink and paper	400	
Mechanics supplies	1 800	
Tools and equipment	6 000	
Cash account	16 500	
Wages – mechanics	5 000	
Cash	100	
Accrued interest		120
Dividends	500	
Loan – due 2040		2 000
Depreciation – furniture and fittings	200	
Interest income		3 200
Trade receivables	7 000	
Stock	8 000	
Rent of office	3 600	
Accumulated depreciation – furniture and fittings		200
Office stationery and supplies	600	
Petrol	400	
Prepaid rent	100	
Furniture and fittings	2 000	
Sales		80 800
Depreciation – tools and equipment	600	
Goodwill	1 600	
Trade payables		4 400
Salary – admin assistant	400	
Newspaper advertising	2 000	
Overdraft		800
TOTAL	**118 000**	**118 000**

During the month of July the following events occurred in the company:

A. *$400 more rent was paid in advance.*

B. *Accrued wages increased to $1 200.*

C. All the prepaid advertising was used up. This relates to a magazine contract.

D. One month of depreciation expense on the tools and equipment needs to be recorded, at 10% straight line.

E. Paid final ordinary dividends are included in the accounts.

Required:

Complete a fully classified Statement of Comprehensive Income and Statement of Financial Position in external reporting format for the company at 30 July 2025 after taking into account the required adjustments. Include all relevant notes.

Adjustments:

A. $400 more rent was paid in advance:
Increase Prepaid Rent by $400 to $500, decrease the Cash Account by $400 to $16 100

B. Accrued wages increased to $1 200:
Increase Accrued Wages by $600 to $1 200, increase Wages – Mechanics by $600 to $5 600.

C. All the prepaid advertising was used up:
Increase Magazine Advertising by $300 to $1 300, decrease Prepaid Advertising by $300 to 0.

D. One month of depreciation expense on the tools and equipment needs to be recorded, at 10% straight line:

Calculation:

Depreciation expense $= 6000 \times 0.10 \times \frac{1}{12}$

$= \$50$

Increase Depreciation Expense – Tools and Equipment by $50 to $650, increase Accumulated Depreciation – Tools and Equipment by $50 to $650.

E. Ordinary dividends of 500 000 are included in the Trial Balance. These are paid final dividends, so will be closed to Retained Earnings.

Cars R Us
Statement of Comprehensive Income
For the month ended 30 July 2025

	$ 000's
Revenue	80000
LESS: Cost of sales	52000
Gross profit	**28000**
Other income	4560
Selling and distribution expenses	6500
Administration expenses	13250
Finance costs	1600
Profit before income tax	**11210**
Income tax	3363
Profit (Loss) for the period	**7847**

Cars R Us
Statement of Financial Position
As at 30 July 2025

	NOTE	$ 000's
CURRENT ASSETS		
Cash and cash equivalents		16200
Trade receivables		7000
Inventories		8000
Other current assets		500
Total Current Assets		31700
NON-CURRENT ASSETS		
Investments		1200
Property, plant and equipment	(1)	9150
Intangible assets		1600
Total Non-Current Assets		11950
Total Assets		43650
EQUITIES		
CURRENT LIABILITIES		
Current tax liability		4363
Trade and other payables		5720
Short term loans		3680
Total Current Liabilities		13763
NON-CURRENT LIABILITIES		
Long term borrowings		2000
Mortgage		5000
Total Non-Current Liabilities		7000
Total Liabilities		20763
Net Assets		22887
EQUITY		
Share capital		11500
Reserves		2000
Retained earnings		9387
Total Equity	(2)	22887

Cars R Us
Notes to the financial statements

1. Property, plant and equipment

	$ 000's
Computer	
At cost	2000
Total	2000
Tools and Equipment	
Tools and equipment	6000
Accumulated depreciation – Tools and equipment	650
Total	5350
Furniture and fittings	
Furniture and fittings	2000
Accumulated depreciation – Furniture and fittings	200
Total	1800
TOTAL NON-CURRENT PROPERTY, PLANT AND EQUIPMENT	9150

2. Reconciliation of movement in capital and reserves

In thousands of Australian dollars

	Share Capital	General Reserve	Retained Earnings	Total Equity
Balance at 1 July 2025	11 500	2 000	2 040	**15 540**
Total profit recognised			7 847	**7 847**
Dividends paid			(500)	**(500)**
Balance at 30 July 2025	11 500	2 000	9 387	**22 887**

14. *Using the following information, prepare a Statement of Changes in Equity for* Shakespeare Ltd *at 30 June 2023.*

Shakespeare Ltd
Account balances as at 1 July 2022:

Income tax	$ 56 000
Profit before tax	168 000
General reserve	200 000
Revaluation reserve	330 000
Interim dividend – ordinary	26 250
Interim dividend – preference	70 000

Additional information:

- The company has 500 000 $2.00 ordinary shares and 200 000 $5.00 7% preference shares which are fully paid up.
- During the year ending 30 June 2023, a 1 for 20 bonus share issue was made from the asset revaluation reserve.

Shakespeare Ltd
Statement of Changes in Equity
For the year ended 30 June 2023

	$
Profit for the period	112000
Net income recognised directly in equity	0
Total recognised income and expense for the period	112000
Share capital:	
Ordinary	
Share capital at 1 July 2022	1000000
Issue of bonus shares	50000
Share capital at 30 June 2023	1050000
Preference	
Share capital at 1 July 2022	1000000
Share capital at 30 June 2023	1000000
Other reserves:	
Revaluation	
Revaluation reserve at 1 July 2022	330000
Issue of bonus shares	50000
Revaluation reserve at 30 June 2023	280000
General	
General reserve at 1 July 2022	200000
General reserve at 30 June 2023	200000
Retained earnings:	
Retained earnings at 1 July 2022	0
ADD: Total profit recognised for period	112000
LESS: Dividend - Ordinary	26250
Dividend - Preference	70000
Retained earnings at 30 June 2021	15750

15. *Using the following information from the accounts of* Malouf Ltd, *prepare a Statement of Changes in Equity for this company at 30 June 2026.*

Malouf Ltd
Account balances as at 1 July 2025:

Ordinary share capital	$ 3 000 000
5% Preference share capital	4 800 000
General reserve	1 000 DEBIT
Revaluation reserve	500 000
Interim dividend – ordinary	100 000
Interim dividend – preference	240 000
Profit before tax	320 000

Additional information:

- During the year ending 30 June 2026, $40 000 was transferred from the asset revaluation reserve to retained profit and $5 000 was transferred from retained profits to the general reserve.
- Price per share is $3.00 ordinary shares and $6.00 preference shares.

Workings:

Company tax rate	=	30%
Total tax	=	$96 000

Malouf Ltd
Statement of Changes in Equity
For the year ended 30 June 2026

	$
Profit for the period	224000
Net income recognised directly in equity	<u>0</u>
Total recognised income and expense for the period	<u>224000</u>
Share capital:	
Ordinary	
Share capital at 1 July 2025	<u>3000000</u>
Share capital at 30 June 2026	3000000
Preference	
Share capital at 1 July 2025	<u>4800000</u>
Share capital at 30 June 2026	4800000
Other reserves:	
General	
General reserve at 1 July 2025	(1000)
Transfer from retained earnings	<u>5000</u>
General reserve at 30 June 2026	<u>4000</u>
Revaluation	
Revaluation reserve at 1 July 2025	500000
Transfer to retained earnings	<u>-40000</u>
Revaluation reserve at 30 June 2026	<u>460000</u>
Retained earnings:	
Retained earnings at 1 July 2025	0
ADD: Total profit recognised for period	224000
Transfer from revaluation reserve	<u>40000</u>
LESS: Dividend - Ordinary	100000
Dividend - Preference	240000
Transfer to general reserve	<u>5000</u>
Retained earnings at 30 June 2026	<u>(81000)</u>

16. *Analyse the following Trial Balance information for* Sparkies Ltd f*or the financial year ended 30 June 2020 and complete the questions which follow.*

Account Name	**DEBIT $000**	**CREDIT $000**
Cost of sales	43 561	
Insurance	12 450	
Supplies	4 200	
Rent expense	24 000	
Wages	13 450	
Interest	890	
Electricity	5 790	
Bad debts	130	
Provision for doubtful debts		180
Commission paid to staff	4 398	
Sales in advance (Unearned sales)		105 094
Dividend income		4 390
Discount received		320
Accrued commission	3 400	
Gain on sale of motor vehicle		568
Cash and cash equivalents	560	
Plant and equipment	57 600	
Accumulated depreciation of plant and equipment		5 800
Vehicles	31 000	
Accumulated depreciation of vehicles		5 000
Inventory	34 980	
Accounts receivable	3 800	
Accounts payable		7 890
Long-term borrowings		35 677
Ordinary shares		70 000
Tax liability		5 290
TOTAL	**240 209**	**240 209**

Additional Information:

- *Plant and Equipment had been revalued from a value of $55 000*
- *A loss of $2 000 was made on available for sale – financial assets*

A. *Complete the following balance day adjustments:*
   - *The bad debts are to be written off and the allowance for doubtful debts set at 2% of accounts receivable*
   - *Depreciation is as follows: vehicle 20% reducing balance, plant and equipment 10% straight line.*
   - *Inventory loss of $300 000*
   - *All sales in advance have been completed and delivered*
   - *On balance day $3 000 000 of commission has been earned*
   - *There is $200 000 of supplies remaining*
   - *$500 000 staff wages owing*

B. *Calculate the profit or loss made by the company for the 2020 financial year.*

C. *Complete a Statement of Comprehensive Income.*

A. *Adjustments:*

Bad and doubtful debts:

CR Bad Debts, DR Provision for Doubtful Debts $130 000
Doubtful debs to be set at $76 000
DR Bad Debts CR Provision for Doubtful debts $26 000

Depreciation:

Vehicle	=	(31 000 – 5 000) x 0.20	=	$ 4 200 000
Plant and Equipment	=	57 600 x 0.10	=	$ 5 760 000

Inventory adjustment $300 000

Sales $105 094 000

CR Accrued commission and DR Commission paid to staff $3 000 000
DR Supplies Expense and CR Supplies Asset $4 000 000
DR Wages CR Accrued wages $500 000

Cost of Sales	=	43 561 – 320	=	43 241

Sparkies Ltd
Adjusted Trial Balance

Account Name	**DEBIT $ 000's**	**CREDIT $ 000's**
Cost of sales	43561	
Insurance	12450	
Supplies	200	
Supplies expense	4000	
Rent expense	24000	
Wages administration staff	13950	
Accrued wages		500
Interest	890	
Electricity	5790	
Bad debts	26	
Provision for doubtful debts		76
Commission paid to staff	7398	
Sales revenue		105094
Dividend income		4390
Discount received		320
Accrued commission	400	
Gain on sale of motor vehicle		568
Cash and cash equivalents	560	
Plant and equipment	57600	
Accumulated depreciation of plant and equipment		11560
Depreciation plant and equipment	5760	
Vehicles	31000	
Accumulated depreciation of vehicles		9200
Depreciation vehicles	4200	
Inventory	34680	
Inventory adjustment expense	300	
Accounts receivable	3800	
Accounts payable		7890
Long term borrowings		35677
Ordinary shares		70000
Tax liability		5290
TOTAL	**250565**	**250565**

B. Profit or loss = $(11 953) LOSS

C.

Sparkies Ltd
Statement of Comprehensive Income

	$ 000's
Revenue	105 094
LESS: Cost of sales	43 241
Gross profit	**61 853**
Other income	5 278
Selling and distribution expenses	11 698
Administration expenses	66 176
Finance costs	890
Profit before income tax	**(11 953)**
Income tax at 30%	0
Profit (Loss) for the period	**(11 953)**
Other Comprehensive Income	
Revaluation of land	0
Gains (losses) on available for sale - financial assets	(2)
Exchange differences on translating foreign currencies	0
Total Other Comprehensive Income	**(2)**
Total Comprehensive Income for the period	**(11 955)**

17. *An extract of the Trial Balance of* Green Machine Ltd *as at 30 June 2025 follows:*

Green Machine Ltd
Trial Balance (extract)

	DEBIT $	CREDIT $
Long term borrowings		1 200 000
Investments	678 000	
Plant and equipment	900 000	
Land	2 000 000	
Profit after tax		600 000
Revaluation reserve		800 000
General reserve		970 000
Share capital	9 000 000	
Retained earnings	150 000	
Debentures		660 000

Notes:

Share capital

Number of shares issued at end of	2025
Ordinary $3.70 shares	1 000 000
Preference $8.00 shares	662 500

On 30 June 2025 the directors proposed a final ordinary dividend of $200 000 which was subsequently approved at the annual general meeting and then paid on 1 November 2025.

A bonus share issue was made to ordinary shareholders on 2 January 2026 from the general reserve. The market price of the shares on the date of issue was $4.00 and it was a 1 for 20 issue.

On 1 December 2025, an interim ordinary dividend of $0.05 per share was declared and paid.

During the year ended 30 June 2026, the directors transferred $500 000 to the Retained Earnings account from the general reserve, and a final ordinary dividend of $0.10 per share was recommended. Plant and equipment was revalued upward by $80 000.

A. *What is the closing balance in the general reserve?*
B. *What is the closing balance in the revaluation reserve?*
C. *What is the total share capital on 30 June 2026?*
D. *How much will the directors pay for the interim dividend?*
E. *Reconstruct the Retained Earnings ledger account.*
F. *Complete the Equity section of the Statement of Financial Position.*

A. General Reserve:

Balance 1 July 2025	970 000
Issue of bonus shares	(200 000)
Transfer of retained earnings	(500 000)
Balance 30 June 2026	$270 000

B. Revaluation Reserve:

Balance 1 July 2025	800 000
Revaluation plant and equipment	80 000
Balance 30 June 2026	$880 000

C.

Ordinary $3.10 shares	3 700 000
Ordinary $4.00 shares	200 000
Preference shares	5 300 000
TOTAL SHARE CAPITAL	$9 200 000

D.

Interim dividend = 1 050 000 x 0.05
= $52 500

E.

Retained Earnings

Opening balance	150 000		
Final dividend	200 000	General Reserve	500 000
Interim dividend	52 500		
Balance c/d	97 500		
	500 000		500 000
		Balance b/d	97 500

NOTE: Final dividend of $0.10 per share declared during the year will appear in the notes to the accounts and be paid in the NEXT accounting period.

18. An extract of the Trial Balance of *Red Setting Ltd* as at 30 June 2021 follows:

Red Setting Ltd
Trial Balance (extract)

	DEBIT $	CREDIT $
Plant and equipment	2 000 000	
Accumulated depreciation – plant and equipment		330 000
Land	3 050 000	
Machinery	660 000	
Accumulated depreciation – machinery		23 000
Profit after tax		340 000
General reserve		300 000
Share capital	4 000 000	
Retained earnings		450 000
Mortgage		1 800 000
Goodwill	547 000	

Notes:

Share capital

Number of shares issued at end of	2021
Ordinary	5 000 000

On 30 June 2021 the directors proposed a final ordinary dividend of 7 cents per share which was approved at the AM on 14 July 2021 and paid on 23 July 2021.

On 13 December 2021, an interim ordinary dividend of 3 cents per share was declared and paid.

During the year ended 30 June 2022, the directors transferred $32 600 from the retained earnings account to the general reserve, and a final ordinary dividend of 3% was recommended. The land is being held in the accounts at its fair value.

A. What is the closing balance in the general reserve?
B. What is the dollar value of each ordinary share?
C. What is the total closing share capital?
D. How much will the directors pay for the final dividend on 23 July 2021 and the interim dividend on 13 December 2021?
E. What is the final dividend (per share) on 30 June 2022?
F. Reconstruct the Retained Earnings ledger account.
G. Complete the Equity section of the Statement of Financial Position.
H. Complete the Property, Plant and Equipment note.

A. General Reserve:

Balance 30 June 2021	300 000
Transfer of retained earnings	32 600
Balance 30 June 2022	$332 600

B.

Ordinary share value $= \dfrac{4\,000\,000}{5\,000\,000}$

= 80c per share

C. Ordinary $0.80 shares $4 000 000

D.

Final dividend = 5 000 000 x 0.07

= $350 000

Interim dividend = 5 000 000 x 0.03

= $150 000

E. 3% or 12c per share

F.

Retained Earnings

23/07/21	Final dividend	350 000	30/06/21	Balance b/d	450 000
13/12/21	Interim dividend	150 000			
30/06/22	Transfer to general reserve	32 600	30/06/22	Balance c/d	
		500 000			500 000

19. *An extract of the Trial Balance of* Purple Cloud Ltd *as at 30 June 2019 follows:*

Purple Cloud Ltd
Trial Balance (extract)

	DEBIT $	CREDIT $
Property	3 000 000	
Land	5 000 000	
General reserve		1 800 000
Equipment	2 000 000	
Loss	500 000	
Long-term borrowings		2 300 000
Share capital	12 000 000	
Retained earnings	200 000	
Debentures		400 000
Investments	600 000	
Mortgage		1 000 000

Notes:

Share capital

Number of shares issued at end of 2019		Cents per share
Ordinary	4 000 000	150
Preference	1 000 000	600

On 30 June 2019 the directors proposed a final ordinary dividend of 3% which was approved at the AGM and paid on 9 August 2019.

On 25 December 2019, an interim ordinary dividend of $0.06 per share was declared and paid.

A bonus share issue was made to ordinary shareholders on 3 March 2020. The market price of the shares on the date of issue was $2.00 and it was a 1 for 10 issue.

During the year ended 30 June 2020, the directors transferred $440 000 from the general reserve to the Retained Earnings account. A final ordinary dividend of $0.09 per share and a final preference share dividend of 8% was recommended.

A. What is the closing balance in the general reserve?

B. What is the closing balance in retained earnings?

C. What is the total closing share capital?

D. Reconstruct the Retained Earnings ledger account.

E. Complete the Dividends note to the financial statements.

F. Complete the Equity section of the financial statements.

General reserve on 30 June 2020 = $1 360 000
Ordinary dividend 30 June 2019 = $180 000
Ordinary dividend 25 December 2019 = $240 000
Value of bonus share issue n 3 March 2020 = 400 000 shares for $800 000
Must state an assumption about which account is used for the issue.

20. Consider the following information for the company *Cool Air Ltd* which upgrades and delivers airconditioners, and answer the questions which follow.

