

STUDY NOTES



ACCOUNTING UNIT 4

PETER SOLANIKOW

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ACCOUNTING
UNIT 4 STUDY NOTES

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These notes have been designed with the student in mind, taking into account that the student will already be bombarded with course reading material, handouts as well as possibly a number and variety of subject notes and materials. As a result, the writing in these notes is kept to a minimum with the intention of providing information that is relevant and to the point. Examples are used when required to illustrate a point being made. In many cases point form summaries are used, as this provides accurate information in a concise and summarised manner, helping to reduce reading and study time without compromising on study quality.

SUMMARIES AND KEY POINTS ARE PRESENTED IN PURPLE
EXAMPLES ARE PRESENTED IN GREEN
DEFINITIONS ARE PRESENTED IN AQUA

Please read the information in the paragraphs of the study notes very carefully. This information has been presented in a specific way, based on the historical style of exam theory questions. Generally, theory represents 40% of the total exam mark. The information presented in the paragraphs may answer possible exam and SAC theory questions. A typical assessable theory question can be:

Explain why accurate stock valuation is so important in accounting. (2 marks)

ANSWER:

“Accurate stock valuation is necessary to calculate the cost of sales, which has an implication on the net profit or loss of the business. Accurate stock valuation is needed to calculate the stock balance at the end of the period, which is then recorded in the Balance Sheet.” (pg 16).

These study notes should be used as part of subject and topic revision, ideally after each topic is covered in class, as well as prior to exam and SAC sitting dates.

I sincerely hope that you find these notes useful and relevant, and that they may enable you to get those extra few marks that you need to get into the course of your choice next year.

Peter Solanikou

TRANSACTIONS

SOURCE DOCUMENTS

PURPOSE

CREDIT NOTE

TRANSACTIONS

STUDY NOTES

PURPOSE OF SOURCE DOCUMENTS

All business transactions have to be proven or “evidenced”. The evidence of a transaction is a **SOURCE DOCUMENT**. There are 5 varieties of source documents that are used to evidence **ALL** possible transactions. As you can see, accounting is not that scary. Although there are millions of possible transactions, there are only 5 source documents that you need to know about. Four of these have been covered in Unit 3 – receipts, invoices, cheque butts and memos. The one that remains is the **credit note**.

At this stage you should know that receipts invoices and cheque butts have something in common. They provide evidence of external transactions i.e. transactions between the business and other non-related parties. The memo is an internal document and is used to evidence an internal transaction or occurrence e.g. drawings by owner, rate of depreciation of specific assets, stock losses or gains etc.

The credit note provides evidence of external transactions.

As stated in the Unit 3 Accounting study notes, it is very important to understand and recognise the various source documents and the transactions that they represent. It is quite common to have exam questions that are structured using source documents to represent transaction. Those students who cannot recognise the various source documents are unable to answer the exam questions properly.

EXAMPLE

Most students know how to deal with this transaction:

Jan 1 2007: Paid rent for the month of January (\$2000).

However, when they see this transaction in the form of a source document, they become confused and don't know what to do. **REMEMBER** – you need to be able to recognise a transaction written in the form illustrated above, as well as in the form of a source document shown below:

THESE ARE EXACTLY THE SAME TRANSACTION, EXCEPT PRESENTED IN DIFFERENT FORMATS

AUSTRALIA BANK		
1/1/07		
PAYEE: <i>ESTATE CO.</i>		
FOR: <i>RENT (JAN 2007)</i>		
AMOUNT: <i>\$2000</i>		
BALANCE:		
3000	1314	2006
	00 00	61

Jan 1 2007: Paid rent for the month of January (\$2000).

HINT: It is very important for you to be able to recognise the different source documents since you may get an exam question that will describe a transaction using source documents. You will then have to recognise what kind of transaction it is and record it in the appropriate journal.

QUALITATIVE CHARACTERISTIC

RELIABILITY – Items should be recorded on the basis of reliable, accurate and verifiable information.

TRANSACTIONS

STUDY NOTES

CREDIT NOTE

A credit note is evidence of a **return of a good/product**. Not only can a customer return goods to the place of purchase (store), but also the business can return goods to the supplier. Goods can be returned for a number of reasons.

REASONS FOR THE RETURN OF GOODS

- ❏ Product may be damaged;
- ❏ May have been a delivery error causing an oversupply of the product (no credit given here though);
- ❏ Wrong product was supplied or sold;
- ❏ Customer may be dissatisfied with some aspect of the product;
- ❏ Product may not have been sold (unsold products may be returned to supplier).

When a return of goods occurs, there are two possible courses of action. There is either an on the spot cash refund given, or credit is provided to the value of the product returned. The latter is the most commonly used option, and when this occurs a credit note is issued.

The following are illustrations of sample credit notes. Compare the samples with the key characteristics given below. In reality most people don't see credit notes too often. So in order to be able to identify a credit note in an exam question, look for the term "CREDIT NOTE" on the source document provided.

EXAMPLES

CREDIT NOTE No.12	CHILLY ICE-CREAM
TO: THE SNOWMAN LTD 15 Christmas St, North Pole 2512	13/1/07
ORDER No. 9263	INVOICE No. 4499
REASON FOR CREDIT: Melted on delivery	

SHADY SCHOOL BOOK SUPPLIES 1 Shady St Sunshine 3030 CREDIT NOTE NO. 788
DATE: 28/2/07 TO: SUKER SECONDARY COLLEGE ADDRESS: 1 HIGH ST SUKER 3333 ITEM: (10) "MATHS FOR GEEKS" BOOKS AMOUNT: \$200.00 REASON: RETURN OF 10 MATHS BOOKS WITH PAGES MISSING

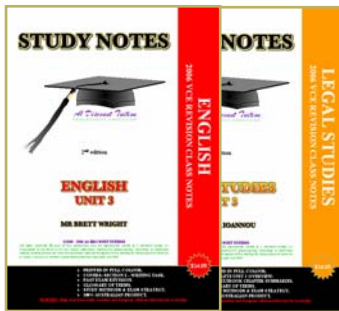
KEY CHARACTERISTICS OF CREDIT NOTES

- ❏ Will have the words "credit note" printed usually near the top;
- ❏ Will have the credit note number on it;
- ❏ Will have a business letterhead on it. This is the business that issues the credit note;
- ❏ Will have "to" written on it i.e. the name of the business or customer receiving the credit;
- ❏ May have "total" or "amount" written on it i.e. the amount of the credit given, or alternatively may have the invoice number to which it relates to.

HINT: Be very careful with credit notes, since a credit note can be issued to the business, or be issued by the business. Accordingly, this will either be recorded in the sales returns journal as a sales return, or in the purchase returns journal as a purchase return.

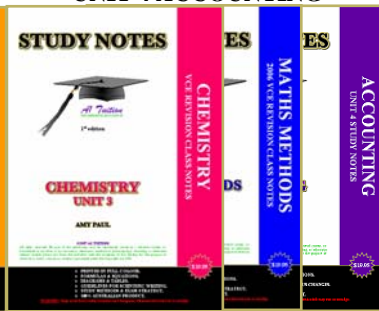
STUDY NOTES

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UNIT 3 LEGAL STUDIES



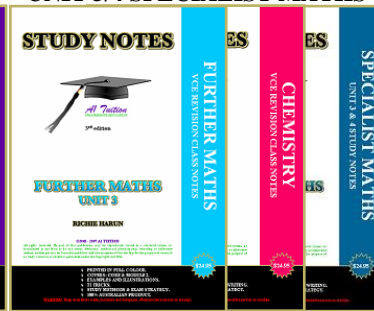
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UNIT 4 ACCOUNTING



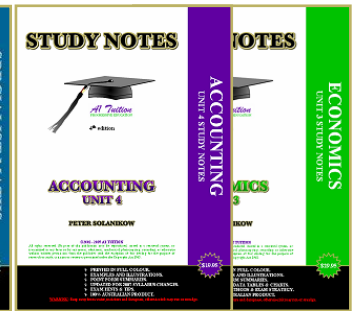
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GENERAL JOURNAL

GENERAL JOURNAL ENTRIES

OVERVIEW

RETURNS & ALLOWANCES

DISPOSAL OF NON CURRENT ASSET

GENERAL JOURNAL

STUDY NOTES

OVERVIEW

In Unit 3 you covered the General Journal and learnt that some transactions have to be recorded in this journal, as the other journals are not appropriate. The General Journal is a “catch all” journal. This means that if a transaction cannot be recorded in any of the other special journals, then it will have to be recorded in the General Journal. Another point to note is that if required, all transactions can be recorded in the General Journal. The General Journal is an alternative representation of the ledger account.

The following transactions would need to be recorded in the General Journal:

- ✦ Establishment of a double entry recording system.
- ✦ Error corrections.
- ✦ Drawings other than cash.
- ✦ Owner contributions other than cash.
- ✦ Non-cash purchases of non current assets.
- ✦ Asset revaluations.
- ✦ Disposals of assets.
- ✦ Balance day adjustments.
- ✦ Stock adjustments (loss or gain recording) and write downs.
- ✦ Bad Debts.

Making entries in the General Journal is another way of recording transactions. The transactions are recorded in the General Journal just as they would be in the ledger, or T accounts i.e. debit one side and credit the other side. All rules relating to debits and credits apply when dealing with the General Journal.

GENERAL JOURNAL

DATE	PARTICULARS	GENERAL LEDGER		SUBSIDIARY LEDGER	
		DR	CR	DR	CR
1/1/XX	Account to be debited				
	→ Account to be credited (don't forget the indent)				
	NARRATION – note to describe transaction				

KEY CHARACTERISTICS OF THE GENERAL JOURNAL

- ✦ A “catch all” journal - transactions that cannot be recorded in the other special journals will have to be recorded in the General Journal;
- ✦ It is possible to record all transactions in the General Journal;
- ✦ Has a generic design with 4 columns – “date”, “details”, “debit” and “credit”;
- ✦ Debit entries must be recorded first;
- ✦ Credit entries have to be indented;
- ✦ A narration is used to describe the transaction recorded.

You will find prepared templates of the General Journal on the **A1 TUITION** website. Instead of drawing up the General Journal yourself, you can save time by downloading the **FREE** ready-made template, and saving it on your computer to print as required.

GENERAL JOURNAL

STUDY NOTES

RETURNS & ALLOWANCES

There are two types of returns and allowances that can occur – sales returns/allowances as well as purchase returns/allowances. Ideally these transactions are recorded in their appropriate journals, being the Sales Returns Journal as well as the Purchase Returns Journal. However, like any other transaction, these types of transactions can also be recorded in the General Journal. This is not the most appropriate journal for these transactions, but it is certainly not wrong to record the transactions there. In fact, if in the course of a business's life sales returns/allowances or purchase returns/allowances rarely occur, it may not warrant the need to keep separate journals for such transactions. If this were the case all such transactions would be recorded in the business's General Journal.

NOTE: The VCE syllabus requires sales and purchase returns to be recorded in the General Journal only. Furthermore, GST needs to be identified when such transactions occur.

RETURN OR ALLOWANCE?

A return occurs when goods are actually returned to the place of purchase. In other words, a purchase return occurs when the store **RETURNS** goods to the supplier, and a sales return occurs when a customer **RETURNS** goods to the shop. The consequence of such a situation is that there is a movement of stock, at cost price, as well as either a change in the bank or the debtor/creditor account. In such cases an allowance will be provided in the form of credit or cash back. A credit note is the source document used to represent an allowance on a return. The credit note will usually include details of the product, and the value of the credit provided.

In reality though, goods may not necessarily always be returned. There are a number of reasons why a seller may not want the goods back. It could result from the fact that the goods are seriously faulty or damaged rendering them to be useless and not worthwhile repairing, or perhaps because the seller may not want the hassle of transport and its associated costs. In these cases it may be cheaper and more efficient to just provide a credit note without the hassles associated with returning of the goods. The consequence in these cases is that there is no movement in the seller's stock control account or stock cards.

NOTE: Traditionally, assessable questions dealing with returns/allowances assume that goods are returned. In these cases appropriate recordings need to be made with adjustments to the STOCK CONTROL - ASSET account. It may be possible however, that future assessable questions may include theory components requiring a contrast and comparison to be made between returns and allowances, as well as asking for reasons why a store may not want the goods back.