Cool Air Ltd
Trial Balance as at 30 June 2025

	$	$
Overdraft		50 000
Trade payables		330 000
Trade receivables	390 000	
Allowance for doubtful debts		5 000
Prepaid insurance	32 000	
Accrued wages		65 000
Dividends – final	80 000	
Interim dividend ordinary	55 000	
Interim dividend preference	250 000	
Property	2 000 000	
Plant	4 000 000	
Accumulated depreciation plant		1200 000
Machinery	3 400 000	
Accumulated depreciation machinery		400 000
Vehicles	500 000	
Accumulated depreciation vehicles		330 000
Intangibles	1 980 000	
Short-term borrowings		121 000
Current tax liability		23 000
Asset revaluation reserve		287 000
General reserve		1 230 000
Ordinary share capital		3 000 000
5% Preference share capital		5 000 000
Retained earnings	135 000	
After-tax profit		781 000
TOTAL	12 822 000	12 822 000

Cool Air Ltd
Statement of Changes in Equity
Movements in Equity 2024

	$
Share capital:	
Ordinary $3 shares	
Share capital at 1 July 2023	2 500 000
Issue of share capital	500 000
Share capital at 30 June 2024	3 000 000
Preference $50 shares	
Share capital at 1 July 2023	5 000 000
Share capital at 30 June 2024	5 000 000
Other reserves:	
General	
General reserve at 1 July 2023	1 000 000
Transfer from retained earnings	230 000
General reserve at 30 June 2024	1 230 000

Retained earnings:

Retained earnings at 1 July 2023	75 000
ADD: Total profit recognised for period	300 000
LESS: Dividend – ordinary	30 000
Dividend – preference	250 000
Transfer to general reserve	230 000
Retained earnings at 30 June 2024	(135 000)

During the 2025 financial year the following occurred:

- *authorisation of the $80 000 final dividend declared in the 2025 accounts*
- *payment of interim dividend ordinary*
- *payment of interim dividend preference.*

On 30 June 2025 the directors:

- *revalued property, and a reserve was created to record a revaluation increment of $500000*
- *proposed a 3% final ordinary dividend*
- *proposed payment of the final preference dividend in full.*

Required:

A. *Prepare a Statement of Financial Position in the correct format for the financial year ended 30 June 2025.*

B. *Prepare the following notes to the accounts for 2025:*
   i. *Dividends note*
   ii. *Property, plant and equipment note*

Workings

Number of shares at 30 June 2025:

Ordinary $= \frac{3\,000\,000}{3}$

$= 1\,000\,000$ shares

Preference $= \frac{5\,000\,000}{50}$

$= 100\,000$ shares

Revised Trial Balance 2025

Overdraft		50000
Trade payables		330000
Trade receivables	390000	
Allowance for doubtful debts		5000
Prepaid insurance	32000	
Accrued wages		65000
Property	2500000	
Plant	4000000	
Accumulated depreciation plant		1200000
Machinery	3400000	
Accumulated depreciation machinery		400000
Vehicles	500000	
Accumulated depreciation vehicles		330000
Intangibles	1980000	
Short term borrowings		121000
Current tax liability		23000
Asset revaluation reserve		287000
Property revaluation reserve		500000
General reserve		1230000
Ordinary share capital		3000000
Preference share capital		5000000
Retained earnings	520000	
After tax profit		781000
TOTAL	**13322000**	**13322000**

A.

Statement of Financial Position
As at 30 June 2025

CURRENT ASSETS	
Trade and other receivables	385000
Other current assets	32000
Total Current Assets	417000
NON-CURRENT ASSETS	
Property, plant and equipment	8470000
Intangible assets	1980000
Total Non-Current Assets	10450000
Total Assets	10867000
CURRENT LIABILITIES	
Current tax liability	23000
Trade and other payables	395000
Short term loans	171000
Total Current Liabilities	589000
Total Liabilities	589000
Net Assets	**10278000**
EQUITY	
Share capital	8000000
Reserves	2017000
Retained earnings	261000
Total Equity	**10278000**

B. **Notes to the accounts**

i. **Property, plant and equipment**

	$ 000's
Property	
At fair value	2500000
Total land	2500000
Machinery	
At cost	3400000
Accumulated depreciation	400000
Total machinery	3000000
Vehicles	
At cost	500000
Accumulated depreciation	330000
Total vehicles	170000
Plant	
At cost	4000000
Accumulated depreciation	1200000
Total plant	2800000
TOTAL NON-CURRENT PROPERTY, PLANT AND EQUIPMENT	8470000

ii. **Dividends**

Dividends recognised in the current year:
In Australian dollars

	Cents per share	Total amount
2025		
Final 2025 dividend		80 000
Interim 2025 Ordinary	5.5	55 000
Interim 2025 Preference	250	250 000
TOTAL AMOUNT		385 000

After 30 June 2025 the following dividends were proposed by the directors. The dividends have not been provided for. The financial effect of these dividends has not been recognised in 2025 and will be recognised in subsequent financial reports.
In Australian dollars

	Cents per share	Total amount
Final Ordinary	9	90 000
Final Preference	250	250 000
TOTAL AMOUNT		340 000

21. *The company* Medics Ltd *manufactures and supplies medical equipment. Following is an extract from their financial information for the financial year ending 30 June 2020.*

Medics Ltd
Statement of Changes in Equity
Movements in Equity 2019

	$
Share capital:	
Ordinary	
Share capital at 1 July 2018	4 310 000
Share capital at 30 June 2019	4 310 000
Preference	
Share capital at 1 July 2018	3 003 000
Share capital at 30 June 2019	3 003 000
Other reserves:	
Revaluation	
At 1 July 2018	700 000
At 30 June 2019	700 000
General	
General reserve at 1 July 2018	4 000 000
Transfer to retained earnings	500 000
General reserve at 30 June 2019	4 500 000
Retained earnings:	
Retained earnings at 1 July 2018	(378 550)
ADD: Total profit recognised for period	23 000
Transfer from reserve	500 000
LESS: Dividend – ordinary	129 300
Dividend – preference	150 150
Transfer to general reserve	0
Retained earnings at 30 June 2019	(135 000)

Medics Ltd
Trial Balance as at 30 June 2020

	$	$
Cash	43 000	
Trade payables		420 000
Trade receivables	470 000	
Inventory	560 000	
Non-current assets held for sale	5 000	
Prepaid expenses	30 000	
Dividends	80 000	
Interim dividend ordinary	34 000	
Laboratory supplies	60 000	
Property	3 500 000	
Plant	5 100 000	
Accumulated depreciation plant		2 220 000

Equipment	4 500 000	
Accumulated depreciation equipment	800 000	
Vehicles	700 000	
Accumulated depreciation vehicles	460 000	
Patents	1 650 000	
Short-term borrowings		321 000
Current tax liability		65 000
Revaluation reserve		800 000
General reserve		4 500 000
Ordinary share capital		4 310 000
5% Preference share capital		3 003 000
Retained earnings	135 000	
	12 000	
TOTAL	**18 139 000**	**16 879 000**

Additional information:

- *At 30 June 2020, preference shares were valued at $3 and ordinary shares at $1 each.*
- *During the year the company authorised the payment of the final ordinary dividend of $80000 and land was revalued upwards.*
- *Dividends were paid from the general reserve.*

Required:

A. *Reconstruct the Retained Earnings ledger account at 30 June 2020.*

B. *Prepare a Statement of Financial Position that the directors can include in the annual report to shareholders for the year ended 30 June 2020.*

C. *Prepare the Share Capital note to the financial statements for this annual report.*

D. *Prepare a Statement of Changes in Equity for the year.*

Workings:

Medics Ltd
Adjusted Trial Balance as at 30 June 2020

	$	**$**
Cash	43000	
Trade payables		420000
Trade receivables	470000	
Inventory	560000	
Non-current assets held for sale	5000	
Prepaid expenses	30000	
Laboratory supplies	60000	
Property	3500000	
Plant	5100000	
Accumulated depreciation plant		2200000
Equipment	4500000	
Accumulated depreciation equipment		800000
Vehicles	700000	
Accumulated depreciation vehicles		460000
Patents	1650000	
Short term borrowings		321000
Current tax liability		65000
Asset revaluation reserve		800000
General reserve		4386000
Ordinary share capital		4310000
5% Preference share capital		3003000
Retained earnings	135000	
After tax loss	12000	
	18 139 000	**16765000**

B.

Statement of Financial Position
As at 30 June 2020

	$
CURRENT ASSETS	
Cash and cash equivalents	43000
Trade and other receivables	470000
Inventories	560000
Other current assets	30000
Non-current assets held for sale	5000
Total Current Assets	1108000
NON-CURRENT ASSETS	
Investments	
Property, plant and equipment	10400000
Intangible assets	1650000
Total Non-Current Assets	12050000
Total Assets	13158000
CURRENT LIABILITIES	
Current tax liability	65000
Trade and other payables	420000
Short term loans	321000
Total Current Liabilities	806000
Total Liabilities	806000
Net Assets	**$ 12352000**
EQUITY	
Share capital	7313000
Reserves	5186000
Retained earnings	(147000)
Total Equity	**$ 12352000**

C.

Notes to the financial statements

Reconciliation of movement in capital and reserves
In Australian dollars

	Share Capital	**General Reserve**	**Revaluation Reserve**	**Retained Earnings**	**Total Equity**
Balance at 1 July 2019	7 313 000	4 500 000	700 000	(135 000)	**12 378 000**
Total loss recognised				(12 000)	**(12 000)**
Dividends to equity holders		(114 000)			**(114 000)**
Revaluation increment			100 000		**100 000**
Balance at 30 June 2020	7 313 000	4 386 000	800 000	(147 000)	**1 2352 000**

Share capital

Number of shares issued at end of	**2019**	**2020**
Ordinary	4 310 000	4 310 000
Preference shares	1 001 000	1 001 000

22. *The following information is from the accounts of the company* Voltaic Ltd.

Voltaic Ltd
Trial Balance as at 30 June 2022

	$	$
Goodwill	60 000	
Property	4 000 000	
Factory	8 800 000	
Accumulated depreciation – factory	3 090 000	
Furniture and fittings	5 000 000	
Accumulated depreciation – furniture and fittings	2 300 000	
Vehicles	1 200 000	
Accumulated depreciation – vehicles	660 000	
Machinery	1 650 000	
Accumulated depreciation – machinery	640 000	
Current tax liability		120 000
Asset revaluation reserve		2 600 000
General reserve		6 320 000
Cash and cash equivalents	1 890 000	
Trade payables		3 450 000
Trade receivables	3 560 000	
Inventory	9 300 000	
Other non-current assets	889 000	
Prepaid expenses	40 000	
Dividends	238 000	
Interim dividend preference	560 000	
Ordinary share capital		8 000 000
7% Preference share capital		8 000 000
Retained earnings		20 000
After-tax profit		1 987 000
TOTALS	$ 37 187 000	$ 37 187 000

Voltaic Ltd
Extract from the notes to the accounts

Share capital:

Number of shares issued at end of	**2022**
Ordinary	4 000 000
Preference shares	1 000 000

Voltaic Ltd
Statement of Changes in Equity
Movements in Equity 2021

	$
Share capital:	
Ordinary	
Share capital at 1 July 2020	8 000 000
Share capital at 30 June 2021	8 000 000
Preference	
Share capital at 1 July 2020	8 000 000
Share capital at 30 June 2021	8 000 000
Other reserves:	
Asset revaluation	
At 1 July 2020	3 000 000
Revaluation increment – property	800 000
At 30 June 2021	3 800 000
General	
General reserve at 1 July 2020	14 020 000
Transfer to retained earnings	(770 000)
General reserve at 30 June 2021	6 320 000
Retained earnings:	
Retained earnings at 1 July 2020	(148 000)
ADD: Transfer from reserve	770 000
LESS: Loss recognised for period	(34 000)
Dividend – ordinary	(8 000)
Dividend – preference	(560 000)
Retained earnings at 30 June 2021	20 000

During the 2021/2022 financial year the following occurred:

- *a further revaluation of property*
- *authorisation of the final dividend of $238000 that was declared at the AGM, from retained earnings*
- *interim dividend* preference of $560000 paid from retained earnings

On 30 June 2022 a final preference dividend was declared in full and a final dividend of 3% to the preference shareholders.

Required:

A. *Prepare a Statement of Financial Position for the financial year ended 30 June 2022.*

B. *Prepare the following notes to the accounts for 2022:*
   i. *Share capital*
   ii. *Dividends*
   iii. *Property, plant and equipment*

C. *Prepare a Statement of Changes in Equity for the financial year ended 30 June 2022.*

Workings

Revaluation = 3 800 000 – 2 600 000
= decrement of $1 200 000

Voltaic Ltd	**$**	**$**
Adjusted Trial Balance as at 30 June 2022		
Goodwill	60000	
Property	4000000	
Factory	8800000	
Accumulated depreciation - factory		3090000
Furniture and fittings	5000000	
Accumulated depreciation – furniture and fittings		2300000
Vehicles	1200000	
Accumulated depreciation - vehicles		660000
Machinery	1650000	
Accumulated depreciation - machinery		640000
Current tax liability		120000
Asset revaluation reserve		2600000
General reserve		6320000
Cash and cash equivalents	1890000	
Trade payables		3450000
Trade receivables	3560000	
Inventory	9300000	
Other non-current assets	889000	
Prepaid expenses	40000	
Ordinary share capital		8000000
7% Preference share capital		8000000
Retained earnings		1209000
	36389000	**36389000**

A.

Voltaic Ltd
Statement of Financial Position
As at 30 June 2022

CURRENT ASSETS	
Cash and cash equivalents	1890000
Trade and other receivables	3560000
Inventories	9300000
Other current assets	929000
Total Current Assets	15679000
NON-CURRENT ASSETS	
Property, plant and equipment	13960000
Intangible assets	60000
Total Non-Current Assets	14020000
Total Assets	29699000
CURRENT LIABILITIES	
Current tax liability	120000
Trade and other payables	3450000
Total Current Liabilities	3570000
Total Liabilities	3570000
Net Assets	26129000
EQUITY	
Share capital	16000000
Reserves	8920000
Retained earnings	1209000
Total Equity	26129000

B. Notes to the accounts

1. Reconciliation of movement in capital and reserves
In thousands of Australian dollars

Reconciliation of movement in capital and reserves
In Australian dollars

	Share Capital	General Reserve	Revaluation Reserve	Retained Earnings	Total Equity
Balance at 1 July 2021	16 000 000	6 320 000	3 800 000	20 000	**26 140 000**
Total profit recognised				1 987 000	**1 987 000**
Dividends				(798 000)	**(798 000)**
Revaluation decrement			(1 200 000)		**(1 200 000)**
Balance at 30 June 2022	16 000 000	6 320 000	2 600 000	1 209 000	**26 129 000**

2. Dividends

Dividends recognised in the current year:
In Australian dollars

	Cents per share	Total amount
2022		
Final dividend		238 000
Preference dividend		560 000
TOTAL	798 00	

3. Property, Plant and Equipment

Property	4000 000
Factory	8800 000
Accumulated depreciation - factory	3090 000
Furniture and fittings	5000 000
Accumulated depreciation – furniture and fittings	2300 000
Vehicles	1200 000
Accumulated depreciation - vehicles	660 000
Machinery	1650 000
Accumulated depreciation - machinery	640 000
Other non-current assets	889 000
TOTAL PROPERTY PLANT AND EQUIPMENT	13 960 000

C.

Voltaic Ltd
Statement of Changes in Equity 2022

Share capital:	
Ordinary	
Share capital at 1 July 2021	8000000
Share capital at 30 June 2022	8000000
Preference	
Share capital at 1 July 2021	8000000
Share capital at 30 June 2022	8000000
Other reserves:	
Asset revaluation	
At 1 July 2021	3800000
Revaluation decrement - property	1200000
At 30 June 2022	2600000
Retained earnings:	
Retained earnings at 1 July 2021	20000
ADD: Profit for period	1987000
LESS: Dividend	238000
Dividend – Preference	560000
Retained earnings at 30 June 2022	1209000

23. *Consider the following information for the farming company* Sheep Ltd *and answer the questions which follow.*

Sheep Ltd
Trial Balance for the 12 months ending 30 June 2020

	$000	**$000**
Asset revaluation reserve		340
General reserve		890
Ordinary share capital		5 200
3% Preference share capital		9 000
Retained earnings		34
After tax profit		67
Cash at bank	364	
Trade and other payables		450
Trade and other receivables	490	
Biological assets	6 300	
Prepaid insurance	5	
Accrued wages		98
Dividends	492	
Interim dividend ordinary	50	
Interim dividend preference	270	
Land	6 340	
Buildings	3 450	
Accumulated depreciation buildings		230
Machinery	2 980	
Accumulated depreciation machinery		1 090
Employee benefits owed		160
Long-term borrowings		3 700
Intangibles	1 530	
Short-term borrowings		920
Current tax liability		92
TOTAL	**22 271**	**22 271**

Sheep Ltd
Notes to the Statement of Changes in Equity
Movements in Equity 2019

	$000
Share capital:	
Ordinary $1 shares	
Share capital at 1 July 2018	5 000
Issue of share capital	200
Share capital at 30 June 2019	5 200
3% Preference shares, valued at $9 each	
Share capital at 1 July 2018	9 000
Share capital at 30 June 2019	9 000

Other reserves:	
General	
General reserve at 1 July 2018	1095
Issue of bonus shares	(200)
Transfer to retained earnings	(5)
General reserve at 30 June 2019	890
Retained earnings:	
Retained earnings at 1 July 2018	246
ADD: Total profit recognised for period	103
Transfer from reserve	5
LESS: Dividend – Ordinary	(50)
Dividend – Preference	(270)
Retained earnings at 30 June 2019	34

Additional information:

Gains of $30 000 were made on available for sale – financial assets and a $4 000 exchange difference on translating foreign currencies.

During the year the directors decided to make a 1 for 20 bonus share issue out of the general reserve and the AGM authorised the final dividends declared at the 2019 AGM. The directors also paid interim dividends to the preference and ordinary shareholders on 1 January 2020.

Required:

Prepare a Statement of Financial Position, Statement of Changes in Equity, Statement of Comprehensive Income and all accompanying notes in external reporting format as at 30 June 2020.