EXAMPLES

PURCHASE RETURN

In the example below it is assumed that the supplier is a creditor.

2007
NOV 1 GEEKY COMP STORE RETURNS COMPUTER TO NARS-T COMPUTERS (SUPPLIER). CN 1856. \$2000 + GST

DATE	PARTICULARS	GENERAL LEDGER		SUBSIDIARY LEDGER	
		DR	CR	DR	CR
1/10/07	CREDITORS' CONTROL – LIABILITY	2200			
	STOCK CONTROL - ASSET		2000		
	GST CLEARING – LIABILITY		200		
	NARS-T COMPUTERS - LIABILITY			2200	
	PURCHASE RETURN TO CREDITOR – CREDIT NOTE 1856				

If you find the recording a little confusing then take a breath and look at the transaction again. Break down the transaction and visualise what has occurred.

Firstly, *Nars-T Computers* is a creditor – they are owed money. By returning the computer and getting an allowance, *Geeky Comp* has reduced the amount that it owes *Nars-T Computers*. The amount is more than the \$2000 that the computer costs, since it also has to consider the 10% GST, or \$200. However, the GST is recorded separately. Therefore, the Creditors' Control is debited by the full \$2200, representing a decrease in overall liabilities to

GENERAL JOURNAL

STUDY NOTES

creditors of \$2200. More specifically, the creditor in question is *Nars-T Computers*, so their specific account is debited, which is represented by a debit of the \$2200 in the *Nars-T Computers* subsidiary account.

Secondly, stock has left the business, meaning that there is \$2000 less computers on hand. Straight away you should realise that a reduction in stock is represented by a credit to the **STOCK CONTROL – ASSET** account, since the value of the assets has decreased. The reduction of computers is in fact \$2000, not \$2200, since the extra \$200 is GST. For this reason the **STOCK CONTROL – ASSET** account is credited by \$2000 and NOT \$2200.

Finally comes the recording of the GST component of the transaction. We need to work back a little here. Initially, when *Geeky Comp* purchased the computer they would have debited the **GST CLEARING – LIABILITY** account to account for the fact that they paid GST on this transaction. By doing this *Geeky Comp* would be reducing its GST liability with the tax office, since any time a business pays GST it can offset this against any GST that it collects. Such offsets are done by debiting the **GST CLEARING – LIABILITY** account. This was then. Now, however, we find that the original transaction is null and void since the computer has been returned back to the supplier. This means that the GST which was initially paid has not really been earned by *Geeky Comp*. As a result, the original GST recording has to be reversed/offset. This is done by crediting the **GST CLEARING – LIABILITY** account.

2007

NOV 1 *GEEKY COMP STORE RETURNS COMPUTER TO SUPPLIER FOR FULL REFUND. CN C22.*

\$2000 + GST

DATE	PARTICULARS	GENERAL LEDGER		SUBSIDIARY LEDGER	
		DR	CR	DR	CR
1/10/07	BANK – ASSET	2200			
	STOCK CONTROL - ASSET		2000		
	GST CLEARING – LIABILITY		200		
	PURCHASE RETURN FOR CASH – CREDIT NOTE C22				

This example is a little simpler. The refund includes the cost price of the computer as well the as initial GST that was paid - \$2200. This amount is banked by *Geeky Comp* which is represented by debiting the **BANK – ASSET** account.

As outlined previously, the stock of computers has now decreased by \$2000 since this is the value of the computer that has been returned and the business is now liable for the \$200 in GST which it had previously paid.

Finally, those students who are on the ball would have noticed that whilst the account recordings are correct; the fact that this transaction was recorded in the General Journal renders the recording not entirely appropriate. The transaction that is provided in this example should in fact have been recorded in the CASH RECEIPTS JOURNAL, since *Geeky Comp* received cash. Did you pick up on this??

HINT: The General Journal is most appropriate for recording credit returns. Returns for cash would be recorded in one of the cash journals.

SALES RETURN

Before we get to the example, let's introduce a new account: **SALES RETURNS – (REVENUE)**. This is a “negative revenue” account since it reduces actual revenues. This account is the opposite of the **SALES – REVENUE** account as it offsets the sales which were made in the past. This makes sense when you think about it. Initially, when a sale is made it is recorded in the **SALES – REVENUE** account. This increases the business's revenue and net profit. However, when a sales return occurs, the original sale is null and void. It means that we didn't really earn the income that we initially recorded. We could debit the **SALES – REVENUE** account to reduce it, but it is better to record the transaction in a separate account so that later we will know exactly how many sales returns had occurred. If we just debited the **SALES – REVENUE** account then the sales returns would be lost in the process when we close off the **SALES – REVENUE** account at balance day. By creating a separate **SALES RETURNS – (REVENUE)** account that is debited, the total is transferred to the Profit & Loss Statement where we can see the initial sales made as well as the total of all the sales returns that occurred. This provides users with more relevant information.

The recording of sales returns is a little more complex than recording purchase returns, since two recordings are required - one at cost price and one at selling price. Due to the double double-entry required in such transactions, the following example will split the recordings into two for ease of understanding.

GENERAL JOURNAL

STUDY NOTES

EXAMPLE

In the example below it is assumed that customer is a debtor who is issued with credit.

2007

NOV 1 SALES RETURN OF 1 COMPUTER BY B. SEOW (\$2000 COST). CREDIT NOTE ISSUED (CN 14). \$4400 inc GST

SELLING PRICE RECORDINGS

DATE	PARTICULARS	GENERAL LEDGER		SUBSIDIARY LEDGER	
		DR	CR	DR	CR
1/10/07	SALES RETURNS – (REVENUE)	4000			
	GST CLEARING – LIABILITY	400			
	DEBTORS' CONTROL - ASSET		4400		
	B. SEOW - ASSET				4400
	SALES RETURN BY DEBTOR – CREDIT NOTE 14				

Let's interpret the selling price transactions as recorded above. The **SALES RETURNS – (REVENUE)** account needs to be debited in an effort to offset the previous sale of the computer. Although it seems to be a \$4400 sale, the actual sale was \$4000 with an additional 10% GST component. For this reason we need to adjust the **GST CLEARING – LIABILITY** account by taking away the \$400 which we no longer owe to the ATO because this amount has just been credited to the customer. Our liability to the ATO falls by \$400, so the **GST CLEARING – LIABILITY** account is debited. Overall, the debtors now owe the business \$4400 less. This includes the \$400 of GST which was initially paid when the initial sale was made. More specifically, the debtor – B. Seow is the one whose debt has fallen by \$4400. To illustrate this in the business's records, both the **DEBTORS' CONTROL – ASSET** and the subsidiary **B. SEOW – ASSET** accounts are credited. Crediting asset accounts reduces their balances.