Sheep Ltd
Statement of Financial Position

As at 30 June 2020	**$000**
CURRENT ASSETS	
Cash and cash equivalents	364
Trade and other receivables	490
Other current assets	6305
Total Current Assets	7159
NON-CURRENT ASSETS	
Property, plant and equipment	11450
Intangible assets	1530
Total Non-Current Assets	12980
Total Assets	20139
EQUITIES	
CURRENT LIABILITIES	
Current tax liability	92
Trade and other payables	450
Short term loans	920
Other current liabilities	258
Total Current Liabilities	1720
NON-CURRENT LIABILITIES	
Long term borrowings	3700
Total Non-Current Liabilities	3700
Total Liabilities	5420
Net Assets	14719
EQUITY	
Share capital	14400
Reserves	1030
Retained earnings	(711)
Total Equity	14719

Sheep Ltd
Statement of Changes in Equity 2020

	000's
	$
Share capital:	
Ordinary $1 shares	
Share capital at 1 July 2019	5200
Issue of share capital	200
Share capital at 30 June 2020	5400
3% Preference shares	
Share capital at 1 July 2019	9000
Share capital at 30 June 2020	9000
Other reserves:	
General	
General reserve at 1 July 2019	890
Issue of bonus shares	200
General reserve at 30 June 2020	690
Revaluation	
Revaluation reserve at 1 July 2019	340
Revaluation reserve at 30 June 2020	340
Retained earnings:	
Retained earnings at 1 July 2019	34
ADD: Total profit recognised for period	67
LESS: Interim dividend - Ordinary	50
Interim dividend – Preference	270
Final dividend	492
Retained earnings at 30 June 2020	$ (711)

Notes to the financial statements

Property, plant and equipment

	$ 000's
Property	
At fair value	6340
Total land	6340
Machinery	
At cost	2980
Accumulated depreciation	1090
Total machinery	1890
Buildings	
At cost	3450
Accumulated depreciation	230
Total buildings	3220
TOTAL NON-CURRENT PROPERTY, PLANT AND EQUIPMENT	11450

Reconciliation of movement in capital and reserves
In thousands of Australian dollars

	Share Capital	General Reserve	Revaluation Reserve	Retained Earnings	Total Equity
Balance at 1 July 2019	5 200	890	340	34	**6 464**
Total profit recognised				67	**67**
Dividends to equity holders				(812)	**(812)**
Issue of shares	200	(200)			**0**
Balance at 30 June 2020	5 400	690	340	(711)	**5 719**

Share capital

Number of shares issued at end of	**2029**	**2030**
Ordinary	5 200 000	5 400 000
Preference shares	1 000 000	1 000 000

Dividends

Dividends recognised in the current financial year:
In Australian dollars

	Cents per share	Total amount	Payment date
2019			
Final 2019 dividend		492 000	30 June 2020
Interim 2019 Ordinary	0.96	50 000	1 Jan 2020
Interim 2019 Preference	0.27	270 000	1 Jan 2020
TOTAL AMOUNT		812 000	

After 30 June 2020 there were no further dividends proposed by the directors.

24. *The following information has been taken from the accounts of the company* International Traders Ltd.

International Traders Ltd		
Trial Balance as at 30 June 2025	**$**	**$**
Current tax liability		13 000
Interim dividend – preference	53 000	
Ordinary share capital		1 000 000
Inventory	980 000	
Accumulated depreciation – furniture and fittings		20 300
After-tax profit		1 133 000
Prepaid expenses	3 000	
Goodwill	681 000	
Accumulated depreciation – factory		60 400
Vehicles	110 000	
General reserve		450 000
Cash and cash equivalents	197 000	
Trade payables		632 000
Property	380 000	
Factory	900 000	
Accumulated depreciation – vehicles		54 000
Machinery and equipment	180 000	
Accumulated depreciation – machinery and equipment		54 000
Asset revaluation reserve		500 000
Trade receivables	421 000	
Dividends	32 000	
5% Preference share capital		600 000
Retained earnings		20 300
Furniture and fittings	600 000	
	4 537 000	**4 537 000**

This additional information is NOT included in the account balances above.

During the 2025 financial year the following occurred:

- The final divided that was declared at the AGM from retained earnings was authorised.
- The sum of $50 000 was transfered from the general reserve to retained profits.
- An interim preference dividend was paid out of retained earnings on 1 January 2025.
- Property was revalued upwards by $60 000.

On 30 June 2025 the following occurred:

- *A final preference dividend was declared in full.*
- *A final dividend of 5% for ordinary shareholders was declared.*

Required:

A. Prepare a Statement of Financial Position for the financial year ended 30 June 2025.

B. Prepare a Statement of Changes in Equity for the financial year ended 20 June 2025.

A.

International Traders Ltd
Statement of Financial Position
as at 30 June 2025

ASSETS	
CURRENT ASSETS	**$**
Cash and cash equivalents	197 000
Trade and other receivables	421 000
Inventories	980 000
Other current assets	3 000
Total Current Assets	**1601 000**
NON-CURRENT ASSETS	
Property, plant and equipment	2 041 300
Intangible assets	681 000
Total Non-Current Assets	**2 722 300**
Total Assets	**$ 4 323 300**
EQUITIES	
CURRENT LIABILITIES	
Current tax liability	13 000
Trade and other payables	632 000
Total Current Liabilities	645 000
Total Liabilities	**645 000**
Net Assets	$ 3 678 300
EQUITY	
Share capital	1 600 000
Reserves	960 000
Retained earnings	1 118 300
Total Equity	**$ 3 678 300**

B.

International Traders Ltd.
Statement of Changes in Equity 2025

Share capital:	
Ordinary	
Share capital at 1 July 2024	1 000 000
Share capital at 30 June 2025	1 000 000
Preference	
Share capital at 1 July 2024	600 000
Share capital at 30 June 2025	600 000
Other reserves:	
Asset revaluation	
Opening balance	500 000
Revaluation	60 000
At 30 June 2025	560 000
General	
Opening balance	450 000
Transfer to retained earnings	50 000
At 30 June 2025	400 000
Retained earnings:	
Retained earnings at 1 July 2024	20 300
ADD: Profit for period	1 133 000
Transfer from reserve	50 000
LESS: Dividend	32 000
Dividend – Preference	53000
Retained earnings at 30 June 2025	1 118 300

25. *The following information has been taken from the accounts of the business* Kalgoorlie Ltd.

Kalgoorlie Ltd **Trial Balance as at 30 June 2022**	**$**	**$**
Interim dividend – preference	53 000	
Ordinary share capital		1 000 000
Goodwill	681 000	
General reserve		450 000
Cash and cash equivalents	197 000	
Trade payables		632 000
Property	380 000	
Factory	900 000	
Accumulated depreciation – factory		60 400
Vehicles	110 000	
Accumulated depreciation – vehicles		54 000
Machinery and equipment	180 000	
Accumulated depreciation – machinery and equipment		54 000
Current tax liability		13 000
Asset revaluation reserve		500 000
Trade receivables	421 000	
Inventory	980 000	
Prepaid expenses	3 000	
Dividends	32 000	
5% Preference share capital		600 000
Retained earnings		20 300
Furniture and fittings	600 000	
Accumulated depreciation – furniture and fittings		20 300
After-tax profit		1 133 000
	4 537 000	**4 537 000**

This additional information is NOT included in the account balances above.

During the 2022 financial year the following occurred:

- *The final divided that was declared at the AGM from retained earnings was authorised.*
- *A sum of $50000 was transfered from the general reserve to retained profits.*
- *An interim preference dividend was paid out of retained earnings on the 1 January 2022.*
- *Property was revalued upwards by $60 000.*

On the 30 June 2022 the following occurred:

- *A final preference dividend was declared in full.*
- *A final dividend of 5% for ordinary shareholders was declared.*

A. *Prepare a Statement of Financial Position/Balance Sheet for the financial year ended 30 June 2022.*

B. *Prepare a Statement of Changes in Equity for the financial year ended 20 June 2022.*

Extended answer questions

1. *Discuss the following statement in essay format, correcting any errors and fully justifying your final response:*

   'Companies usually create reserves when they have assets to set aside for future investment in company activities and this is done in order to keep assets separate from shareholder dividends.'

In their answer, students should:

- define each of the three types of reserve
- explain the purpose of each type of reserve, giving examples
- explain source of the amounts that accumulate in reserves, and their varied uses – go beyond the preservation of assets for investment in the company future
- explain the course of shareholder dividends
- outline how shareholder dividends are declared and paid
- conclude by clearly distinguishing between reserves and dividends.

2. *Why does a public company report using notes to the accounts?*

Explain the purpose of having additional notes to the financial statements or notes to the accounts. In your response, also include a summary of the main notes and describe their purpose.

Notes to the accounts expand on the information that is contained in the overview financial statements, the Balance Sheet, Income Statement and Cash Flow Statement. The detail in the notes gives further information that cannot be contained on the face of the statements due to the level of detail or due to reporting requirements.

Share capital and reserves presents information about each class of share capital in the notes to the accounts. It must list specific information to ensure full disclosure of the company's state of affairs. This includes the number of shares issued and fully paid, the number of shares that have been authorised, par value per share, or that the shares have no par value (generally a statement is made that the company has neither of these), and the rights, preferences and restrictions attaching to that class including restrictions on the distribution of dividends and the repayment of capital. These totals must be able to be reconciled with the amounts in the Balance Sheet.

Property, plant and equipment contains information in the notes which breaks down the different classes of assets in the property, plant and equipment account. This shows detail of the fair value or the historical cost of each type of asset and subtracts its accumulated depreciation, reconciling this with the final balance found in the Balance Sheet.

Dividends recommended by directors explains details of final and interim dividends. Final dividends are recognised in the accounts on the date the directors declare them and are then paid on a later payment date. Interim dividends are recognised in the accounts and paid on the date the directors declare them. Both types are included in the notes.

CHAPTER 8: CASH FLOWS

Questions

1. *Define 'cash' and 'cash equivalents', using examples.*

Cash comprises cash on hand and demand deposits. For example, cash in the company bank account.

Cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value. For example, investments that mature in two months time.

2. *What are the main benefits provided by Cash flow statement information?*

A cash flow statement, used with the rest of the financial statements, provides benefits to users who will be able to:

- evaluate changes in net assets of the company
- consider the company's financial structure especially its liquidity position
- assess the company's ability to affect cash flows in order to adapt to changing external and internal opportunities
- evaluate the ability of the company to generate cash and cash equivalents
- assess and compare the present value of the future cash flows of different companies
- compare the performance of different companies because similar accounting treatments are required for some transactions and events.

3. *Define the three main classifications of cash flow activities presented in the Cash flow statement.*

Cash flow activities:

Operating activities are the principal revenue producing activities of the company and other activities that are not investing or financing activities. Transactions associated with the income and expenses of the company.

Investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents. Transactions affecting the assets of the company.

Financing activities are activities that result in changes in the size and composition of the capital and borrowings of the company. Transactions that affect the liability and equity of the company.

4. *Explain the difference between the following two items of information from the Cash flow statement:*

A. *Payments to suppliers and employees.*

Payments to suppliers and employees: all cash outflows to suppliers and employees of the business. Include all cash expenses from the Income Statement except for interest paid.

B. *Receipts from customers.*

Receipts from customers: all cash inflows from customers and clients of the company. Includes all cash income and revenue.

5. *Summarise how to reconstruct the following information for Cash flow statement preparation, using your own examples:*
   - *A. Trade receivables*
   - *B. Trade payables*
   - *C. Prepaid expenses*
   - *D. Accrued expenses*
   - *E. Unearned income*
   - *F. Accrued income*
   - *G. Sale of asset*

Students should develop their own summary.

6. *The directors of a company have asked you to explain to then how it is possible that they are reporting a profit in the company Statement of Profit or Loss, yet their auditors are concerned about the business becoming insolvent. Discuss this problem, outline the main non-cash items that are likely to have contributed to the high profitability for this company, and give examples of the cash items that may have caused the poor liquidity result.*

The calculation of profit includes both cash and non-cash items. Some of the non-cash items that can have a significant effect on profit calculation are credit sales, credit purchases, depreciation and bad debts. If the business has high credit sales the profit may appear to be very good. This is a non-cash items however and if debtors are taking too long to pay, or have been given lenient credit terms the company could be in financial trouble because of a lack of cash flow. If the company does not have a high amount of current assets in its Statement of Financial Position but has a large amount of current liabilities, then these liabilities might fall due before the cash is received to make payment.

7. *What is the main purpose of the Statement of cash flows, and how would it be used by a financial institution considering whether a company can take out a loan?*

The main purpose of analysis of a Cash Flow Statement is to determine the main cause of the final net increase (or decrease) in cash and cash equivalents. This would indicate to a financial institution the ability of the business to meet current short term debt.

8. *In a table like the following, indicate which items are cash, non-cash or potentially BOTH cash and non-cash, explaining your reasoning in the final column.*

Cash or non-cash

Item	Cash	Non-cash	Reason
Depreciation		✔	
Sale of motor vehicle	✔	✔	Could be for cash, trade-in or on credit
Gain on sale of motor vehicle		✔	
Credit sales		✔	
Discount received		✔	
Bad debts		✔	
Petrol expense	✔		
Purchase returns and allowances		✔	
Mortgage repayment	✔		
Interest income	✔		
Employee benefits paid	✔		
Goodwill purchased	✔		

9. *Explain how some items that appear in both the Cash flow statement and the Statement of Profit or Loss can give a clear indication of the liquidity of the company. Which items would only give an indication of profitability?*

Liquidity can be indicated by the information from Asset and Liability accounts, and both appear in the Cash Flow Statement and Statement of Financial Position, with the Cash Flow statement showing movements in these items and the Statement of Financial Position showing their final amount at the end of the accounting period.

10. *Given the following list of items, classify each as an operating, investing or financing cash flow, or as a non-cash item. Include the criteria you used in making your decision. (You may need to make some assumptions.)*

Operating, investing or financing cash flow, or a non-cash item: dependent upon assumptions made by students.

11. *Give three examples of cash inflows and outflows resulting from:*

A. Operating activities

B. Investing activities

C. Financing activities

CASH FLOW	INFLOW	OUTFLOW
OPERATING	Sale of goods Rendering of services Royalties Commissions	Payments to suppliers Payments to employees Tax Interest paid
INVESTING	Sale of: Property Plant Equipment Intangibles Any long term asset Sale of: Equity Debt instruments Interest and dividends received	Acquisition of: Property Plant Equipment Intangibles Any long term asset Acquisition of: Equity Debt instruments
FINANCING	Issuing shares Issuing loans, mortgages and other borrowings Issuing debentures	Redeem company's own shares Repay loans, mortgages and other borrowings Repay debentures Dividends paid

12. *Show how the following amounts are calculated:*

A. Cash receipts from customers

Cash receipts from customers = Opening debtors + Net credit sales – Closing debtors

B. Cash paid to suppliers and employees

Cash paid to suppliers for purchase of inventory

PERPETUAL INVENTORY SYSTEM
= Cost of sales + Change in inventory + Change in creditors

= Cost of sales + (Closing inventory – Opening inventory) + (Opening creditors – Closing creditors)

13. *Analyse the information contained in the following Cash flow statement and discuss the main causes of the final net increase in cash and cash equivalents.*

Orange Ltd
Statement of Cash Flows
As at 30 December 2020

	$
Cash flows from operating activities	
Cash receipts from customers	1 239 800
Cash paid to suppliers and employees	(834 700)
Cash generated from operations	**405 100**
Interest paid	872 000
Income taxes paid	777 000
Net cash from operating activities	**2 054 100**
Cash flows from investing activities	
Acquisition of vehicle	(120 600)
Purchase of property, plant and equipment	(2 130 000)
Proceeds from sale of land	3 444 000
Interest received	119 000
Dividends received	209 000
Net cash from investing activities	**(1 521 400)**
Cash flows from financing activities	
Proceeds from issue of share capital	1 000 000
Proceeds from borrowings	500 000
Dividends paid	(339 000)
Net cash from financing activities	**1 161 000**
Net increase in cash and cash equivalents	**1 693 700**
Cash and cash equivalents at beginning of period	345 000
Cash and cash equivalents at end of period	2 038 700

Students should discuss the relatively large decrease in investing activities to a negative amount, in comparison with the increases in operating and financing. Each section should be worked through with the main accounts that are affecting the overall total being examined and potential reason for the significant amount of cash inflow or outflow being listed.

14. *From the following information, reconstruct the relevant account/s to determine the cash paid or received.*

A. *Trade Receivables has an opening balance of $4 000 and a closing balance of $3 600. Credit Sales for the year was $132 000, Sales Returns $5 600 and Discount Expenses $8 900. How much cash has been received from customers?*

Trade Receivables

Opening balance	4 000	Sales returns and allowances	5 600
Sales	132 000	Discount expense	8 900
		Cash at bank	**117 900**
		Closing balance	3 600

B. *Trade Payables has an opening balance of $5 500 and a closing balance of $4 400. Inventory has an opening balance of $3 000 and a closing balance of $2 100. Cost of Sales was $65 700, Purchase Returns $2 000 and Discount Revenue $900. How much cash has been paid to suppliers for inventory?*

Inventory

Opening balance	3 000	Cost of sales	65 700
Trade payables	**67 700**	Purchase returns and allowances	2 000
		Discount revenue	900
		Closing balance	2 100

Trade Payables

Cash at bank	**68 800**	Opening balance	5 500
Closing balance	4 400	Inventory	67 700

C. *The opening balance in Prepaid Rent is $5 000, and at the end of the period, the closing balance is $4 000. The accrual calculated Rent Expense is $155 000. How much cash was paid for rent during the period?*

Prepaid Rent

Opening balance	5 000	Rent expense	155 000
Cash at bank	**154 000**	Closing balance	4 000

D. *Prepaid Insurance started at a balance of $8 800 and had a closing balance of $5 500. Insurance Expense for the period was $607 000. What is the cash paid to insurance?*

Prepaid Insurance

Opening balance	8 800	Insurance expense	607 000
Cash at bank	**603 700**	Closing balance	5 500

E. *The opening balance in Accrued Long Service Leave is $600, and at the end of the period, the closing balance is $800. The accrual calculated Long Service Leave Expense is $706 500. How much cash was paid for long service leave during the period?*

Accrued Long Service Leave

Cash at bank	**699 100**	Opening balance	600
Closing balance	800	Long Service Leave expense	706 500

F. *The opening balance in Unearned Rent is $3 000, and at the end of the period, the closing balance is $2 300. The accrual calculated Rent Income is $16 400. How much cash was received from rent during the period?*

Unearned Rent

Rent income	16 400	Opening balance	3 000
Closing balance	2 300	**Cash at bank**	**15 700**

G. *The opening balance in Accrued Interest $2 000, and at the end of the period, the closing balance is $3 400. The accrual calculated Interest Income is $10 000. How much cash was received from interest during the period?*

Accrued Interest

Opening balance	2 000	**Cash at bank**	**8 600**
Interest income	10 000	Closing balance	3 400

H. *Equipment that originally cost $1 000 000, has been depreciated for five years at 15% straight line was sold for $30 000.*

Calculations:

Accumulated Depreciation = 1 000 000 x 0.15 x 5
= $750 000

Gain on sale = 300 000 – (1 000 000 – 750 000)
= 300 000 – 250 000
= $50 000 gain

Sale of Asset

Equipment	1 000 000	Accumulated Depreciation of Equipment	750 000
Gain on disposal	50 000	**Cash at Bank**	**300 000**

The equipment was sold for $300 000.