COST PRICE RECORDINGS

DATE	PARTICULARS	GENERAL LEDGER		SUBSIDIARY LEDGER	
		DR	CR	DR	CR
1/10/07	STOCK CONTROL - ASSET	2000			
	COST OF SALES – EXPENSE		2000		
	SALES RETURN BY DEBTOR – CREDIT NOTE 14				

From the cost side, **STOCK CONTROL – ASSET** is debited since goods are actually coming in. Stock is generally recorded at cost price, so we use the \$2000 (cost price) and not the \$4400 which was the selling price. The **COST OF SALES – EXPENSE** account is credited to offset the debit which was made when the goods were originally sold.

Remember, **STOCK CONTROL – ASSET** is an asset account. By debiting the account the amount of the asset is increased (\$2000). Because a \$2000 computer has entered the store the value of stock in the store has increased by \$2000. **COST OF SALES – EXPENSE** is an expense account. This account was debited when the sale was initially made. Now, that recording has to be offset, since the sale needs to be cancelled due to the return of the goods. A credit offsets a debit in this case.

When recording such transactions in real life, or in an exam, you will not split the recordings as was done in the example. Illustrated below is how the recording is made. Essentially, it is one recording that consists of two double entries, and an extra one to account for the GST component.

DATE	PARTICULARS	GENERAL LEDGER		SUBSIDIARY LEDGER	
		DR	CR	DR	CR
1/10/07	SALES RETURNS – (REVENUE)	4000			
	GST CLEARING – LIABILITY	400			
	DEBTORS CONTROL - ASSET		4400		
	B. SEOW - ASSET				4400
	STOCK CONTROL - ASSET	2000			
	COST OF SALES – EXPENSE		2000		
	SALES RETURN BY DEBTOR – CREDIT NOTE 14				

GENERAL JOURNAL

STUDY NOTES

DISPOSAL OF A NON CURRENT ASSET

To be able to fully understand and follow the recording of this type of transaction, an overview of the procedures involved need to be presented.

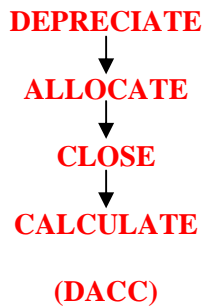
When a business disposes of a **non-current asset** all traces of the asset must be eliminated from the accounts of the business. Which accounts normally deal with non-current assets?

- 📁 The actual non-current asset account;
- 📁 Accumulated depreciation of that asset.

DEPRECIATION - EXPENSE also deals with a non-current asset, but this account is always eventually closed off to the **PROFIT & LOSS SUMMARY**. Therefore, after posting to the **PROFIT & LOSS SUMMARY** account, it will have a zero balance.

PROCEDURE TO DISPOSE OF A NON CURRENT ASSET

1. **Depreciate** the asset to the day of its disposal.
2. **Allocate** this extra depreciation to the **ACCUMULATED DEPRECIATION – (ASSET)** account.
3. **Close** the **DEPRECIATION – EXPENSE** account to the **PROFIT & LOSS SUMMARY** account and the asset related accounts to the **DISPOSAL OF ASSET** account.
4. **Calculate** the profit or loss on disposal in the **DISPOSAL OF ASSET** account.



EXAMPLE

A vehicle costing \$10 000 is disposed of on May 1st 2007.
 Depreciation is calculated to be \$1 000 for the period up to disposal.

DEPRECIATION - EXPENSE			
1/5/07	ACC DEP ⁿ – (ASSET)	1 000	
ACCUMULATED DEPRECIATION – (ASSET)			
	1/7/06	BALANCE	3 000
	1/5/07	DEPRECIATION – EXP	1 000

DATE	PARTICULARS	GENERAL LEDGER		SUBSIDIARY LEDGER	
		DR	CR	DR	CR
1/5/07	DEPRECIATION – EXPENSE	1 000			
	ACCUMULATED DEPRECIATION – (ASSET)		1 000		
	DEPRECIATION OF VEHICLE - MEMO 59				

GENERAL JOURNAL

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DEPRECIATION - EXPENSE

1/5/07	ACC DEP ⁿ – (ASSET)	1 000	1/5/07	PROFIT & LOSS SUMMARY	1 000
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ACCUMULATED DEPRECIATION – (ASSET)

			1/7/06	BALANCE	3 000
			1/5/07	DEPRECIATION – EXP	1 000

PROFIT & LOSS SUMMARY

1/5/07	DEPRECIATION – EXPENSE	1 000			
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DATE	PARTICULARS	GENERAL LEDGER		SUBSIDIARY LEDGER	
		DR	CR	DR	CR
1/5/07	DEPRECIATION – EXPENSE	1 000			
	ACCUMULATED DEPRECIATION – (ASSET)		1 000		
	DEPRECIATION OF VEHICLE - MEMO 59				
	PROFIT & LOSS SUMMARY	1 000			
	DEPRECIATION – EXPENSE		1 000		
	CLOSING ENTRY – MEMO 60				

ACCUMULATED DEPRECIATION – (ASSET)

1/5/07	DISPOSAL OF VEHICLE	4 000	1/7/06	BALANCE	3 000
			1/5/07	DEPRECIATION – EXPENSE	1 000
		4 000			4 000

MOTOR VEHICLE - ASSET

1/7/06	BALANCE	10 000	1/5/07	DISPOSAL OF VEHICLE	10 000
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DISPOSAL OF VEHICLE