I. *Machinery that originally cost $1 000 000 and had accumulated depreciation of $600 000 was sold for $300 000 cash. The opening balance of the Machinery account was $5 000 000 and the closing balance $1 200 000. Machinery was purchased for cash during the year.*

Machinery

Opening balance	5 000 000	Sale of asset	1 000 000
Cash at bank	**2 800 000**	Closing balance	1 200 000

15. *Prepare a Cash flow statement for* Xenon Limited *for the year ended 30 June 2025 showing the cash from operating activities ONLY. Interpret the movements in the cash flow items.*

Xenon Ltd
Comparative ending balances for the year ended 30 June

	2025	**2024**
Sales	40 000	50 000
Cost of sales	25 000	28 000
Expenses*	12 000	17 000
Inventory	10 000	12 000
Trade payables	13 000	11 000
Trade receivables	14 000	15 000

*Includes $5 000 interest paid and $2 000 depreciation for each year.

Cash flows from operating activities 2025

	$
Receipts from customers	41 000
Payments to suppliers and employees	(26 000)
Interest paid	(5 000)
	10 000

Working out:

Trade Payables

Cash at bank	**21 000**	Opening balance	11 000
Closing balance	13 000	Inventory	23 000

Trade Receivables

Opening balance	15 000	**Cash at bank**	**41 000**
Sales	40 000	Closing balance	14 000

Inventory

Opening balance	12 000	Cost of sales	25 000
Sales	23 000	Closing balance	10 000

16. *Prepare a Cash flow statement for* Yabbies Limited *for the year ended 30 June 2022 showing the cash from operating activities ONLY. Interpret the movements in the cash flow items.*

Yabbies Ltd
Comparative ending balances for the year ended 30 June

	2022	**2021**
Trade payables	22 000	22 000
Trade receivables	23 000	25 000
Sales	60 000	55 000
Cost of sales	35 000	27 000
Expenses*	21 000	19 000
Inventory	23 000	18 000

*Includes $1 000 bad debts and $3 500 interest paid for each year

Cash from operating activities = $112 000

17. *Use the following information about the activities of* Zebra Ltd *to prepare a Cash flow statement for the year showing the cash from financing activities ONLY. Interpret the movements in the cash flow items.*

- *The year commenced with $5 000 000 in ordinary share capital. During the year 100 000 more $4 ordinary shares were issued for cash.*
- *The company purchased a factory building, paying $500 000 as a deposit and with the remaining $4 000 000 owing.*
- *A short-term loan of $50 000 was paid off.*
- *The ordinary shares received a dividend of 2% at the end of the year.*
- *Debentures held in the company Rex Ltd and worth $60 000 were redeemed.*

Cash flows from financing activities

	$
Proceeds from issue of share capital	400 000
Purchase of factory	(500 000)
Payment of borrowings	(50 000)
Dividends paid	(108 000)
Proceeds from redemption of debentures	60 000
	(198 000)

18. *Use the following information about the activities of* Quirky Limited *to prepare a Cash flow statement for the year ended 30 June 2021 showing the cash from financing activities and investing activities ONLY. Interpret the movements in the cash flow items.*

    - *Paid $500 000 cash to purchase a share in a new business, with 20% of the purchase price being recognised as goodwill.*
    - *Sold a vehicle for cash $55 000*
    - *Plant and equipment that originally cost $2 000 000, has been depreciated for eight years at 10% straight line was sold for $250 000.*
    - *Interest earning deposit of $400 000 was paid 5% interest.*
    - *Paid a 3% preference share dividend on the company shares. The company has 2 000 000 preference shares valued at $9 each.*
    - *Received dividends of $30 000.*
    - *Mortgage of $4 000 000 entered into.*

Cash from financing activities = $(540 000)
Cash from investing activities = $745 000

19. *Consider the following information, perform the relevant calculations, and complete the 'Investing Activities' section of the Cash flow statement.*

    Ed is the owner and managing director of Ed's Eager Eggs Ltd *a free range chicken farm in Western Australia's wheat belt area. In the last financial year, Ed purchased a new $66 000 (GST-exclusive) shed for the farm, paying a 5% deposit, with the remainder a loan due in annual instalments. He also sold a tractor, which had a historical cost of $55 000 and accumulated depreciation of $49 000, for $7 000 cash. The opening balance of Farm Machinery was $220 000 at the start of the period, and the closing balance was $310 000 (Assume any other changes in this account were cash transactions).*

Cash paid to purchase farm machinery = $145 000
Cash paid as deposit for shed = $3 300
Net cash used in investing activities = $(141 300).

20.

A. Examine the following information for Delightful Doughnuts Ltd *and calculate the total cash paid to suppliers and employees for this business. Discuss what the information reveals about the business's profitability and liquidity situation, and outline some useful advice for the directors to follow to improve results over the next three months.*

Delightful Doughnuts Ltd
Income Statement (internal)
For the three months ended 1 March 2025

	$ 000's	**$ 000's**
Income		
Sales (all cash)	5 500	
Less: Sales returns and allowances	10	5 490
LESS: Cost of sales		
Opening inventory	200	
ADD: Net purchases	3 300	
Transport fees	467	
	3 967	
LESS: Closing inventory	560	3 407
Gross profit		**2 083**
ADD: Other income		
Interest		45
		2 128
LESS: Other expenses		
Advertising	130	
Wages	2 134	
Interest	290	
Office expenses	550	
Depreciation	230	
Rent of premises	1 000	
Bad debts	12	4 346
LOSS		**(2 218)**

Some extra information has been provided for your analysis:

On 1 March 2025, Accrued Interest was $90 000; Prepaid Advertising $600 000; and the balance of Trade Payables was $400 000. None of these items had opening balances.

Cash paid to purchase inventory
= Opening creditors + Net purchases – Closing creditors
= 0 + 3300 – 400
= $ 2 900

Cash interest paid = $200 (not included in cash paid to employees and suppliers though!);

Cash paid for advertising
= Closing advertising + Advertising expense – Opening advertising
= 600 + 130 – 0
= $ 730

Cash paid to suppliers and employees:

Payments to trade payables	$ 2 900 000
Advertising	730 000
Wages	2 134 000
Office expenses	550 000
Rent	1 000 000
Transport	467 000
	$ (7 781 000)

B. Following is information obtained for the next three months of *Delightful Doughnuts Ltd's* operations. Calculate the cash receipts from customers based on the following information and complete the 'Operating Activities' section of the Cash flow statement.

Delightful Doughnuts Ltd
Income Statement (internal)
For the three months ended 1 June 2025

	$ 000's	**$ 000's**
Income		
Sales: Cash	4 200	
Credit	1 000	
LESS: Sales returns and allowances	20	5 180
LESS: Cost of sales		
Opening inventory	560	
ADD: Purchases	2 400	
Transport fees	400	
	3 360	
LESS: Closing inventory	410	2 950
Gross profit		**2 230**
ADD: Other income		
Commission fees	500	
Interest	55	
		2 785
LESS: Other expenses		
Cleaning supplies	30	
Advertising	400	
Wages	1 200	
Interest	290	
Depreciation	230	
Rent of premises	1 000	
Bad debts	8	3 158
LOSS		**(373)**

Some extra information has been provided for your analysis:

- *On 1 March 2025, Accrued Interest Expense was $90 000; Prepaid Advertising $600 000; and the balance of Trade Payables $400 000.*
- *On 1 June 2025, Prepaid Advertising was $250 000; the balance of Trade Payables $200 000 and the balance of Trade Receivables $130 000.*
- *Items not specifically mentioned have zero opening or closing balances.*

B.

Cash paid to purchase inventory

= Opening creditors + Net purchases – Closing creditors

= 400 + 2 400 – 200

= $ 2 600

Cash paid for advertising

= 250 + 400 – 600

= $ 50

Cash paid to suppliers and employees:

Payments to trade payables	2 600
Advertising	50
Wages	1 200
Transport	400
Rent	1 000
Cleaning	30
	5 280

Cash received from trade receivables

= Opening balance + Credit sales – Closing

= 0 + (1 000 – 20) – 130

= $ 850

CASH FLOWS FROM OPERATING ACTIVITIES

Cash from customers	$ 4 700 000
Cash received from trade receivables	850 000
Cash paid to suppliers and employees	(5 280 000)
Interest paid	(280 000)
Interest received	55 000
	$ 45 000

21. *Examine this financial information for* Jenna's Handbags Ltd *and calculate the total cash paid to suppliers and employees for this business. Discuss what the information reveals about the business's profitability and liquidity situation, and outline some useful advice for the directors to follow to improve results in the next accounting period.*

Jenna's Handbags Ltd
Income Statement (internal)
For the 10 months ended 1 November 2024

	$ 000's	$ 000's
Income		
Sales	54 780	
LESS: Discount allowed	2 390	
Sales returns and allowances	1 390	51 000
LESS: Cost of sales		
Inventory available for sale	23 450	
Discount received	(450)	
Customs duty	2 400	
Freight 1 360	26 760	
Gross profit		**24 240**
LESS: Other expenses		
Wages	16 700	
Insurance	4 500	
Electricity	980	
Depreciation	3 400	
Sewing supplies	4 000	
Doubtful debts	340	29 920
LOSS FOR PERIOD		**(5 680)**

Some extra information has been provided for your analysis:

On 1 November 2024, Accrued Wages was $130 000; Prepaid Insurance was $1 300 000; the balance of Inventory was $3 000 000; and the balance of Accounts Payable was $9 800 000. None of these items had opening balances.

Cash paid for inventory purchases
= Cost of sales + (Closing inventory – Opening inventory) + (Opening creditors – Closing creditors)
= 26 760 + (3000 – 0) + (0 – 9800)
= $ 19 960

Cash paid for wages
= Opening accrued wages + Wages expense – Closing accrued wages
= 0 + 16 700 – 130
= $ 16 570

Cash paid for insurance
= Closing prepaid insurance + Insurance expense – Opening prepaid insurance
= 1 300 + 4 500 – 0
= $ 5 800

Cash paid to suppliers and employees:

Cash paid to purchase inventory	$ 19 960
Wages	16 570
Insurance	5 800
Electricity	980
Sewing supplies	4 000
	$ 47 310

22. *The following information is from the accounts of* African Amusements Ltd*, a chain of shops selling imported ornaments and goods from West Africa.*

African Amusements Ltd
Income Statement (Internal)
For the year ended 31 December 2020

	$ 000's	**$ 000's**
Income		
Sales	57 000	
LESS: Sales returns and allowances	600	56 400
LESS: Cost of sales		
Inventory sold	44 000	
Customs duty	1 660	45 660
Gross profit		**10 740**
ADD: Other income		
Interest	810	
Dividends	120	930
		11 670
LESS: Other expenses		
Shop		
Wages	4 250	
Depreciation	770	
Rent	1 780	
Consumables	700	
Bad debts	380	7 880
Financial		
Interest	720	720
PROFIT BEFORE INCOME TAX		3 070
Income tax		1 023
PROFIT		2 047

African Amusements Ltd
Comparative Balance Sheet (Internal)

For the year:	2019	2020
	$ 000's	$ 000's
ASSETS		
Cash and cash equivalents	-	257
Inventory	1 000	3 300
Accrued interest	20	30
Prepaid rent	50	370
Trade debtors	4 000	200
Shop fittings	1 340	2 000
Accumulated depreciation – shop fittings	(268)	(538)
Computer and equipment	7 000	7 000
Accumulated depreciation – computer	(1 830)	(2 330)
	11 312	**10 289**
LIABILITIES		
Overdraft	2 280	-
Trade creditors	120	80
Accrued wages	100	350
Mortgage	1 300	2 200
Loan – due 2025	3 000	1 100
EQUITY		
Retained earnings	3 512	5 559
Share capital	1 000	1 000
	11 312	**10 289**

Required

A. Reconstruct the Retained Earnings, Creditors and relevant income/expense accounts, to determine the cash paid or received for specific accounts.

B. Calculate the Cash Receipts from Customers and Cash Paid to Suppliers and Employees.

C. Complete a Cash Flow Statement for African Amusements Ltd for the year ended 31 December 2020.

D. Interpret the movements in the cash flow items.

A.
Cash paid for wages = $4 000, Cash received from interest income = $800, Cash paid for rent = $2 100, Cash paid for purchase of inventory = $48 000.

Cash paid to creditors (to purchase inventory)
= 45 660 + (3300 – 1000) + (120 – 80)
= $48 000

Retained earnings (Eq)

		Opening balance	3512
		Profit	2047
Closing balance	5559		

Debtors (A)

Opening balance	4000	Sales R&A	600
Sales	5700	**Cash at bank**	**60200**
		Closing balance	200
	61000		**61000**

Accrued interest (A)

Opening balance	20	**Cash at bank**	**800**
Interest income	810	Closing balance	30

Accrued wages (L)

Cash at bank	**4000**	Opening balance	100
Closing balance	350	Wages expense	4250

B.
Cash received from customers (debtors) = $60 200 – bad debts = $59820

Cash paid to suppliers and employees = (creditors) + wages + rent + consumables
= 48 000 + 4 000 + 2 100 + 700
= $54 800

C.
African Amusements Ltd
Cash Flow Statement
For the period ended 31 December 2020

CASH FLOWS FROM OPERATING ACTIVITIES

Cash receipts from customers	$ 59 820
Cash paid to suppliers and employees	(54 800)
Interest paid	(720)
Income taxes paid	(1 023)
NET CASH USED IN OPERATING ACTIVITIES	3 277
CASH FLOWS FROM INVESTING ACTIVITIES	
Purchase of shop fittings	(660)
Interest received	800
Dividends received	120
NET CASH USED IN INVESTING ACTIVITIES	260

CASH FLOWS FROM FINANCING ACTIVITIES

Proceeds from mortgage	900
Payment of loan	(1 900)
NET CASH USED IN FINANCING ACTIVITIES	(1 000)
NET INCREASE IN CASH AND CASH EQUIVALENTS	**2537**
Cash and cash equivalents at beginning of period	(2 280)
Cash and cash equivalents at end of period	257

23. *Consider the information below and answer the questions that follow.*

Harvest Vegan Restaurant Chain Ltd
Cash flow statement
For the year ended 30 June 2020

	$
CASH FLOWS FROM OPERATING ACTIVITIES	
Cash receipts from customers	160 000
Cash paid to suppliers and employees	(175 000)
Interest paid	(15 000)
NET CASH USED IN OPERATING ACTIVITIES	(30 000)
CASH FLOWS FROM INVESTING ACTIVITIES	
Proceeds from sale of motor vehicle	25 000
Payment for purchase of furniture and fittings	(22 000)
Interest received	3 000
NET CASH USED IN INVESTING ACTIVITIES	6 000
CASH FLOWS FROM FINANCING ACTIVITIES	
Payment of loan	(25 000)
Contribution from owner	20 000
Drawings	(45 000)
NET CASH USED IN FINANCING ACTIVITIES	(50 000)
NET DECREASE IN CASH AND CASH EQUIVALENTS	**(74 000)**
Cash and cash equivalents at beginning of period	**60 000**
Cash and cash equivalents at end of period	**(14 000)**

Harvest Vegan Restaurant Chain Ltd

Income Statement
For the year ended 30 June 2020

	$	$
Income		
Cash sales		160 000
Credit sales		290 000
		450 000
LESS: Cost of sales		220 000
Gross profit		**230 000**
ADD: OTHER INCOME		
Gain on sale of motor vehicle		20 000
Interest		3 000
		253 000

LESS: EXPENSES		
Marketing expenses		
Advertising	8 000	
Customer discount vouchers	25 000	
General expenses		
Wages	93 000	
Utilities	12 000	
Depreciation	4 000	
Distribution expenses		
Rent	36 000	
Cleaning	10 000	
Financial expenses		
Interest	14 000	202 000
PROFIT		**51 000**

From a discussion with Braden Luc, the managing director of the Harvest Vegan Restaurant Chain Ltd, you have discovered the following information about the business. The restaurants are located in very popular 'café strips' in the outer Perth suburbs, where it is predicted that the population will increase rapidly in the next year. In relation to the company, the loan has another two years of similar repayments required, the business premises requires a new coffee machine, and a Health Department notice has just been received requiring $5 000 worth of urgent renovations. Braden is willing to review all aspects of cash payments and receipts, and believes that some of the business expenses could be adjusted in response to the local environment.

A. Prioritise Braden's requirements and list your expectations for the business.

B. Using the 'Steps to follow in analysing the Cash Flow Statement' outlined in this chapter, complete a simple feasibility study.

C. Compare your analysis of the data with expectations, and outline an action plan for the Harvest Vegan Restaurant Chain Ltd.

Discussion question. Student answers will vary but should cover:

- The overall change in cash.
- Cash flows from operating, investing and financing activities.
- The internal and external environment in which the business is operating.
- Recommendations.

24. *Following is information for the public company* Plastic Fantastic Ltd *which manufactures children's toys for the Australian market.*

Plastic Fantastic Ltd
Balance Sheet as at 30 June:

	2021	**2022**
	$ 000's	**$ 000's**
ASSETS		
Cash equivalents	300	
Inventory	2 000	4 000
Prepaid advertising	300	500
Trade debtors	3 000	2 500
Factory	4 000	4 000
Accumulated depreciation – factory	(1 200)	(1 300)
Machinery	3 200	3 000
Accumulated depreciation – machinery	(500)	(700)
	11 100	**12 000**
LIABILITIES		
Overdraft		200
Trade creditors	2 500	2 100
Mortgage	2 000	1 950
Long-term borrowings	1 500	2 750
EQUITY		
General reserve	1 500	
Retained earnings	1 600	3 000
Share capital	2 000	2 000
	11 100	**12 000**

Plastic Fantastic Ltd
Income Statement (internal)
for the year ended 30 June 2022

	000's
Income	
Net sales	8 500
LESS: Cost of sales	6 500
Gross profit	**2 000**
ADD: Other income	
Interest	320
Dividends	190
	510
LESS: Other expenses	
ADMINISTRATIVE	
Advertising	290
Wages	570
	860

GENERAL	
Depreciation	300
Supplies	660
	960
FINANCIAL	
Interest	300
PROFIT BEFORE INCOME TAX	390
Income tax	117
PROFIT	**273**

Additional information:

- *All sales were on credit.*
- *All purchase and sales of non-current assets were for cash.*
- *During the year, dividends were paid in cash. The balance of General Reserve was transferred to Retained Earnings.*

Required:

A. *Reconstruct the Retained Earnings, Trade Creditors and relevant income/expense accounts, to determine the cash paid or received for specific accounts.*

B. *Calculate the Cash Receipts from Customers and Cash Paid to Suppliers and Employees.*

C. *Complete a Cash flow statement in external reporting format for Plastic Fantastic Ltd for the year ended 30 June 2022.*

D. *Interpret the movements in the cash flow items.*

A.

Prepaid advertising (A)

Opening balance	300 00	Advertising expense	290 000
Cash at bank	**49 000**	Closing balance	500 000

B.
Cash receipts from customers = Opening debtors + Net credit sales – Closing debtors
= 3000 000 + 8500 000 – 2500 000
= $9 000 000

Cash paid to suppliers for purchase of inventory
= Cost of sales + Change in inventory + Change in creditors
= Cost of sales + (Closing inventory – Opening inventory) + (Opening creditors – Closing creditors)
= 6 500 000 + (4 000 000 – 2 000 000) + (2500 000 – 2100 000)
= $8900 000

Cash paid to suppliers and employees = (creditors) + wages + advertising + supplies
= 8900 000 + 570 000 + 490 000 + 660 000
= $10 620 000

Retained earnings (Eq)

Dividends	190	Opening balance	1600
		Profit	273
Closing balance	3000	General reserve	1500
	3373		**3373**

C.

Plastic Fantastic Ltd
Cash Flow Statement
For the period ended 30 June 2022

Cash flows from operating activities	
Cash receipts from customers	9000
Cash paid to suppliers and employees	(10620)
Cash generated from operations	(1620)
Interest paid	(300)
Income taxes paid	(117)
Net cash from operating activities	**(2037)**
Cash flows from investing activities	
Sale of machinery	200
Interest received	320
Dividends received	190
Net cash from investing activities	**710**
Cash flows from financing activities	
Repayment of mortgage	(50)
Proceeds from borrowings	1250
Dividends paid	(373)
Net cash from financing activities	**827**
NET INCREASE IN CASH AND CASH EQUIVALENTS	(500)
Cash and cash equivalents at beginning of period	300
Cash and cash equivalents at end of period	(200)

25. Ski Escapades Ltd *has provided you with the following information.*

Ski Escapades Ltd
Balance Sheet as at 30 June

	2022	2023
	$ 000's	$ 000's
ASSETS		
Cash equivalents		494
Inventory	600	650
Prepaid insurance	100	120
Trade debtors	700	870
Plant and equipment	3 500	3 500
Accumulated depreciation – plant and equipment	(600)	(900)
Motor vehicles	800	780
Accumulated depreciation – motor vehicles	(600)	(700)
	4 500	**4 814**
LIABILITIES		
Overdraft	60	
Trade creditors	660	630
Short-term borrowings	30	15
Long-term borrowings	100	100
EQUITY		
General reserve	550	550
Retained earnings	700	1 119
Share capital	2 400	2 400
	4 500	**4 814**

Ski Escapades Ltd
Income Statement for the year ended 30 June 2023

	$ 000's
Income	
Net sales	9 000
LESS: Cost of sales	7 000
Gross profit	**2 000**
ADD: Other income	
Interest	400
Dividends	200
	600
LESS: Other expenses	
ADMINISTRATIVE	
Insurance	300
Wages	500
	800

GENERAL	
Depreciation	400
Supplies	500
	900
FINANCIAL	
Interest	302
PROFIT BEFORE INCOME TAX	598
Income tax	179.4
PROFIT	**418.6**

Additional information:

- *During the year, a motor vehicle with a carrying amount of $70 000 was sold.*
- *During the year, additional motor vehicles were purchased for cash.*

Required:

A. *Reconstruct the Retained Earnings, Trade Creditors and relevant income/expense accounts, to determine the cash paid or received for specific accounts.*

B. *Calculate the Cash Receipts from Customers and Cash Paid to Suppliers and Employees.*

C. *Complete a Cash Flow Statement in external reporting format for Ski Escapades Ltd for the year ended 30 June 2023.*

D. *Interpret the movements in the cash flow items.*

A.

Loss on sale = Proceeds – Carrying amount
-2 000 = Proceeds – 70 000
Proceeds = $68 000

Motor Vehicles

1 May	Opening balance	800 000	1 May	Sale of asset	70 000
	Cash at bank	**50 000**		Closing balance	780 000

Prepaid Insurance (A)

Opening balance	100 000	Insurance expense	300 000
Cash at bank	**320 000**	Closing balance	120 000

B.
Cash receipts from customers:
= 700 000 + 9000 000 – 870 000
= $8830 000

Inventory

Opening balance	600 000	Cost of sales	7 000 000
Trade creditors	**7 050 000**	Closing balance	650 000

Trade creditors

Cash at bank	**7 080 000**	Opening balance	660 000
Closing balance	630 000	Inventory	7 050 000

Cash paid to suppliers and employees
= 7 080 000 + 320 000 + 500 000 + 500 000
= $8400 000

C.
Ski Escapades Ltd
Cash Flow Statement
For the period ended 30 June 2023

Cash flows from operating activities	
Cash receipts from customers	8830
Cash paid to suppliers and employees	(8400)
Cash generated from operations	430
Interest paid	(300)
Income taxes paid	(179)
Net cash from operating activities	(49)
Cash flows from investing activities	
Sale of motor vehicle	68
Purchase of vehicles	(50)
Interest received	400
Dividends received	200
Net cash from investing activities	618
Cash flows from financing activities	
Repayment of borrowings	(15)
Net cash from financing activities	(15)
Net increase in cash and cash equivalents	**554**
Cash and cash equivalents at beginning of period	(60)
Cash and cash equivalents at end of period	494

Extended answer questions

1. *You are the chief financial officer for a large Australian company. You have recently given a summary report to the board of directors, showing a negative operating cashflow of $4 million for the last quarter that was mainly the impact of a large decrease in cash and cash equivalents. The company has reported a profit of $0.7 million for the same quarter. You have stated to the chief executive officer (CEO) that you are concerned that the company might go out of business within the next year. The CEO has asked you to prepare a report for the board.*

Write an essay explaining how it is possible for a company to be profitable, yet have a large negative cashflow. Justify why it is possible for a company in this situation to rapidly go out of business.

Students should address the following:

- Definition of cash and cash equivalents
- Explanation of the difference between profitability and liquidity, using examples
- Comparison of the different information that is revealed through each of the different financial statements: Balance Sheet (Statement of Financial Position), Profit and Loss Statement (Statement of Financial Performance) and Cash Flow Statement
- Clearly explain the advantage that the Cash Flow Statement has over other financial reports when revealing information about the cash situation of the company
- Outline the reasons why a company will go out of business if it has high profits but cannot repay short term debt.

2. *Write an essay describing how the Cash Flow Statement incorporates information found in both the Profit and loss statement and Statement of financial position. Include a description of the purpose of the Cash flow statement and its usefulness for the managers of a company.*

Concepts that students should cover:

Statement of Profit or Loss information derived from the cash inflows and cash outflows from income and expense operating items. These are from the principal revenue producing activities of the company and other activities that are not investing or financing activities. They tend to mainly be transactions associated with the income and expenses of the company.

Statement of Financial Position information is presented in the investing and financing sections. The cash acquisition and disposal of long-term assets and other investments not included in cash equivalents tend to be transactions affecting the non-current assets of the company.

Financing activities are activities that result in changes in the size and composition of the capital and borrowings of the company. In other words they are transactions that affect the non-current liabilities and equity of the company.

Purposes of Cash Flow Statement:

- Evaluate change in net assets
- Consider financial structure and liquidity – the ability to repay short term debt
- Examine ability to affect cash inflows and cash outflows in response to the changing external environmental conditions
- Evaluate the ability of the company to generate cash
- Compare the cash flows over time, and examine the impact of different accounting treatments.

CHAPTER 9: ANALYSIS

Questions

1. *Use the following Statement of Financial Position extracts to calculate liquidity ratios for these companies. Write all answers as both a percentage and a ratio.*

A. **Apple Ltd**
Balance Sheet (extract)

	$
Property, plant and equipment =	300 000
Cash in hand =	4 000
Overdraft =	32 000
Trade receivables =	100 000
Stock =	184 000
Prepaid rent =	9 600
Vehicles =	120 000
Trade payables =	264 000
Loan =	303 000
Equity =	**?**

B. **Pear Ltd**
Balance Sheet (extract)

	$
Cash and equivalents =	33 000
Prepaid insurance =	6 900
Debtors =	135 000
Prepaid rent =	16 800
Accrued wages =	43 500
Creditors =	228 000
Delivery vans =	215 000
Inventory =	320 000
Furniture and fittings =	1 000 000
Loan =	318 000
Mortgage =	2 402 700
Factory building =	1 020 000
Machinery =	1 680 000

C. **Mango Ltd**
Balance Sheet (extract)

	$
Current assets* =	3 225 000
Non-current assets =	1 600 000
Current liabilities# =	2 002 500
Non-current liabilities =	2 800 000

* Including prepaid advertising of $20 000
\# Including overdraft of $50 000

D. Compare the results for these businesses. Which has the best results? Justify your answer.

E. How does your answer to ‘D’ change if *Mango Ltd* is situated in the service industry as compared to the other two companies from the retail industry?

1. Liquidity ratios:

	WORKING CAPITAL RATIO	QUICK RATIO
A. Apple Ltd	= <u>4000 + 100000 + 184000 + 9600</u> 32000 +264000 = 1.00: 1 or 100%	= <u>4000 +100000</u> 264000 = 0.39: 1 or 39%
B. Pear Ltd	= <u>33000 + 6900 + 135000 + 16800 + 320000</u> 43500 + 228000 = 188: 1 or 188%	= <u>33000 +135000</u> 43500 +228000 = 0.62: 1 or 62%
C. Mango Ltd	= <u>3 225 000</u> 2 002 500 = 1.61: 1 or 161%	= <u>3 205 000</u> 1 952 500 =1.64: 1 or 164%

E. In a service industry liquidity ratios can be lower and still acceptable because it is more difficult to sell inventory quickly (if at all).

2. *Consider the following trend information showing final ratios that were reported for a company over the last five years. Interpret the trends revealed in this information.*

Ratio	Year 1	Year 2	Year 3	Year 4	Year 5
Working capital	202%	180%	190%	150%	102%
Quick asset	110%	108%	100%	70%	60%

This solution requires the input of the teacher in response to the assumptions made by the student.

A correct answer must have a clear case presented to back up the answer given. The general understanding expressed would be that the decline in these two liquidity ratios to well below the ideal is a negative trend which needs to be reversed.

3. *Define 'liquidity' and explain its importance to a business.*

Liquidity analysis requires the comparison of current assets with current liabilities. It enables analysis of the ability of the company to meet debts as they fall due. Creditors and potential lenders to the company would be most concerned about liquidity ratios.

4. *Compare the information that can be obtained from the working capital ratio with that obtained from the quick asset ratio. In what situations would a creditor of a company find the quick ratio more useful, and why?*

Quick asset ratio removes current assets that could take a few weeks to convert into cash, and reduces the ratio focus on debtor and creditor information.

5. *How is it possible for a company with poor liquidity to have good profitability?*

Liquidity is the ability of the company to repay short term debt as it falls due and as such relies on the business to have cash on hand and a positive cash flow. Profits can be recorded because of the impact of non-cash items in the Statement of Profit or Loss and Other Comprehensive Income – for example high credit sales and low bad debts. Profit is not necessarily cash.

6. *A company has a quick ratio of 99%, and the directors have concluded that it is in an optimal position to repay short term debt. Is this correct? Explain.*

A quick ratio of 100% or above would indicate an immediate ability to repay any very short term debts that are highly liquid. 99% could not in any way be described as 'ideal', perhaps it is a positive indication – dependent upon if it has increased or decreased from previous results.

7. *Calculate efficiency ratios for the following companies, using the extracts provided from their Trial Balances. Write all answers in the correct format.*

A. **Points Ltd**

	$
Credit sales =	2 200 000
Cash sales =	250 000
Credit purchases =	2 060 000
Cash purchases =	113 000
Opening debtors =	84 000
Closing debtors =	109 000
Opening creditors =	55 000
Closing creditors =	145 000
Opening inventory =	25 000
Closing inventory =	424 000
Cost of sales =	1 250 000

B. **Myers Ltd**

	$
Sales =	3 560 000
Purchases of inventory at cost =	2 560 000
Debtors =	900 000
Creditors =	1 340 000
Inventory =	3 080 000
Cost of sales =	2 100 000

(All sales and purchases of inventory are done on credit)

C. *Compare the results for the two businesses. Which is being run more efficiently and making the best use of its resources? Explain.*

Efficiency ratios

	DEBTORS COLLECTION PERIOD	DEBTORS TURNOVER	STOCK TURNOVER	STOCK COLLECTION PERIOD
A. Points Ltd	$= \frac{(84000 + 109000)/2}{2200000} \times 365$ = 16 days	$= \frac{2200000}{96500}$ = 23 times per year	$= \frac{1\,250\,000}{(25\,000 + 424\,000)/2}$ = 5.57 times per year	$= \frac{365}{5.57}$ = 65 days
B. Myers Ltd	$= \frac{900\,000}{3\,560\,000} \times 365$ = 92 days = 3 months	$= \frac{3\,560\,000}{900\,000}$ = 3.9 times per year	$= \frac{2\,100\,000}{3\,080\,000}$ = 0.7 times per year	$= \frac{365}{0.7}$ = 535 days

8. *Consider the following information and final ratios that were reported for a company over the last five years. Interpret the trends revealed in this information.*

Ratio	Year 1	Year 2	Year 3	Year 4	Year 5
Debtors collection	20 days	30 days	31 days	40 days	60 days
Stock turnover	5 times	4.7 times	4.8 times	3.9 times	3.3 times

This solution requires the input of the teacher in response to the assumptions made by the student. A correct answer must have a clear case presented to back up the answer given.

The general understanding expressed would be that debtors collection is increasing to an unacceptable level, no matter the type of business. The stock turnover might be quite acceptable – different types of stock must be discussed here. Taken together the increased time to pay as well as less frequent turnover are not usually positive trends.

9. *What does the debtors collection period measure?*

The debtors collection period is the number of days, on average, that it takes for a debtor to pay the company the amount owed on a credit sale.

10. *What does an increase in the stock turnover ratio generally indicate to the management of the company?*

An increase in stock turnover indicates that stock is selling more quickly. This means that inventory does not need to be stored for longer and there may be a need to revise delivery and ordering to ensure that customer orders can be met in time. Inventory management is probably improving and there will be less expired stock. There might be a subsequent improvement in the payments from debtors so this efficiency ratio might also improve.

11. *Calculate the profitability ratios for the following companies, and write all answers as both a percentage and a ratio. Compare the company results.*

A. **Rose Ltd**
Statement of Profit or Loss and Other Comprehensive Income (Extract)

	$
Sales	800 000
Cost of sales	490 000
Administrative expenses	101 000
Selling expenses	90 000
Finance expenses	33 000
Income tax	29 000
Average assets	450 000

B. **Thorne Ltd**
Statement of Profit or Loss and Other Comprehensive Income (Extract)

	$
Sales	909 000
Cost of sales	505 000
Gross profit	**404 000**
Other income	100 000
Other expenses*	303 000
Profit	**201 000**
Income tax	67 000
Profit after income tax	**134 000**

*Includes $101 000 interest expense.

Statement of Financial Position (Extract)

Opening assets	2 000 000
Closing assets	1 900 000

Profitability ratios:

	PROFIT RATIO	RETURN ON ASSETS	TIMES INTEREST EARNED
A. Rose Ltd	= $\frac{57\,000}{800\,000}$ = 0.07: 1 or 7%	= $\frac{86\,000 + 33\,000}{450\,000}$ = 0.26: 1 or 26%	= $\frac{86\,000 + 33\,000}{33\,000}$ = 3.61 times
B. Thorne Ltd	= $\frac{134\,000}{909\,000}$ = 0.15: 1 or 15%	= $\frac{201\,000 + 101\,000}{(2\,000\,000 + 1\,900\,000)/2}$ = 0.15: 1 or 15%	= $\frac{201\,000 + 101\,000}{101\,000}$ = 2.99 times

12. *The following information has been provided to you by the directors of a phone retail company. Information is provided in THOUSANDS.*

YEAR:	**2025**	**2026**
	$000	**$000**
Sales	66 000	77 000
Gross profit	19 000	31 000
Financial expenses	11 000	6 500
Profit	(3 000)	10 000
Average assets	150 000	149 000

Average ratios for the phone retail industry have been reported as follows:

- *Profit ratio = 27%*
- *Times interest earned = 7%*
- *Rate of return on assets = 13%*

The directors budgeted to achieve a profit of $2 000 000 in 2025 and $5 000 000 in 2026.

Ratio results in 2024 were 75% of the industry average ratios reported above.

A. Calculate the following ratios for 2025 and 2026:

- *profit*
- *times interest earned*
- *rate of return on assets*

B. Interpret the ratios. In your analysis, use each of the following methods of comparison:

- *industry averages*
- *budgeted profit*
- *comparison over time.*

	2025	**2026**
A.	Profit ratio:	
	$= \dfrac{(3\ 000\ 000)}{66\ 000\ 000}$	$= \dfrac{7\ 000\ 000}{77\ 000\ 000}$
	= -4.5%	= 9.0%
B.	Times interest earned:	
	$= \dfrac{(3\ 000\ 000) + 5\ 500\ 000}{5\ 500\ 000}$	$= \dfrac{10\ 000\ 000 + 3\ 250\ 000}{3\ 250\ 000}$
	= 0.45 times	= 4.07 times
C.	Rate of return on assets:	
	$= \dfrac{(3\ 000\ 000) + 5\ 500\ 000}{150\ 000\ 000}$	$= \dfrac{10\ 000\ 000 + 3\ 250\ 000}{149\ 000\ 000}$
	= 2%	= 8.9%

13. *Consider the following information and final ratios that were reported for a company over the last five years. Interpret the trends revealed in this information.*

Ratio	Year 1	Year 2	Year 3	Year 4	Year 5
Profit	- 4%	10%	16%	11%	17%
Times interest earned	-1.0	5.0	6.0	5.5	7.4
Return on assets	0.11: 1.0	0.12: 1.0	0.17: 1.0	0.18: 1.0	0.18: 1.0

In their answer students must discuss the assumptions made when analysing the trend data as this will affect the argument put forward.