1/5/07	MOTOR VEHICLE - ASSET	10 000	1/5/07	ACC DEP ⁿ – (ASSET)	4 000
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DATE	PARTICULARS	GENERAL LEDGER		SUBSIDIARY LEDGER	
		DR	CR	DR	CR
1/5/07	DEPRECIATION – EXPENSE	1 000			
	ACCUMULATED DEPRECIATION – (ASSET)		1 000		
	DEPRECIATION OF VEHICLE - MEMO 59				
	PROFIT & LOSS SUMMARY	1 000			
	DEPRECIATION – EXPENSE		1 000		
	CLOSING ENTRY – MEMO 60				
	ACCUMULATED DEPRECIATION – (ASSET)	4 000			
	DISPOSAL OF VEHICLE		4 000		
	TRANSFER OF ACC DEP ⁿ WRITTEN OFF – MEMO 61				
	DISPOSAL OF VEHICLE	10 000			
	MOTOR VEHICLE – ASSET		10 000		
	TRANSFER OF HISTORICAL COST OF ASSET – MEMO 62				

GENERAL JOURNAL

STUDY NOTES

DISPOSAL OF VEHICLE

1/5/07	MOTOR VEHICLE - ASSET	10 000	1/5/07	ACC DEP ⁿ - (ASSET)	4 000
		<u>10 000</u>		LOSS ON DISP OF VEHICLE	<u>6 000</u>
					<u>10 000</u>

LOSS ON DISPOSAL OF VEHICLE - EXPENSE

1/5/07	DISPOSAL OF VEHICLE	6 000	1/5/07	PROFIT & LOSS SUMMARY	6 000
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PROFIT & LOSS SUMMARY

1/5/07	DEPRECIATION - EXPENSE	1 000
	LOSS ON DISP OF VEHICLE	6 000

DATE	PARTICULARS	GENERAL LEDGER		SUBSIDIARY LEDGER	
		DR	CR	DR	CR
1/5/07	DEPRECIATION - EXPENSE	1 000			
	ACCUMULATED DEPRECIATION - (ASSET)		1 000		
	DEPRECIATION OF VEHICLE - MEMO 59				
	PROFIT & LOSS SUMMARY	1 000			
	DEPRECIATION - EXPENSE		1 000		
	CLOSING ENTRY - MEMO 60				
	ACCUMULATED DEPRECIATION - (ASSET)	4 000			
	DISPOSAL OF VEHICLE		4 000		
	TRANSFER OF ACC DEP ⁿ WRITTEN OFF - MEMO 61				
	DISPOSAL OF VEHICLE	10 000			
	MOTOR VEHICLE - ASSET		10 000		
	TRANSFER OF HISTORICAL COST OF ASSET - MEMO 62				
	LOSS ON DISPOSAL OF VEHICLE - EXPENSE	6 000			
	DISPOSAL OF VEHICLE		6 000		
	TRANSFER OF LOSS ON DISPOSAL OF VEHICLE - MEMO 63				
	PROFIT & LOSS SUMMARY	6 000			
	LOSS ON DISPOSAL OF VEHICLE - EXPENSE		6 000		
	CLOSING ENTRY - MEMO 64				

Let's revise and summarise the recordings by looking at the General Journal entries made above.

The first thing that we did was to depreciate the asset to the day of its disposal. Once this was done we closed the **DEPRECIATION - EXPENSE** account to the **PROFIT & LOSS SUMMARY** account, as is general practice. In the process of depreciating the asset we updated the **ACCUMULATED DEPRECIATION - (ASSET)** account. Having updated the **ACCUMULATED DEPRECIATION - (ASSET)** account we are now in the position to eliminate (close) all the accounts that are related to the asset being disposed of. This is done by closing all the asset related accounts to the **DISPOSAL OF ASSET** account. These accounts include both the actual **MOTOR VEHICLE - ASSET** account as well as the **ACCUMULATED DEPRECIATION - (ASSET)** account. Having closed both these accounts, all traces of the asset are eliminated from our books. At this stage we look at the **DISPOSAL OF ASSET** account and note that the debit side of \$10 000 is larger than the \$4 000 credit side. This means that we have either made a profit or loss of \$6 000 on the disposal. So which is it? We can tell that it is in fact a loss, since we have disposed of a \$10 000 vehicle (its historical cost) of which we allocated only \$4 000 in costs over its useful life (Accumulated depreciation). In other words, we had under depreciated the asset in the past, meaning that we had understated the depreciation expenses and therefore, over stated previous year's profits. Now that we have disposed of the asset, we have adjusted for these previously understated expenses and overstated profits by recording a one-off loss on disposal, which is an expense, and will reduce the business's profit in this financial year.

GENERAL JOURNAL

STUDY NOTES

The previous example assumed that no consideration was received for the asset. This will not always be the case. In fact, in most cases the asset will be sold or traded in for some consideration. In such cases the four steps of **depreciate**, **allocate**, **close** and **calculate** will be the same, except that the calculation step will involve taking into account the consideration given for the asset.

The following example is based on the previous example, except that some consideration for the disposed asset is provided. Most accounts will be exactly the same as before.

EXAMPLE

A vehicle costing \$10 000 is disposed of on May 1st 2007 and traded in for a new vehicle costing \$15 000. The trade-in consideration of the disposed vehicle was \$7500. The remainder was paid in cash. Depreciation is calculated to be \$1 000 for the period up to disposal.

DEPRECIATION - EXPENSE					
1/5/07	ACC DEP ⁿ - (ASSET)	1 000	1/5/07	PROFIT & LOSS SUMMARY	1 000
ACCUMULATED DEPRECIATION - (ASSET)					
1/5/07	DISPOSAL OF VEHICLE	4 000	1/7/06	BALANCE	3 000
		<u>4 000</u>	1/5/07	DEPRECIATION - EXPENSE	1 000
					<u>4 000</u>
MOTOR VEHICLE - ASSET*					
1/7/06	BALANCE	10 000	1/5/07	DISPOSAL OF VEHICLE	10 000
1/5/07	BANK - ASSET	7 500		BALANCE	15 000
	DISPOSAL OF VEHICLE	7 500			<u>25 000</u>
		<u>25 000</u>			
2/5/07	BALANCE	15 000			
DISPOSAL OF VEHICLE					
1/5/07	MOTOR VEHICLE - ASSET	10 000	1/5/07	ACC DEP ⁿ - (ASSET)	4 000
	PROFIT ON DISP OF VEHICLE	1 500		VEHICLE - ASSET	7 500
		<u>11 500</u>			<u>11 500</u>
PROFIT ON DISPOSAL OF VEHICLE - REVENUE					
1/5/07	PROFIT & LOSS SUMMARY	1 500	1/5/07	DISPOSAL OF VEHICLE	1 500
PROFIT & LOSS SUMMARY					
1/5/07	DEPRECIATION - EXPENSE	1 000		PROFIT ON DISP OF VEHICLE	1 500

* **NOTE:** Under normal circumstances, accounts are not balanced during the accounting period, as has been done in the **MOTOR VEHICLE - ASSET** account. Instead accounts are balanced at balance day, which normally occurs at the end of the accounting period. In this example the account has been balanced to illustrate that it now has a \$15 000 debit balance, which is the historical cost of the new vehicle. Even though a number of recordings have been made in the account, the final balance is representative of the current situation. Remember, we disposed of one vehicle, but gained another \$15 000 motor vehicle in its place. As a result, the account needs to reflect this and have a debit balance of \$15 000, representing the historical cost of the motor vehicle in the business's possession.

GENERAL JOURNAL

STUDY NOTES

DATE	PARTICULARS	GENERAL LEDGER		SUBSIDIARY LEDGER	
		DR	CR	DR	CR
1/5/07	DEPRECIATION – EXPENSE	1 000			
	ACCUMULATED DEPRECIATION – (ASSET)		1 000		
	DEPRECIATION OF VEHICLE - MEMO 59				
	PROFIT & LOSS SUMMARY	1 000			
	DEPRECIATION – EXPENSE		1 000		
	CLOSING ENTRY – MEMO 60				
	ACCUMULATED DEPRECIATION – (ASSET)	4 000			
	DISPOSAL OF VEHICLE		4 000		
	TRANSFER OF ACC DEP ⁿ WRITTEN OFF – MEMO 61				
	DISPOSAL OF VEHICLE	10 000			
	MOTOR VEHICLE – ASSET		10 000		
	TRANSFER OF HISTORICAL COST OF ASSET – MEMO 62				
	MOTOR VEHICLE – ASSET	7 500			
	DISPOSAL OF VEHICLE		7 500		
	CONSIDERATION GIVEN FOR SALE OF ASSET – MEMO 63				
	DISPOSAL OF VEHICLE	1 500			
	PROFIT ON DISPOSAL OF VEHICLE - REVENUE		1 500		
	TRANSFER OF PROFIT ON DISP OF VEHICLE – MEMO 64				
	PROFIT ON DISPOSAL OF VEHICLE – REVENUE	1 500			
	PROFIT & LOSS SUMMARY		1 500		
	CLOSING ENTRY – MEMO 65				

Oops, we've missed a recording. Note that the remaining \$7500 that was paid for the new vehicle has not been recorded above. Why? This is because the example specifically stated that the remaining amount of the new vehicle's purchase price after taking into account the trade-in was paid in cash. At this stage you should know that "every time the business makes **cash payments** of any kind to any source they must be recorded in the Cash Payments Journal". So here it is:

CASH PAYMENTS JOURNAL

DATE	DETAILS	CHQ NO.	BANK	DISCOUNT REVENUE	CREDITORS	STOCK	SUNDRY PAYMENTS
1/5/07	MOTOR VEHICLE - ASSET	XX	7500				7500

NOTE: For VCE purposes, GST does not apply to disposal of asset transactions, so they have been ignored in these notes.

ACCOUNTING FOR STOCK

STOCK VALUATION

NET REALISABLE VALUE

LOWER OF COST OR NET REALISABLE VALUE

STOCK WRITEDOWN

STOCK CARDS

PRODUCT VS PERIOD COST

ACCOUNTING FOR STOCK

STUDY NOTES

STOCK VALUATION

Accurate stock valuation is crucial in accounting. There are a number of very important reasons why stock needs to be valued accurately in the accounting records of a business. Accurate stock valuation is necessary to calculate the cost of sales, which has an implication on the net profit or loss of the business. Accurate stock valuation is needed to calculate the stock balance at the end of the period, which is then recorded in the **Balance Sheet**. Valuation methods include the most commonly used First In, First Out (FIFO), identified cost, as well as a couple more that you may have heard of such as Last In, First Out (LIFO) and the weighted average method. These four valuation methods have one thing in common – they value stock at **COST** price. If stock were always to be purchased at the same price, then stock valuation would be easy. However, in reality, prices for goods purchased vary over time. As a result there are a number of different methods that are available in order to value stock as accurately as possible, again, at **COST** price.

NOTE: The VCE syllabus requires focus on the FIFO method of stock valuation only.

One of the rules of accounting states that stock needs to be valued at the “**lower of cost or net realisable value**”. This may seem scary and weird to some, but don’t worry if you are one of those students, its not as confusing as it sounds. This rule is based on the principle of conservatism where there is a requirement to recognise and record anticipated future losses and expenses.

NET REALISABLE VALUE

Net realisable value is the amount that you can receive for the stock after deducting the expenses required to sell the items in the open market. For example, you can receive \$10 for an item, but you have to place an advertisement that costs \$2 per item. Therefore, the net realisable value of the item will be \$8. When thinking about net realisable value, think of it as the value you can realise (get/receive) for the item less costs associated with the sale (net).

LOWER OF COST OR NET REALISABLE VALUE

The conservatism principle of accounting states that possible future losses need to be recognised and recorded immediately. This accounting principle is applied to stock valuation in the form of **LOWER OF COST OR NET REALISABLE VALUE**. I know that this doesn’t make much sense to some students – so break up the phrase. Stock is valued at the lower of:

- ↳ **COST**
- ↳ **NET REALISABLE VALUE**

This means that stock is valued at the amount that is lower of the two options. Usually the option that will provide the lowest value will be cost. This should be obvious. If a business was to receive less for an item (realisable value) than what it costs to purchase the item, less costs associated with selling the item (net realisable value), the business would no longer be in business – it would go bankrupt!