14. *The directors of* Snakes Ltd *are applying for a loan to purchase machinery for their workshop. Following is information taken from this year's financial statements.*

Snakes Ltd
Extract from financial statements

	$
Sales	1 200 000
Cost of sales	750 000
Financial expenses	55 000
Selling expenses	150 000
General expenses	92 000
Assets	600 000
Liabilities	490 000
Equity	110 000

A. *Calculate the following ratios:*

- *profit*
- *times interest earned*
- *return on assets.*

Assume income tax rate of 30%

$$\text{Profit ratio} = \frac{198\,900}{1\,200\,000} = 16.6\%$$

$$\text{Times interest earned} = \frac{198\,900 + 55\,000}{55\,000} = 4.6 \text{ times}$$

$$\text{Return on assets} = \frac{198\,900 + 55\,000}{600\,000} = 42.3\%$$

B. Consider how these ratios might change if a loan of $300 000 was approved for the business, and if over the following year this also resulted in an increase in sales of 13% and an increase in cost of sales of 8%. What was the effect?

In their response, students should show an understanding of the difference between an increase in liabilities (from the loan) and an increase in profits (from sales). They should outline how profit ratios can increase over time, while a business might be actually entering a poor gearing situation because of increased debt, and committed to increasing interest repayments.

15. What does the profit margin enable investigation of?

The profit margin compares the total profit to net revenues, calculating the profit earned from each dollar of revenue. A positive result indicates that the company has not made a loss and that there are earnings arising from the use of the assets of the company.

16. How will the return on assets and the profit margin be affected if a company undergoes a change in accounting policy by adjusting depreciation methods (from reducing balance to the straight line method?)

If depreciation is a significant expense for the company, moving to straight line depreciation is likely to result in a more even amount of depreciation each year, rather than a gradually declining amount over the years. This could result in more consistent profits over time as the depreciation expense will not be changing. **Profitability ratios could appear more stable.**

17. If all three profitability ratios are increasing, what might this indicate about the company?

Increasing profitability ratios indicate more efficient use of assets to generate a proportionally higher profit for the company.

18. Calculate the debt to equity ratios for these companies, and comment on their leverage.

A. Equity $6 000 000, liabilities $9 000 000

150%

B. Equity $6 000 000, liabilities $3 000 000

50%

C. Non-current liabilities $2 360 000, current liabilities $2 000 000, reserves $1 500 000, share capital $3 500 000

87.2%

D. Liabilities $2 700 000, share capital $1800 000, assets $4500 000

150%

E. Assets $1 380 000, liabilities $615 000

80.4%

19. *Following is financial information for the company* Tiger Ltd *for the last three financial years. Information is shown in thousands.*

	2025	**2026**	**2027**
	$	**$**	**$**
Current liabilities	8 000	9 000	8 500
Non-current liabilities	0	30 000	30 000
Equity	8 000	39 000	38 500
Profit (excluding interest)	3 000	6 000	2 500
Interest expense	0	1 800	2 100

A. *Calculate the leverage and relevant profitability ratios for 2026 and 2027.*

B. *What is your advice to the directors on how best to manage leverage into the future?*

	2026	**2027**
A.		
Leverage	$= \frac{9\,000\,000 + 30\,000\,000}{39\,000\,000}$ = 100%	$= \frac{8\,500\,000 + 30\,000\,000}{38\,500\,000}$ = 100%
Return on assets	$= \frac{6\,000\,000 + 1\,800\,000}{(16\,000\,000 + 78\,000\,000)/2}$ = 16.6 %	$= \frac{2\,500\,000 + 2\,100\,000}{(78\,000\,000 + 77\,000\,000)/2}$ = 5.9%
Times interest earned	$= \frac{6\,000\,000 + 1\,800\,000}{1\,800\,000}$ = 4.3 times	$= \frac{2\,500\,000 + 2\,100\,000}{2\,100\,000}$ = 2.2 times

20. *The chief financial officer of* Monkey Ltd *is considering increasing the company's investment in furniture and fittings by purchasing $200 000 of fittings outright.*

Information from this year's financial statements follows:

Monkey Ltd
Extract from financial statements

	$
Current liabilities	5 000 000
Non-current liabilities	13 050 000
Equity	17 040 000

A. *Calculate the company's leverage before and after the investment decision.*

Leverage before $= \frac{18\,050\,000}{17\,040\,000}$

= 106%

Leverage after $= \frac{18\,050\,000}{17\,040\,000}$

= 106%

B. *How would the ratio change if the investment in furniture and fittings was done using a loan, rather than an outright purchase?*

Leverage with loan $= \frac{18\,250\,000}{17\,040\,000}$

= 107%

21. *Consider these leverage ratios that were reported for a company over the last five years. Interpret the trends revealed in this information.*

Year 1	Year 2	Year 3	Year 4	Year 5
2.00: 1.0	1.87: 1.0	1.65: 1.0	1.01: 1.0	0.70: 1.0

This solution requires the input of the teacher in response to all assumptions that must be made by the student. A correct answer must have a clear case presented to back up the answer given.

The general understanding expressed would be that gearing is decreased substantially, and this might be a positive trend but it is very dependent upon the level of external interest rates and the future plans of the company for borrowings.

22. *Define 'gearing', and explain the different types of internal and external financing available to a company.*

Gearing is the relationship between the debt and the equity of a business, measured by the debt to equity ratio. If a business has high gearing, there is a high level of borrowed external funds compared to internal equity. A low gearing means that there is a low portion of external debt compared to internally generated equity.

23. *What impact will an increase in interest rates have on a company with high gearing?*

When more funds are provided from external debt, there is a requirement to repay this debt at a specific point in time, as well as to pay interest, and this places pressure on the business. The pressure can affect the cash flow of the business.

A business with high gearing may be able to meet interest payments, especially useful if interest rates are low. Unfortunately in times of high interest rates a lot of pressure is placed on a heavily geared company as interest payments cannot be deferred.

24. *Calculate market ratios for the following companies, and write all answers using the correct format. Compare the company results.*

A. *Profit $2 000 000, preference dividends $50 000, ordinary dividends $250 000. Issued ordinary shares 800 000 selling on the share market at $5.00.*

B. *Profit $5 460 000, preference dividends $102 000, ordinary dividends $607 000. Issued ordinary shares at start of period 900 000, with 200 000 more being issued three months into the period. At the end of the period ordinary shares are selling at $9.00.*

C. *Loss $50 000, preference dividends none, ordinary dividends $20 000. Issued ordinary shares 1 000 000 selling at $2.00 per share.*

Market ratios

	EARNINGS PER SHARE	PRICE EARNINGS RATIO	DIVIDEND YIELD
A.	= 2 000 000 – 50 000 / 800 000 = $2.43 per share_	= 5.00 / 2.43 = 2.06 times	= 0.31 / 5.00 = 6%
B.	= 3 822 000 – 102 000 / (900 000 x 3/12) + (1 100 000 x 9/12) = $3.54 per share	= 9.00 / 3.54 = 2.54 times	= 0.55 / 9.00 = 6%
C.	= -500 000 – 0 / 1 000 000 = -$0.50 per share	= -0.50 / 2.00 = -0.25	= 0.02 / 2.00 = 1%

25. *Consider the following information and final ratios that were reported for a company over the last five years. Interpret the trends revealed in this information.*

Ratio	Year 1	Year 2	Year 3	Year 4	Year 5
Earnings per share	$0.60	$0.50	$0.70	$1.10	$1.05
Price/Earnings ratio	0.7 times	0.6 times	0.7 times	0.9 times	0.9 times
Dividend yield	5%	5%	5%	7%	7%

Discussion question, requiring the input of the teacher in response to the assumptions made by the student. A correct answer must have a clear case presented to back up the answer given.

The general understanding expressed would be that these market ratios appear to be moving in a positive direction – for the shareholder. The company may not wish to be indicating such trends to the market however, depending on plans for expansion or for future share issues.

26. *Two different companies have shares that are currently earning a $7 per share annual dividend. Company A shares trade at $4 per share, while Company B shares are selling at $11 per share. Based only on dividend yield, which company is the better investment, and why?*

Company A has a much higher dividend yield which will interest a shareholder who is investing only on the basis of the return on investment in the company.

27. *Company C has a price/earnings ratio of 10, and Company D has a ratio of 15. Which company has better prospects for future growth and expansion, and why?*

The lower price earning ratio of Company C indicates that investors in that company will receive a return on their capital investment more quickly, as there is a higher proportional dividend. However, Company D has better prospects for the future as it has a higher ratio. All available information about the two companies needs to be studied to determine the likelihood of positive future earnings.

28. *The directors of* Spencer and Lewis Ltd *own a business that manufactures hats. They are considering taking out a loan to expand their business, because they are currently manufacturing at full capacity and have unfilled orders. They own the factory and rent several city shops.*

    Calculate the, liquidity, efficiency, profitability and stability ratios for 2022 and 2023, and advise the directors on the loan decision.

Spencer and Lewis Ltd
Statement of Profit or Loss and other Comprehensive Income (internal)

For the years ended	2021	2022	2023
	$000	$000	$000
INCOME			
Sales	29 500	28 000	27 000
Rent from investment property	500	500	500
Interest	300	400	350
EXPENSES			
Cost of sales	11 500	9 300	9 700
Interest	1 000	1 000	1 000
Depreciation	2 000	2 000	2 000

Delivery costs	1 700	1 800	2 000
Utilities	600	550	500
Wages	8 000	9 150	10 350
Consumables	1 600	1 900	2 050
Rent expense	2 400	2 500	2 600

Spencer and Lewis Ltd
Statement of Financial Position (internal)

As at 30 June	**2021**	**2022**	**2023**
	$000	**$000**	**$000**
ASSETS			
Cash and equivalents	4 050	2 150	70
Inventory	10 000	9 800	8 800
Prepaid rent	200	200	300
Trade debtors	5 300	6 400	6 350
Cash management accounts	1 200	1 000	500
Equipment	3 100	3 100	3 100
Vehicles	5 000	5 000	5 000
Machinery	20 000	20 000	20 000
Factory	100 000	100 000	100 000
Accumulated depreciation	(24 000)	(26 000)	(28 000)
LIABILITIES			
Overdraft	0	0	300
Accrued wages	400	600	800
Trade creditors	6 000	6 500	7 000
Short term loans	8 000	7 000	6 000
Long term loans	15 000	14 000	13 000
Mortgage	50 000	50 000	50 000
EQUITY			
Share capital	36 000	36 000	36 000
Reserves	4 950	2 350	170
Retained earnings	4 500	5 200	2 850

RATIO	**2022**	**2023**
Working capital	139%	114%
Quick asset	68%	50%
Debtors collection	76 days	4 days
Inventory turnover	0.94 times	1.04 times
Profit margin	2.5%	-8.7%
Rate of return on assets	1.4%	-1.1%
Debt to equity	179%	197%

29. *Following are ratios for the company* Green Solutions Ltd *for the three year period ended 30 June 2020, as well as the industry average for each ratio in 2020. Analyse these results.*

Ratio	2018	2019	2020	Industry average 2020
Current ratio	200%	180%	195%	190%
Quick ratio	105%	102%	104%	103%
Price earnings ratio	16	13	10	19
Times interest earned	10	9	7	8.5
Earnings per share	20%	15%	10%	15%
Gross profit ratio	25%	24%	24%	25%
Operating profit margin	10%	8%	6%	8%

Discussion question.

30. *The following information has been extracted from the annual report of* Mikey Ltd*.*

Mikey Ltd
Balance Sheet/Statement of Financial Position as at ...

	2023 $	2024 $
CURRENT ASSETS		
Cash and cash equivalents	14 000	36 000
Trade and other receivables	55 000	69 000
Inventories	270 000	260 000
Other current assets	102 000	105 000
Total Current Assets	441 000	470 000
	2023 $	**2024 $**
NON-CURRENT ASSETS		
Investments	198 000	196 000
Property, plant and equipment (1)	904 000	920 000
Intangible assets	300 000	300 000
Other non-current assets	3 000	4 000
Total Non-Current Assets	1 405 000	1 420 000
Total Assets	1 846 000	1 890 000
EQUITIES		
CURRENT LIABILITIES		
Current tax liability	4 000	6 000
Trade and other payables	89 000	87 000
Short-term loans	110 000	104 000
Other current liabilities	17 000	12 000
Total Current Liabilities	220 000	209 000
NON-CURRENT LIABILITIES		
Long-term borrowings	710 000	690 500
Mortgage	645 000	656 000
Total Non-Current Liabilities	1 355 000	1 346 500
Total Liabilities	1 575 000	1 555 500
Net Assets	271 000	334 500
EQUITY		
Share capital	250 000	300 000
Reserves	1 000	1 000
Retained earnings	20 000	33 500
Total Equity	271 000	334 500

Mikey Ltd
Income Statement for the year ended 30 June 2024

	$
Sales (all on credit)	411 000
Cost of sales	278 000
GROSS PROFIT	133 000
Other income	45 000
Administration expenses	62 000
Selling expenses	53 000
Finance costs	33 000
PROFIT BEFORE TAX	30 000
Income tax	9 000
PROFIT	21 000

Mikey Ltd
Statement of Changes in Equity for the year ended 30 June 2024

	$
SHARE CAPITAL	
Ordinary shares	
Balance at 1 July 2023	150 000
Issue of share capital	50 000
Balance at 30 June 2024	200 000
Preference shares	
Balance at 1 July 2023	100 000
Balance at 30 June 2024	100 000
RETAINED EARNINGS	
Balance as at 1 July 2023	20 000
ADD: Profit	21 000
LESS: Dividends – ordinary	2 500
Dividends – preference	5 000
Balance as at 30 June 2024	33 500

Note to the financial statements:

Number of shares issued at end of	**2023**	**2024**
Ordinary	150 000	200 000
Preference	50 000	50 000

Required:

Calculate market, liquidity, efficiency, profitability and leverage ratios for the company for 2014 and comment on the viability of the company issuing more ordinary shares for capital raising.

Workings

Market price of ordinary shares $= \frac{200\,000}{200\,000} =$ \$1.00

Annual ordinary share dividend $= \frac{2\,500}{200\,000} =$ 1.25c per share

RATIO	CALCULATION	RESULT
Working capital	$\frac{470\ 000}{209\ 000}$	225%
Quick asset		100%
Debtor's collection	$\frac{(55\ 000 + 69\ 000)\ /2}{411\ 000} \times 365$	55 days
Inventory turnover	$\frac{278\ 000}{(270\ 000 + 260\ 000)\ /2}$	1.05 times per year
Profit	$\frac{21\ 000}{411\ 000}$	5.1%
Rate of return on assets	$\frac{30\ 000 + 33\ 000}{(1\ 846\ 000 + 1\ 890\ 000)\ /2}$	3.4%
Times interest earned	$\frac{30\ 000 + 33\ 000}{33\ 000}$	1.91 times
Debt to equity	$\frac{1\ 555\ 500}{334\ 500}$	465%
Earnings per share	$\frac{21\ 000 - 5\ 000}{(150\ 000 \times 6/12) + (200\ 000 \times 6/12)}$	9c per share
Price/ earnings ratio	$\frac{1{,}00}{0.09}$	11.1 times
Dividend yield	$\frac{0.0125}{1.00}$	1.25 %

31. *The following information has been extracted from the annual report of* Active Ltd.

Active Ltd
Statement of Financial Position as at ...

	2022	2023
	$	$
CURRENT ASSETS		
Cash and cash equivalents	40 000	37 000
Trade and other receivables	82 000	73 000
Inventories	301 000	291 000
Other current assets	110 000	108 000
Total Current Assets	533 000	509 000
NON-CURRENT ASSETS		
Investments	198 000	170 200
Property, plant and equipment (1)	909 000	909 000
Intangible assets	200 000	200 000
Other non-current assets	5 200	5 000
Total Non-Current Assets	1 312 200	1 284 200
Total Assets	1 845 200	1 793 200
EQUITIES		
CURRENT LIABILITIES		
Current tax liability	9 000	10 000
Trade and other payables	90 000	99 000
Short-term loans	101 800	116 000
Other current liabilities	15 400	17 000
Total Current Liabilities	216 200	242 000
NON-CURRENT LIABILITIES		
Long-term borrowings	690 000	650 000
Mortgage	700 000	670 000
Total Non-Current Liabilities	1 390 000	1 320 000
Total Liabilities	1 606 200	1 562 000
Net Assets	239 000	231 200
EQUITY		
Share capital	200 000	200 000
Reserves	3 000	3 000
Retained earnings	36 000	28 200
Total Equity	239 000	231 200

Active Ltd
Statement of Profit or Loss and Other Comprehensive income
For the year ended 30 June 2023

Sales	1 020 000
Cost of sales	872 000
GROSS PROFIT	148 000
Other income	23 000
Administration expenses	72 000
Selling expenses	51 000
Interest expenses	42 000
PROFIT BEFORE TAX	6 000
Income tax	1 800
PROFIT	4 200

Active Ltd
Statement of Changes in Equity for the year ended 30 June 2023

	$
SHARE CAPITAL	
Ordinary shares	
Balance at 1 July 2022	100 000
Balance at 30 June 2023	100 000
Preference shares	
Balance at 1 July 2022	100 000
Balance at 30 June 2023	100 000
RETAINED EARNINGS	
Balance as at 1 July 2022	36 000
ADD: Profit	4 200
LESS: Dividends – Ordinary	4 000
Dividends – Preference	8 000
Balance as at 30 June 2023	28 200

Note to the financial statements:

Number of shares issued at end of	**2022**	**2023**
Ordinary	200 000	200 000
Preference	20 000	20 000

Required:

Calculate market, liquidity, efficiency, profitability and leverage ratios for the company, and discuss how attractive an investment option this company might be (or not be) to a potential investor.

A. Workings

Price of each ordinary share = $\frac{1\,000\,000}{2\,000\,000}$

= 50c

Ordinary share dividend = $\frac{4\,000}{200\,000}$

= 2c per share

RATIO	CALCULATION	RESULT
Working capital	509 000 / 242 000	210%
Quick asset	(509 000 – 291 000) / 242 000	91%
Debtor's collection	(82 000 + 73 000) /2 / 1 020 000 x 365	27.7 days
Inventory turnover	8 720 000 / (301 000 + 291 000) /2	29.5 times per year
Profit	4 200 / 1 020 000	0.4%
Rate of return on assets	6 000 + 42 000 / (1 845 200 + 1 793 200) /2	2.6%
Times interest earned	(6 000 + 42 000) / 42 000	1.14 times
Debt to equity	1 562 000 / 231 200	675%
Earnings per share	(4 200 – 8 000) / 200 000	-1.9c per share
Price/ earnings ratio	0.50 / -0.019	-26 times
Dividend yield	0.02 / 0.50	4%

B.

A negative price/earnings ratio can occur if the earnings per share are negative, due to a greater proportion of preference dividends being paid compared to profit after income tax or due to a loss being made. This results in making the earnings per share negative. The consequence is that the company is unlikely to report this ratio. The implication is that the company is losing money so there is no incentive to report. The most likely outcome is that Active Ltd will report 'not applicable' for its price/earnings ratio in the company financial statements.