So far in your studies of stock you have always, and will continue in most cases, to value stock at cost. This is because the cost price will be the lower of cost and net realisable value, since businesses will purchase products for a particular price and then add a mark-up and sell the items for a higher price. However, there may be a number of situations where the business may not be able to sell some items for even the cost price. The business may have to reduce the price even further to “below cost”.

ACCOUNTING FOR STOCK

STUDY NOTES

REASONS WHY THE REALISABLE VALUE MAY BE LESS THAN COST

- ❏ Item will be reaching or has passed its “used by” date – food of some sort;
- ❏ Item may now be obsolete – Amiga computer;
- ❏ Item may be out of fashion – yoyo;
- ❏ Item may be out of season – fur coat in summer;
- ❏ Item may have been damaged in the store – flood damage;
- ❏ Item that just nobody wants – Leyland P76.

STOCK WRITEDOWN

Stock will usually be valued at cost price in the accounts and stock cards of the business. When it becomes apparent and foreseeable that the stock can no longer be sold at even cost price, it needs to be written down in the books of the business to its net realisable value.

EXAMPLE

By the end of January 2007 you realise that you can no longer sell your stock for the selling price. In fact, the stock has gone out of fashion and the net realisable value is \$13 000. The stock that you have left has cost you \$14 000.

STOCK CONTROL – ASSET					
1/1/07	BALANCE	14 000	31/1/07	STOCK WRITE DOWN – EXP	1 000
				BALANCE	<u>13 000</u>
		<u>14 000</u>			<u>14 000</u>
1/2/07	BALANCE	13 000			
STOCK WRITE DOWN – EXPENSE					
31/1/07	STOCK CONTROL	<u>1000</u>	31/1/07	PROFIT & LOSS SUMMARY	<u>1000</u>

The stock that has been written down is transferred to the appropriately named **STOCK WRITE DOWN – EXPENSE** account. This account is an expense since it represents the cost that has been incurred in writing the stock down to its net realisable value. The expense account, like all other expense accounts is transferred to the **PROFIT & LOSS SUMMARY** account.

ACCOUNTING FOR STOCK

STUDY NOTES

STOCK CARDS

Stock cards are used to record stock movements. Stock cards supplement the stock control account when it comes to the recording of stock and their use can improve accounting security and control. Stock card balances can be compared with the **STOCK CONTROL - ASSET** account balances to verify actual stock balances. Stock cards provide specific information about individual stock items compared with the **STOCK CONTROL - ASSET** account that provides aggregate or totals for stock movements as a whole.

Stock write downs have to be recorded in the stock cards in order to maintain consistency in the records of the business.

EXAMPLE

Continuing with our example, the following adjustment will be made in the stock card:

STOCK CARD										
ITEM: 2007 YEARLY PLANNER			LOCATION: COUNTER							
CODE: YP2007		SIZE: A5		EDITION: AUSTRALIANA						
DATE	DETAILS	IN			OUT			BALANCE		
		QTY	PRICE	VALUE	QTY	PRICE	VALUE	QTY	PRICE	VALUE
31/1/07	BALANCE							1000	14	14 000
	MEMO 36				1000	1	1000	1000	13	13 000

NOTE: The VCE guidelines for stock card recording states that the information contained in the “Particulars” or “Details” column of a stock card must reflect the relevant document number.

PRODUCT VS PERIOD COSTS

The cost of stock includes all costs associated with bringing the stock into the store in a saleable condition. It is important to include all the costs directly related to the stock in order to be able to attain an accurate costing of stock, which is crucial to be able to appropriately price the item as well as to accurately record the cost of sales.

COSTS THAT ARE RELATED TO STOCK

- 📦 Cartage inwards – delivery of stock to the business;
- 📦 Insurance of stock;
- 📦 Customs duties and fees;
- 📦 Installation;
- 📦 Security;
- 📦 Packaging;
- 📦 Alterations.

In reality, however, sometimes it is not so easy to allocate costs accurately as one would like.

ACCOUNTING FOR STOCK

STUDY NOTES

EXAMPLES

You buy 100 000 marbles and the cost of delivery inwards is \$50. Dividing this cost by the number of marbles would provide such an immaterial value that it is better to record the cost separately. In another situation a car dealer buys 25 cars – 5 BMWs, 10 Mercedes, 3 Audis and 7 Volkswagens. These cars weigh different amounts and are different sizes. Shipping costs \$15 000. Weight and size are factors that make up the price of shipping. How do you allocate this cost amongst the cars mentioned? Hardcore mathematicians would certainly be able to make the calculation, but obviously the amount of time and resources required to make the calculation do not warrant the effort.

Accountants have devised a way to get around these problems, by identifying two types of costs and dealing with them accordingly.

PRODUCT COST - A cost that is included as part of the cost of the product. The product cost is added to the purchase price of the stock item that it relates to. This cost or expense is recorded as part of the cost of sales when the stock is sold. The key to recognising a stock related cost that needs to be included as part of the product cost is that it must be related to the stock item on a logical and measurable basis.

PERIOD COST – A stock related cost (expense) that cannot be related to the stock item on a logical and measurable basis. This expense is recorded separately in the ledger and **Profit & Loss Statement** under the heading “Cost of Goods Sold”. Like product costs, period costs are those that are incurred with bringing the stock into the store in a saleable condition. Unlike period costs however, product costs are reported in the **Profit & Loss Statement** in the period in which they are incurred, and not when the stock is sold.

As discussed so far, there will be some costs incurred that specifically relate to stock. The question arises, do we include these costs together with the cost price of the stock item, or do we separate them and record them in the **Profit & Loss Statement** separately as general Cost of Goods Sold? The answer to this question is dependant on the nature of these costs. To be considered a product cost, and hence, be included as part of the cost of the item, the cost needs to pass two tests – **relationship test** and **materiality test**. This is not an officially recognised “test” as such; it is just a mental method that you should use to increase the chance of making the right decision in relation to stock costing.

Using the previous example of the vehicles and shipping costs, there is an inadequate relationship between the shipping costs and each product. Realistically, the shipping costs cannot be accurately allocated to each product due to the differences in the products. Although it is true that if you took the time to accurately measure the size of the vehicles and their exact weight, the shipping costs could be allocated accordingly. However, to do this would take an unreasonable amount of time and resources. Hence, as is, the costs cannot be reasonably related to each item. In this case the relationship test has failed. Shipping expense is considered to be a period cost and is recorded separately in the Profit & Loss Statement as a Cost of Goods Sold.

The marble example is different. The marbles are all the same, and therefore, there is a strong and direct relationship between the items and their delivery costs. The delivery inwards is simply divided by the number of marbles. This example passes the relationship test. Before delivery inwards can be classified as a product cost, it needs to also pass the materiality test. Dividing the \$50 delivery cost by 100 000 marbles provides such an immaterial value (\$0.0005) that it is not possible to incorporate this amount into the cost of each marble. Doing so is illogical and the cost will become lost in the accounting records. As a result, the delivery inwards of \$50 would be treated as a Cost of Goods Sold.

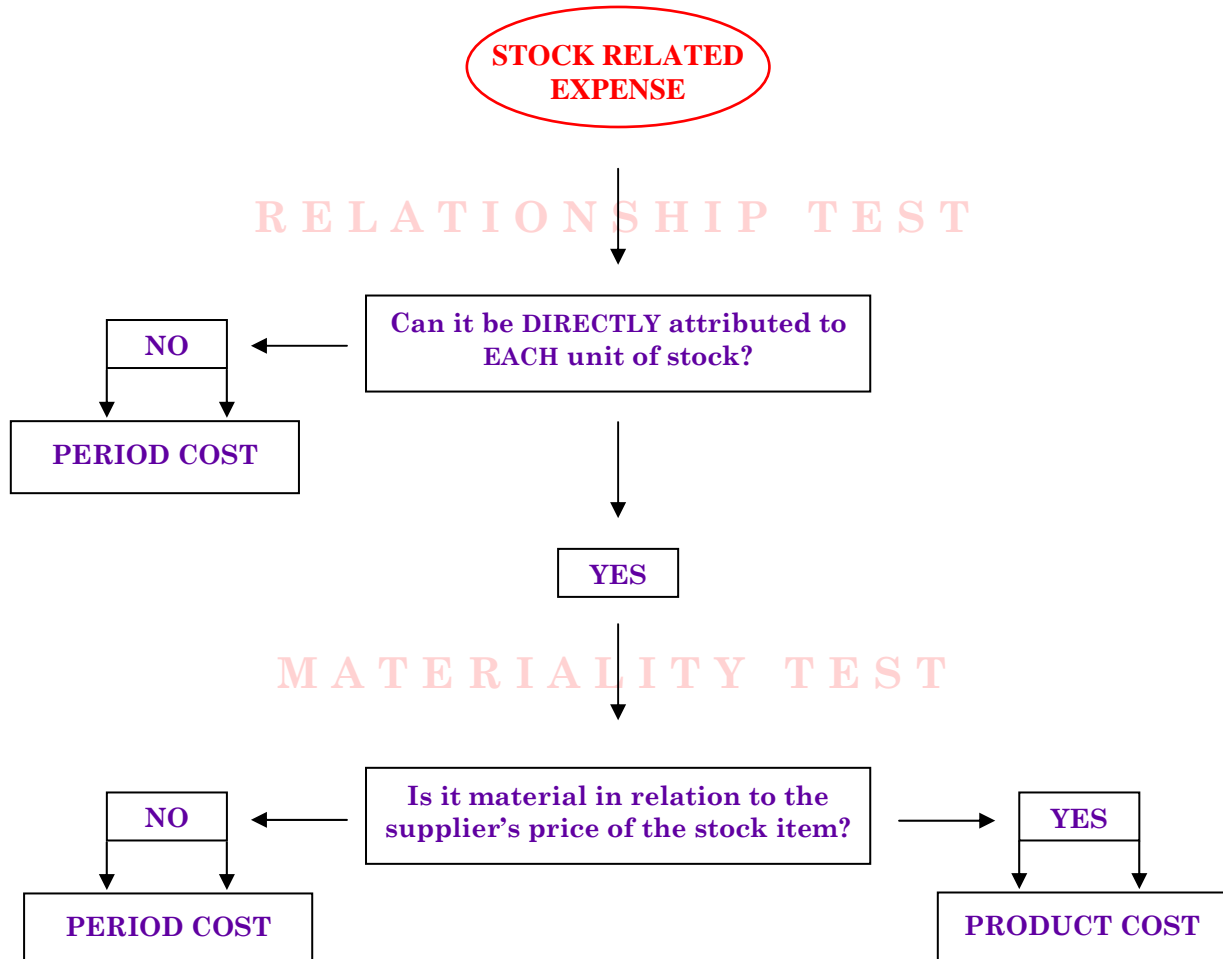
NOTE: The terms “relationship test” and “materiality test” are methods that I have devised to explain the product/period cost concepts to my personal students. If you decide to outline these techniques in your exams or SACs, please be aware that teachers or assessors may not know what you are talking about.

ACCOUNTING FOR STOCK

STUDY NOTES

I have devised a simple flowchart that can be used to identify whether a cost associated with a stock item or items is classified as a product or period cost. Note how the relationship and materiality tests are applied.

RELATIONSHIP & MATERIALITY TEST



PRODUCT COSTS – ADD TO STOCK PRICE

- ✦ Must be directly related and traceable to the stock item – logical basis;
- ✦ Must be material in nature.

PRINCIPLES OF ACCOUNTING

CONSERVATISM – To recognise and record anticipated future losses and expenses, whereas gains are recorded only when they occur.

QUALITATIVE CHARACTERISTIC

RELEVANCE – Information presented must be relevant to decision makers. This requires the inclusion of all accurate information in the financial statements that could assist in influencing economic decisions by users.

STUDY NOTES

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AUTHOR

MR PETER SOLANIKOW

Bachelor of Commerce

Graduate Diploma in Applied Finance & Investment

Certificate IV in Small Business Management

Peter has been current with the VCE system throughout its changes since 1990. He is experienced, up to date with the current curriculum and this experience has enabled him to identify key problem areas that students face when dealing with the subject at the VCE level. Over time Peter has prepared summary and study notes for students to enable them to get a better understanding of the subject, improve their confidence and to cut down on study time whilst not compromising on their final result.

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