32. *The following information has been extracted from the annual report of* Jelly Babies Ltd.

Jelly Babies Ltd
Balance Sheet/ Statement of Financial Position as at …

	2021	2022
	$	$
CURRENT ASSETS		
Cash and cash equivalents	50 000	49 000
Trade and other receivables	80 000	85 000
Inventories	310 000	360 800
Other current assets	50 000	56 000
Total Current Assets	490 000	550 800
NON-CURRENT ASSETS		
Investments	203 000	209 000
Property, plant and equipment (1)	2 200 000	2 400 000
Intangible assets	340 000	373 000
Other non-current assets	32 000	40 000
Total Non-Current Assets	2 775 000	3 022 000
Total Assets	3 265 000	3 572 800
EQUITIES		
CURRENT LIABILITIES		
Current tax liability	50 000	40 000
Trade and other payables	202 000	98 000
Short-term loans	220 000	890 00
Other current liabilities	30 000	40 000
Total Current Liabilities	502 000	267 000
NON-CURRENT LIABILITIES		
Long-term borrowings	810 000	902 000
Mortgage	900 000	720 000
Total Non-Current Liabilities	1 710 000	1 622 000
Total Liabilities	2 212 000	1 889 000
Net Assets	1 053 000	1 683 800
EQUITY		
Share capital	1 000 000	1 500 000
Reserves	3 000	3 000
Retained earnings	50 000	180 800
Total Equity	1 053 000	1 683 800

Jelly babies Ltd
Income Statement for the year ended 30 June 2022

	$
Sales	2 030 000
Cost of sales	1 390 000
GROSS PROFIT	640 000
Other income	56 000
Administration expenses	71 000
Selling expenses	85 000
Finance costs	96 000
PROFIT BEFORE TAX	444 000
Income tax	133 200
PROFIT	310 800

Jelly Babies Ltd
Statement of Changes in Equity for the year ended 30 June 2022

	$
SHARE CAPITAL	
Ordinary shares	
Balance at 1 July 2021	500 000
Issue of share capital	500 000
Balance at 30 June 2022	1000 000
Preference shares	
Balance at 1 July 2021	500 000
Balance at 30 June 2022	500 000
RETAINED EARNINGS	
Balance as at 1 July 2021	50 000
ADD: Profit	310 800
LESS: Dividends – ordinary	80 000
Dividends – preference	100 000
Balance as at 30 June 2022	180 800

Notes to the financial statements:

Number of shares issued at end of	**2021**	**2022**
Ordinary	200 000	220 000
Preference	50 000	50 000

Required:

Calculate market, liquidity, efficiency, profitability and leverage ratios for the company, and discuss whether a financial institution would agree to lend the company a further $2 000 000.

Workings

Annual ordinary dividend = $\frac{80\ 000}{220\ 000}$

= 36c each

RATIO	CALCULATION	RESULT
Working capital	$\frac{550\ 800}{267\ 000}$	206%
Quick asset	$\frac{550\ 800 - 360\ 800}{267\ 000}$	71.1%
Debtor's collection	$\frac{(80\ 000 + 85\ 000)\ /2}{2\ 030\ 000}$ x 365	15 days
Inventory turnover	$\frac{1\ 390\ 000}{(310\ 000 + 360\ 800)\ /2}$	4.1 times per year
Profit	$\frac{310\ 800}{2\ 030\ 000}$	15.3%
Rate of return on assets	$\frac{444\ 000 + 96\ 000}{(3\ 265\ 000 + 3\ 572\ 800)\ /2}$	15.8%
Times interest earned	$\frac{444\ 000 + 96\ 000}{96\ 000}$	5.6 times
Debt to equity	$\frac{1\ 889\ 000}{1\ 683\ 800}$	112.2%
Earnings per share	$\frac{310\ 000 - 100\ 000}{(200\ 000 \times 9/12) + (220\ 000 \times 3/12)}$	$1.03 per share
Price/ earnings ratio	$\frac{2.50}{1.03}$	2.43 times
Dividend yield	$\frac{0.36}{2.50}$	14.4%

33. *Consider the following information for* Happiness Ltd.

Happiness Ltd
Statement of Financial Position
As at 30 June 2025

	$
CURRENT ASSETS	
Cash and cash equivalents	16 500
Trade and other receivables	62 700
Inventories	310 500
Other current assets	133 500
Non-current assets held for sale	1 200
Total Current Assets	524 400
NON-CURRENT ASSETS	
Investments	137 400
Property, plant and equipment	973 800
Intangible assets	614 700
Other non-current assets	4 500
Total Non-Current Assets	1 730 400
Total Assets	2 254 800
EQUITIES	
CURRENT LIABILITIES	
Current tax liability	3 000
Trade and other payables	99 900
Other current liabilities	10 800
Total Current Liabilities	272 700
NON-CURRENT LIABILITIES	
Long-term borrowings	1 035 000
Mortgage	60 0000
Total Non-Current Liabilities	1635 000
Total Liabilities	1 907 700
Net Assets	347 100
EQUITY	
Share capital	300 000
Reserves	30 000
Retained earnings	17 100
Total Equity	347 100

Share capital

In thousands of shares

Number of shares issued at end of	**2024**	**2025**
Ordinary	?	?
Non-redeemable preference shares	?	?

Happiness Ltd
Statement of Profit or Loss and Other Comprehensive Income
For the year ended 30 June 2025

	$
Revenue	360 300
LESS: Cost of sales	309 000
Gross profit	**51 300**
Other income	3 600
Selling and distribution expenses	12 000
Administration expenses	9 900
Finance costs	13 500
Profit before income tax	**19 500**
Income tax	4 500
Profit (Loss) for the period	**15 000**

Happiness Ltd
Notes to the Statement of Changes in Equity

SHARE CAPITAL
Ordinary

	$
Share capital at 1 July 2024	135 000
Issue of share capital	15 000
Share capital at 30 June 2025	150 000
Preference	
Share capital at 1 July 2024	150 000
Share capital at 30 June 2025	150 000
Other reserves:	
General	
General reserve at 1 July 2024	12 000
Transfer from retained earnings	18 000
General reserve at 30 June 2025	30 000
RETAINED EARNINGS	
Retained earnings at 1 July 2024	57 600
ADD: Total profit recognised for period	15 000
LESS: Dividend – ordinary	7 500
Dividend – preference	30 000
Transfer to general reserve	18 000
Retained earnings at 30 June 2025	17 100

Required:

Calculate market, liquidity, efficiency, profitability and leverage ratios for Happiness Ltd, and write a report interpreting the results.

RATIO	CALCULATION	RESULT
Working capital	$\frac{524\,400}{272\,700}$	192.3%
Quick asset	$\frac{524\,400 - 310\,500 - 100\,500}{272\,700 - 800}$	41.7%
Debtor's collection	$\frac{(60\,000 + 62\,700)/2}{(360\,300 \times 0.80)} \times 365$	77.7 days
Inventory turnover	$\frac{309\,000}{310\,500}$	0.99 times
Profit	$\frac{15\,000}{360\,300}$	4.2%
Rate of return on assets	$\frac{19\,500 + (13\,500 \times 0.7)}{(2\,000\,000 + 2\,254\,800)/2}$	1.4%
Times interest earned	$\frac{19\,500 + 9\,450}{9\,450}$	3.06 times
Debt to equity	$\frac{1\,907\,700}{347\,100}$	549.6%
Earnings per share	$\frac{15\,000 - 30\,000}{300\,000}$	-5c per share
Price/ earnings ratio	$\frac{0.50}{-0.05}$	-10 times
Dividend yield	$\frac{0.025}{0.50}$	5.0%

34. *Outline how a shareholder could use annual reports, financial statements and stock exchange data to assess the position and performance of a public company.*

A shareholder can use financial statements to interpret a range of issues such as, for example:

- Interpret information about the operations of the company and its business strategies
- Examine matters that have occurred during the year, as well as forecasts of likely developments in future operations
- Understand the risk profile
- Check auditors reports and modified audit opinions
- Examine profitability and economic productivity
- Compare the company with trends and other companies
- Examine stability
- Compare and calculate ratios
- Examine which accounting policies have changed and why

Extended answer questions

1. *'Why should internal and external users of financial information make use of ratio analysis?'*

Respond to this question in essay format, explaining the different types of ratio comparisons that could be made by each user of the information, the mina categories of analysis, and the limitations of analysis.

Students should cover the following in detail:

- Outline the purpose of ratio analysis
- Distinguish between internal and external users of information and how information is used – to interpret liquidity, efficiency, profitability, leverage or market value?
- Explanation of each type of user of information – at least two internal users and three external users should be easy to define
- Outline different types of ratio information that would be most useful for each user of the information, giving at least one example for each
- Outline the type of analysis that would be performed by each user
- Explain the limitations of ratio analysis

2. *A friend has just purchased shares in a large Australian blue chip company, and they have obtained a copy of the company's last five annual reports. They have asked you to explain to them how to use the ratio information to determine whether the company is a good investment.*

Write a report for your friend, outlining the different methods of calculating and comparing ratios and explaining the importance of relevant market ratios.

Methods of calculating and expressing ratios:

- Provide a common base to information about different business entities or different accounting periods.
- Calculated by dividing the dollar amount of one account by the dollar amount of another account.
- Expressed either directly as a ratio. eg. 2.15: 1.0 or indirectly as a percentage. eg. 215%

Comparing ratios:

- Compare the results of two different companies, with completely disparate income and expenses
- Compare the results achieved by a company between two years, when the business might have had major changes occurring.
- Comparison using a ratio lessens the effect of changes on the financial stability and profitability of the business clear, and allows the performance of the company and the efficiency of management to be analysed.

Market ratios:

- Allow potential investors to determine future prospects using a measure that is related to the company's current market value.
- Do not depend on historical data required by the other ratios.
- Provide a comparison of how much the company is returning to investors through dividends and growth.
- Earnings per share must be calculated even if the result is negative, and are usually included as part of the Statement of Profit or Loss. Companies are required to present earnings per share if their ordinary shares are publicly traded. This ratio indicates how much profit is attributable to each ordinary share.
- Price/ earnings ratio indicates how much the individual investor is willing to pay for each dollar of profits that the company has made. A negative price/earnings ratio can occur if the earnings per share are negative, due to a greater proportion of preference dividends being paid compared to profit after income tax or due to a loss being made. This results in making the earnings per share negative. The implication is that the company is losing money.
- A lower price/earning ratio indicates that investors in company will receive a return on their capital investment more quickly, as there is a higher proportional dividend.
- Dividend yield indicates the proportion of dividend that an individual share provides to the investor.

CHAPTER 10: CORPORATE REPORTING

Questions

1. *Why is it important for companies to be able to be flexible in their choice of accounting policy? In your answer, give one example of a relevant policy.*

Different accounting methods provide more valid and reliable information depending on the company. *Students should discuss examples such as different types of depreciation methods and inventory valuation methods.*

2. *The director of a publicly listed company has said to you, 'I know that we have to ensure we disclose important information in our financial reports, but I don't know what it means to ensure that the investors in the company will be provided with a fair view of the company's situation'. Respond to the directors concern.*

Fair presentation requires the faithful representation of the effects of transactions, and the use of the definitions and recognition criteria for the elements of financial statements. If the directors of the company use accounting standards and provide additional disclosure in the notes to the accounts it is assumed that the reports meet the requirement for a fair presentation.

3. *What must the directors of a company do to ensure that financial reports are comparable and understandable? Under what circumstances could directors deviate from these requirements?*

In order to ensure comparability and understandability the directors of the company must be consistent in the presentation of the reports and keep the same presentation and classification of items unless one of the following occurs. Extenuating circumstances must exist for any change.

Reasons to change the presentation of the financial reports:

- a significant change in the nature of company operations results in the decision that a different presentation or classification would be better
- a review of the company financial report results in the decision that a different presentation or classification would be better
- an Australian accounting standard requires a change in presentation
- a significant acquisition or disposal
- a review of the presentation of the financial report

4. *Name and describe three types of disclosure documents that could be issued by a company. Which one has the most stringent requirements for directors to follow?*

Disclosure documents:

- **Prospectus** – gives a widespread overview of the company with detailed information about the proposed issue of securities. The company issuing the prospectus is responsible for its content. Strictest requirements of the three types of document.
- **Offer information statement** – used when the company is issuing securities to a value less than $10 million. It must include an audited financial statement from within the previous 6 months.
- **Profile statement** – less information and lower requirements. It has to be approved by ASIC and contains limited information.

5. *How do stakeholders who are external to the company reply on reports, statements and stock exchange data to assess company results?*

Stakeholders rely on the information in annual reports, financial statements and stock exchange data to assess position and performance because they are ultimately at arms length from the management and direction of the business of the company. They should not have access to "inside information."

An investor in a public company usually purchases shares or debentures on a secondary market for the trading of securities. The fact that the stakeholders in the company are at a distance from the working of its daily business results in a need for the shareholder to receive information about the financial performance and position, so they can make decisions about the investment of their scarce resources.

Other stakeholders, such as the public, rely on this information in order to hold the company accountable for its social and environmental responsibilities.

6. *Clearly explain the difference between a shareholder who is seeking a return on investment and one who wants a growth investment.*

If an investor wants a **return on investment** in the form of interest or dividends they will seek out debentures and shares that are perceived to have better market ratios such as: earnings per share, dividend yield and price/earning ratio.

If seeking **growth** as the form of return, they are hoping that dividends will gradually increase over time as a sign of improvement in the asset base of the company.

7. *List five compulsory items of general information to be included in the annual directors' report.*

General information:

- A review of operations during the year and results
- Details of significant changes to the company
- The company's principal activities and any significant changes in the nature of activities
- Any matter or circumstance that has arisen that has significantly affected, or may significantly affect operations, results or the state of affairs in the future
- Likely developments in the future
- Details of performance in relation to relevant environmental regulation.

8. *List five compulsory specific information items for the annual directors report.*

Specific information:

- Dividends and distributions to members, both paid and recommended
- Names of directors, officers auditors and other relevant individuals
- Options granted to directors
- Any other options.

9. *Explain how directors can be held accountable through the use of key performance indicators.*

Directors can have measurable targets set in every area of the business. The KPI should relate directly to the aims of the company, be directly measureable and allow for development of areas requiring more action. The directors might be rewarded for the company's achievement of KPIs through financial compensation.

10. How is traditional financial reporting a limited method of assessing company results?

Traditional accounting is based on economic and financial measurements of a company's performance, so it is restrictive and not easily accommodating of new methods related to sustainability and social or community reporting.

11. A shareholder in a publicly listed company has asked you to explain why the company has decided to revalue its factory building, and why an investment item is now recorded at its market value in the financial reports. Explain the reasons to them by outlining the limitations of historical cost accounting.

The main problem with the **historical cost method** is that the current value of the asset can be significantly different, and therefore much more useful information, for those using the financial information. The factory and the investments must have been valued at a significantly different amount, and by waiting until the assets are actually sold and the income from the sale is realised (as required by the historical cost method) the accounts would not have given a fair presentation of the true state of the company.

12. Why is it difficult to compare the financial statement information of different entities?

Different entities can present their financial information in different ways, due to multiple interpretations of accounting standards and requirements.

13. Define 'corporate social disclosure' and explain why a company would produce a CSD report.

Corporate social disclosure involves reporting on the environmental element and the social or community element of company operations, to a wider group of stakeholders than those just interested in financial reporting. These stakeholders include potential investors, employees and employee representatives, lenders, suppliers and trade creditors, customers and governments and their agencies and the general public. As customer values change consumers are supporting companies that have adopted sustainable practices and want to buy products and services that are environmentally and socially friendly.

Reasons for a company to produce a CSD report:

- better management of business risk
- to improve employee relations and staff retention
- to improve the ethics and value driven culture in the workplace
- to enhance the public reputation of the company
- as a benchmark to measure results, which may lead to a competitive advantage
- in some cases, to show that government requirements are being met.

14. What are the difficulties associated with producing social and environmental information?

Difficulties associated with the creation of CSD reports includes the difficulty of verifying the information that is to be included in the report. The lack of clear guidelines or consistent requirements has thus resulted in a wide range of reporting methods which are frequently not comparable between difference companies. Obtaining the input of experts and developing methods of verifying the content of the report are challenges facing company directors. CSD reporting also requires the investment of resources and training of staff to be able to monitor and report on progress.

15. *Summarise five environmental management indicators that give guidance on how a company can provide information on the management of environmental impacts.*

Environmental management indicators:

- Environmental Management System Conformance: the company could report on its compliance with environmental standards, level of certification, give detail of audit processes for environmental systems and how it conforms with industry environmental code.
- Environmental Performance Improvement Process: the company might report on how it identifies environmental ricks, its targets for achieving solutions to environmental issues and how it is progressing with action on environmental issues.
- Integration of Environment with other Business Management Systems: the company can report on organisational structures that include sustainability as a business issue, and how environmental considerations are included across business processes such as in the manufacture, supply, sales of the company's goods and services.
- Due Diligence Process: the company can report on how it ensured that any mergers or acquisitions in the previous accounting period were reviewed to ensure the minimisation of environmental concerns.
- Environmental Liabilities: stakeholders in the company may be particularly interested in this indicator. The company can report on known liabilities such as the clean-up of a spill site, rehabilitation of a site, litigation and often these financial impact are known or can be estimated.

16. *Select FIVE of the following environmental issues and give examples of measurements that could be used by a company to report on this issue:*

    - *Energy*
    - *Greenhouse gas emissions*
    - *Water*
    - *Materials*
    - *Emissions and discharges to air, land and water*
    - *Waste – solid and hazardous*
    - *Biodiversity*
    - *Ozone-depleting substances*
    - *Suppliers*
    - *Products and services*
    - *Compliance*

Research question. Students can select issues and use relevant measurement examples from the text.

17. *Summarise the four main areas of social reporting that the Global Reporting Initiative recommends for companies to report on. Give TWO examples for each.*

- Labour practices and decent work
- Human rights
- Society
- Product responsibility.

Students should select relevant measurement examples from the text.

18. Following is an extract from a company's CSD report. Critically evaluate this disclosure information using the indicators in this chapter, and analyse the company's achievement in terms of of social reporting.

FOCUS AREA	OUR COMPANY INVOLVEMENT
Community	• We sponsor a local football club. • We regularly donate to community fundraising events. • Our staff enter a team in the annual City to Surf fun run every year.
Corruption	• All managers in the company attend annual workshops on how to promote the company's ethical and values policies and procedures. • The company has an anti-corruption officer, to whom employees can report their concerns.

Discussion question. Answers dependent on the justification given.

19. Write a 'Product Responsibility' section for the CSD report of a publicly listed company that manufactures a product of your choice.

Research question. Students can select issues and use relevant measurement examples from the text.

20. Access the online sustainability report of one of Australia's listed public companies. (A list is available on the ASX website.) Critically evaluate the level of corporate social disclosure in your chosen CSD report by evaluating its level of achievement of the environmental and social reporting indicators outlined in this chapter.

Research question. Students can use relevant social reporting indicators from the text.

Extended answer questions

1. *Consider the following statement:*

   General purpose financial statements are designed to be accessible to a wide range of potential users of information. Therefore, there must be compromise in terms of the methods chosen and the information included in the reports. No individual user group can have their needs met, so disclosure requirements cannot possibly assist the user of the reports.

Discuss whether you agree or disagree with this statement, justifying your answer. In your response, consider:

- *the identity of users of general purpose financial statements*
- *the purpose of disclosure in financial reports*
- *the purpose of annual reporting*
- *limitations in assessing performance from financial statement analysis.*

The identity of users of general purpose financial statements

- General purpose financial reporting can be useful for communicating relevant and reliable information about the company to users of the information.
- Users include:
  - Shareholders
  - Investors
  - Financial institutions/ lenders
  - Customers
  - Managers and employees
  - The public
  - Government
  - Creditors/ Suppliers

The purpose of disclosure in financial reports:

- Users need information that is useful for making and evaluating decisions about the allocation of scarce resources.
- Public companies that wish to issues shares or debentures must publish a disclosure document and give this to potential investors, so that they can fully consider before investing their economic resources in the company.
- The disclosure document can be either a prospectus, a profile statement or an offer information statement.

The purpose of annual reporting:

- Explain the company's transactions and financial position.
- Directors must prepare an annual financial report and a directors' report explaining the year's operations, dividends paid or recommended, shares and options issued.
- Large proprietary companies and public companies must prepare annual financial reports and a directors report, have these audited and send these to the shareholders and ASIC.

Limitations in assessing performance from financial statement analysis.

- Historical Cost Accounting
- Lack of Comparability
- Lack of Disclosure

2. *Who are the people who use corporate social disclosure information and what kind of information do they want?*

Discuss this question in an essay format, incorporating the benefits and problems of CSD in your answer.

Users of CSD information:

- Many investors are interested in more than the financial results of a company. They want to invest in the triple bottom line and support businesses that consider social and environmental concerns as well as financial gains.
- Consumers want to purchase products that have been manufactured or sold by businesses that are responsible.
- The government wants companies to follow the regulations and laws that apply to their industry and to be ethical.

Criticisms of CSD:

- costly
- time consuming
- more likely to disclose this type of information if they have poor economic performance
- measurability
- difficult to quantify the benefits
- impact of social and environmental work is in dispute.
- comparability issue

Benefits of producing a CSD report:

- better management of business risk
- to improve employee relations and staff retention
- to improve the ethics and values culture in the company
- to enhance the public reputation of the company
- as a benchmark to measure results, which may lead to a competitive advantage
- in some cases, to show that government requirements are being met.

CHAPTER 11: EXTERNAL INFLUENCES IN THE CORPORATE ENVIRONMENT

Questions

1. *What is the main purpose of the Corporations Act?*

The main purpose of the Corporations Act is to regulate the operations of companies in Australia. It influences the formation and operation of companies in Australia, including on the powers and duties of directors, governance, and the rights of shareholders.

2. *A friend of yours has been asked to join the board of a small Australian company. The board member inviting them to join told them that they did not need to worry that they would be taking on a huge workload, as they just had to 'turn up to a monthly board meeting and sign a few documents'. Advise your friend about the importance of having enough time to put into company board membership and the potential liabilities of a director.*

Company directors must remain fully informed and involved in company meetings. They have wide ranging power to affect the running of the company and to make financial and ethical decisions. They must be cautious at all times and remain fully informed as they may be personally liable – this means they must pay careful attention at meetings and only sign documentation that they understand and agree with.

Directors are required to be honest, have caution in communicating with others on behalf of the company, be knowledgeable about what is occurring in the company and to work to ensure debts can always be paid.

3. *Summarise the main duties of company directors.*

Duties of directors:

- exercise the degree of care and diligence that a reasonable person in a similar position would exercise
- act in good faith in the interests of the company. Directors must avoid conflicts of interest, disclose conflicts and manage any conflicts that arise
- not make improper use of information or improper use of their position as a director
- ensure the company does not trade while insolvent
- ensure relevant information is lodged with ASIC
- report to the liquidator if the company is being wound up
- disclose any material personal interest in the affairs of the company.

4. *Explain the 'business judgement rule', using an example.*

A director who makes a business judgment with the care and diligence required by the regulations is taken to have done this if they:

- make the judgement in good faith
- do not have a material personal interest in the outcome
- are reasonably informed about the situation
- believe rationally that the decision is in the best interests of the company

5. Read the article 'James Hardie Civil Penalty Proceedings' contained in the chapter and answer the following questions.

A. What is the difference between non-executive directors and executive members of a board?

B. What duties of directors have been breached?

C. What problems were found with the way that the board made statements to the market?

D. In your opinion, are the penalties imposed adequate? Why or why not?

Discussion question.

6. Why would a company issue a prospectus?

A prospectus is issued by a public company to invite the public to invest in shares, debentures or other securities in the company. It contains information necessary for the potential investor to make an informed decision about their investment of resources into the company.

7. Draw a diagram summarising the FIVE steps to be followed to register a proprietary company in Australia.

Step 1: Decide on business structure

Step 2: Choose a company name

Step 3: Replaceable rules or a Constitution or a combination

Step 4: Obtain consents

Step 5: Complete and lodge the application form

8. What is the difference between the replaceable rules and the constitution of a company? Which of the two has precedence?

Replaceable rules are a summary of the set of basic rules outlining how a company should be managed. These include rules relating to officers, employees, the inspection of accounts, director's meetings, members' meetings, shares and the transfer of shares. The replaceable rules enable the company to not have to update a constitution every time the law relating to company operations changes.

Replaceable rules automatically apply to a proprietary company unless they are replaced in some form by a constitution.

The company could choose to write its own constitution to govern the internal management of the company. This constitution does not have to be lodged with ASIC if it is a proprietary company, however a copy of the constitution must be made available if requested. Public companies must lodge their constitution.

9. Clearly explain the FOUR possible ways that a company can be wound up, using examples.

Winding up:

Voluntary administration – where the directors appoint an administrator who attempts to trade the company out of the financial problem by negotiating with the creditors of the company. If an agreement cannot be reached with creditors the company may be wound up.

Receivers – can be appointed by a Court or a secured creditor if amounts owing are overdue. Some or all of the assets of the company will be taken over to repay the debt.

Court order – a Court can order that a company be wound up. A liquidator will then be appointed.

Voluntary winding up – the members of the company can pass a special resolution to wind up the company. A liquidator will then be appointed.

10.

A. Define 'liquidator', and explain the liquidator's role.

A **liquidator** is a person appointed to collect all company assets and pay all company debts before the company is wound up. The liquidator's main roles are to take possession of assets, ascertain debts owed by the company, pay creditors, distribute to shareholders any assets of the company that remain and then to have the company deregistered.

B. Outline the five most important indicators of insolvency that a potential supplier to a company should be vigilant about.

Indicators of insolvency:

- Losses reported in the Income Statement
- Poor cash flow and liquidity problems
- Overdue taxes and overdue accounts
- Not being able to borrow more funds from any financial institution
- Court orders and other legal documents being issued against the company
- Cheques being dishonoured
- Poor financial reporting and unreliable budgeting and forecasting

C. What advantages does a company that is becoming insolvent gain from voluntarily going into administration?

Advantages of voluntary administration:

- assess actual financial position
- creditors are frozen
- creditors can consider their options
- value can be gained from the assets of the company
- independent administrator
- full review of the situation

11. How does an individual become a shareholder in a company?

An individual may become a shareholder of a company by being listed as a shareholder of the company in the application for registration, or by the company issuing shares to the person, or by purchasing shares from an existing shareholder and the company registering the transfer.

An individual ceases to be a shareholder if they sell all their shares and the company registers the transfer of the shares, or if the company buys back all the person's shares or if ASIC cancels the company's registration.

12. What rights does a shareholder have in relation to the following:

A. Access to company information

Shareholders may inspect the company share register and request a copy of the financial report.

B. Earning a return from their investment in the company

A return will only be earned if the company is able to pay its debts. It can then make a distribution to shareholders.

C. Voting

Usually one vote is available for each share held

13. Explain the difference between an ordinary resolution and a special resolution. When might a shareholder request a special resolution? For what reason would a director propose an ordinary resolution?

Resolutions:

An ordinary resolution is passed when a simple majority of more than fifty percent of the members present at the meeting vote for the resolution. Members can only vote by proxy if the Constitution allows this. Ordinary resolutions are used to vote on issues such as the election of directors, appointment of auditors, changes in the number of directors and the acceptance of AGM reports.

A special resolution is passed when at least seventy five percent of the votes cast by members voting on a special resolution are in favour. Members must be sent notification of a special resolution at least 28 days (for a listed company) or 21 days before the meeting to vote on the resolution is to be held. Special resolutions are required for a number of actions including modifications to the company Constitution, changes to the company name or type, changes to share rights, the issue of preference share with rights attached, changes to share types, reduction of share capital, selective buy back of shares, changes to dividend rights, winding up, liquidators.

14. Explain the role of the following regulatory bodies in relation to Australian company reporting.

A. Financial Reporting Council

The **Financial Reporting Council** has oversight of the accounting standard setting process in Australia and oversees the activities of the AASB. It monitors the process for adopting IASB's, acts as an advisory body to the AASB, and gives the Federal Treasurer reports and advice on the process of standard setting. The FRC therefore has a major indirect influence on the development of the Accounting Standards that companies are required to follow when preparing financial information and external reports.

B. Australian Securities and Investments Commission

The **Australian Securities and Investments Commission** issues interpretations of accounting standards in the form of Practice Notes, and is involved in monitoring compliance with the standards in relation to companies who are reporting entities. ASIC may refer practice issues to the AASB to consider possible amendments and changes to accounting standards.

C. International Accounting Standards Board

The **International Accounting Standards Board** is part of the International Accounting Standards Committee Foundation (IASCF), and is developing a set of global accounting standards requiring transparent and comparable information in general purpose financial statements. It works with national accounting standard setters around the world such as Australia's AASB. Australian public reporting entities must follow IAS's.

D. Australian Accounting Standards Board

The **Australian Accounting Standards Board** considers the work of the IASB in developing and issuing accounting standards for public sector entities in Australia. It makes accounting standards for the purpose of the Corporations Act and must refer to international Accounting Standards (IASB) in the preparation of Accounting Standards for use in Australia. It must carry out a cost benefit analysis of the impact of a proposed accounting standard to be used in Australia unless that standard is based on an existing international standard.

E. Australian Securities Exchange

The **Australian Securities Exchange** provides for the listing and transfer of equities of listed public companies. It provides the system for trading of securities in the Australian market, to provide regulation of public companies and to provide surveillance of public companies to ensure that regulations are followed. It requires listed companies to produce general purpose financial statements in accordance with accounting standards.

15. How will the changes to the role of the ASX affect the market for securities in Australia?

Changes to the role of the ASX to remove the Australian Securities Exchange role as the regulator of its own market may increase competition. This could potentially lessen the ASX's monopoly over share trading in Australia, and allow new competitors to ASX to enter the securities trading market.

16. How are accounting standards developed in Australia, and what impact does the IASB have on their development?

Australian accounting standards are prepared by the AASB which must refer to International Accounting Standards (IASB) in the preparation of Accounting Standards for use in Australia. The Australian Government requires international accounting standards to be adopted and used for the external reporting done by companies. International standards are only aimed at for-profit entities though, and so these have been adapted to develop Australian standards to be used by not-for-profit and public entities as well. The Australian Accounting Standards Board has developed a set of Australian accounting standards that fulfil the requirements of international accounting standards. Australian standards differ only in that they can sometimes have more stringent requirements, asking the company to provide more information in its financial statements and notes that would normally have been required under an international standard.

17. Clearly outline the role of ASIC in the regulation of company reporting. Include an explanation of the role of the ASX in relation to this Commission.

ASIC enforces and administers company reporting requirements including the accounting standards. It has power to issue specific orders to a company if requirements such as auditing and reporting deadlines are not met.

18. Summarise the main aims of the AASB.

The AASB aims to:

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

19. Clearly outline the role of the FRC in the development of accounting standards. In your answer, include an explanation of the purpose of the AASB in relation to this Council.

The FRC has oversight and influences the AASB through the appointment of its members and allocation of its funding. It cannot direct the AASB.

20. How can a member of one of the professional accounting bodies be involved in lobbying for their goals in relation to the development of company reporting?

A member of a professional accounting body can potentially lobby for the interests of members through:

- Being appointed as a member of the FRC or AASB
- Participating in a committee, or advisory group established by the FRC or AASB
- Employment as staff or a consultant to the AASB
- Giving feedback and participating in the process of setting Accounting Standards.

21. What capabilities does a person need to prove before they can become a registered company auditor? What might be evidence that an individual is not capable of holding this office?

In order to be registered as a Registered Company Auditor, a person must have:

- academic qualifications in auditing
- completion of a prescribed course in auditing
- achievement of ASIC competency standards (or relevant practical experience).

They must be capable of performing the duties of an auditor and be a fit and proper person to hold the position of a company auditor. This means performing audit duties without being negligent and being a ‘fit and proper person’ showing honesty and integrity.

Criminal offences and breaches of civil law are considered evidence that the applicant is not a fit and proper person to hold the position of auditor.

22. What is the role of an external company auditor, and why would directors and investors in a company consider their role important?

An external company auditor focuses on the examination of the company's financial report and reports to the members of the company on the financial record keeping and statutory compliance. They report to ASIC any significant contraventions of the Corporations Act and any problems that the company will not fix up adequately.

Their role is important to directors because it provides feedback on how the company is complying with the regulations and accounting standards and can offer assistance in improving reporting.

Their role is important to investors because they are at "arms length" from the company and they require the reassurance and assistance of an independent inspection and report on the company affairs.

23. Outline FOUR significant contraventions of the Corporations Act that an auditor would be required to report to ASIC.

Significant contraventions by a company include:

- trading while insolvent
- the company not complying with Accounting Standards
- fraudulent conduct by the officers or employees of the company
- not assisting the auditor in their work
- not lodging annual financial reports
- material inconsistencies or misstatements of fact in the reports or the notes to the accounts

24. What processes exist to ensure the independence of company external auditors?

In order to preserve the independence of auditors, the Corporations Act contains the "5/7 rule" or time-out rule. An auditor who has had a significant role in the audit of a listed company for 5 successive financial years is not eligible to continue until they have had at least 2 successive financial years of non-involvement.

25. Draw a flow diagram summarising the process of appointing and removing an auditor for each of the following scenarios.

A. An auditor is appointed by the directors then the auditor decides to resign from their appointment before the AGM.

B. An auditor is appointed by members at an AGM, reappointed at the next AGM, then removed by ASIC at the next AGM.

C. An auditor is appointed at the time of registration of the company and then is removed by the shareholders at a subsequent AGM.

Students should create a diagram using text information.

26. Read the article 'KPMG Partners Provide Enforceable Undertakings Not to Practice' contained in the Chapter and answer the questions that follow.

A. Define an 'enforceable undertaking', and explain this concept in relation to the situation in the article.

B. What concerns did ASIC have in relation to the audits that were carried out by the auditors? What was the response of the auditors?

C. What does this article illustrate about the role and function of external auditors?

Class discussion question.

Extended answer questions

1. *Describe the legislation and regulatory bodies that exist to control the activities of companies in Australia. What effect does the relevant legislation have on the accounting methods and financial reports of a company that is a reporting entity?*

The following areas should be addressed in detail:

- Definition of reporting entity
- The purpose and nature of the Corporations Act
- Legislative requirements for the formation and operation of a company
- Powers of directors
- Rights of shareholders
- Regulatory bodies that impact on the running of a company:
  - Financial Reporting Council
  - Australian Securities and Investments Commission
  - International Accounting Standards Board
  - Australian Accounting Standards Board
  - Australian Securities Exchange
- Effect on company accounting methods
- Effect on financial reports

2. *Write a report containing clear guidelines for the setting up and voluntary winding down of a proprietary limited company in Australia. In your answer, outline the limitations of report analysis for external users of reports.*

Step 1: Decide on business structure
Register business names on the Department of Commerce's Business names website. Business names are checked on ASIC's National Names Index.

Step 2: Choose a company name
The name of a company indicates legal status, and for a proprietary company this requires use of the word 'Proprietary' or the abbreviation 'Pty' in the business name.

A company must also indicate the liability of company shareholders.

The company name will not be approved if it already registered or if it appears on ASICs list of words requiring special approval.

The company could choose to not have a name but rather could use their Australian Company Number (ACN) as a name.

Step 3: Replaceable rules or a Constitution or a combination
The company will be managed internally under one of three possible scenarios:

- Replaceable Rules: These are outlined in the Corporations Act (2001)
- A Constitution: This is developed by the company
- A combination of both replaceable rules and a Constitution

Replaceable Rules

The Replaceable Rules are the set of basic rules outlining how a company should be managed including rules relating to officers, employees, the inspection of accounts, director's meetings, members' meetings, shares and the transfer of shares.

Replaceable rules automatically apply to a proprietary company unless they are replaced in some form by a Constitution.

Constitution

The company could choose to write its own Constitution to govern the internal management of the company. This Constitution does not have to be lodged with ASIC as it is a proprietary company.

Step 4: Obtain consents

Written agreement must be obtained from:

- director(s)
- the secretary
- member(s).

A proprietary company must have at least one director and does not have to have a secretary.

Step 5: Complete and lodge the application form

Form 201 'Application for registration as an Australian company' must be completed and lodged with ASIC. A fee must also be paid.

Winding Up

A company is voluntarily deregistered by completing Form 6010 'Application for voluntary deregistration of a company'and by meeting these conditions:

- not carrying on business
- assets of less than $1000
- no outstanding liabilities
- not a party to legal proceedings
- all members have agreed to the deregistration
- paid all fees and penalties under the Corporations Act

The liquidator will take possession of assets, ascertain debts owed by the company, pay creditors, distribute to shareholders any assets of the company that remain and have the company deregistered. External users must rely on published financial statements to inform their financial decisions. An external audit is an attempt to overcome this limitation by:

- giving confidence to stakeholders that the financial statements of reporting entities can be relied upon to make decisions.
- independently verifying the reporting entity's information systems and records to ensure they are properly maintained.