

# Chapter 5

## Revenue

### Learning objectives

- To describe the nature of liabilities
- To describe the criteria for the recognition of liabilities
- To explain executory contracts and contingent liabilities
- To explain liability measurement techniques, particularly for the measurement of debentures and leases

### Introduction

For many organisations inventory is one of their largest assets. Therefore it is important that accurate records are kept to provide information to both internal and external users. Many of the records kept relate to the control of inventory and there are several different inventory control systems that can be used.

### ← Looking back

Chapter 4 focused on the recording of transactions, including recording in the ledger and describing the closing process and the preparation of final reports. The transactions analysed in previous chapters were primarily concerned with those of businesses that sell services.

### Looking forward →

In this chapter the focus will be the accounting processes of **merchandisers**. These businesses buy and sell goods as their primary activity. Retailers and wholesalers are merchandisers. This chapter introduces the business and accounting practices used by organisations engaged in the purchase of inventory from suppliers and the sale of inventory to customers. We show how financial statements reflect these merchandising activities and explain how these new elements are incorporated in the recording and reporting process.

Merchandising activities are a major part of modern business. Generally merchandisers operate at the retail level. Examples include supermarkets, clothing **retailers**, electrical goods retailers and pharmacies. In some circumstances they might act as wholesalers distributing inventory to retail outlets. A **wholesaler** is an intermediary who buys products from manufacturers or other wholesalers and sells them to retailers or other wholesalers. In contrast, a retailer buys products from manufacturers or wholesalers and sells them to consumers.

## 5.1 Profit measurement: merchandiser and service enterprises

Unlike a service organisation, merchandisers buy inventory to resell at a profit. The term **inventory** may be defined as goods held for the purpose of resale. Other terms commonly used include merchandise, stock or goods.

As seen in previous chapters, profit is determined for a service enterprise by matching revenues earned with expenses incurred for a period. The merchandiser follows the same principle based on the accounting equation. To record the additional information an extra category of expense must be included to record the cost of inventory sold—usually called ‘Cost of goods sold’. The usual accounting term for revenues from selling merchandise is ‘sales’.<sup>1</sup>

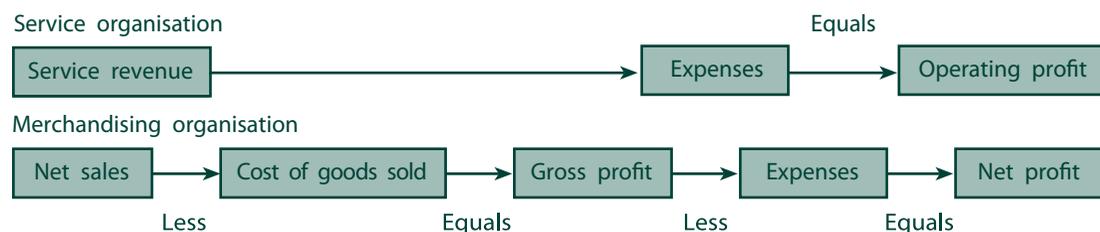
Typical income statement formats for service and merchandising organisations are presented below. The operating profit of the service organisations is derived from revenue *less* expenses. The net profit to a merchandiser is derived from the revenue from selling merchandise *less* the cost of merchandise and the cost of other expenses for the period (see Figure 5.1).

The typical income statement formats for each type of enterprise is shown below.

Note: the merchandiser incurs costs associated with the acquisition of the goods for sale as well as expenses in operation of the business.

A merchandiser (e.g. a supermarket) sells goods for revenue, incurring costs of buying the good and of selling the good.

A service enterprise (e.g. an accounting firm) sells the labour of the owner and/or employees.



**Figure 5.1** Determining profit for a merchandising organisation versus a service organisation

Source: Where is my money? McGraw-Hill Australia

Merchandiser Income statement for the period ended XX		Service enterprise Income statement for the period ended XX	
Sales revenue	\$1000	Service revenue	\$1000
less Sales returns	10		
Net sales	990		
less Cost of goods sold	440		
Gross profit	550		
less Expenses	50	less Expenses	500
Net profit	500	Operating profit	500

### 5.1.1 Important distinguishing aspects of reporting for merchandisers:

1. A merchandiser's revenue is referred to as **sales revenue**, not service revenue. Reductions of revenue due to inventory returned by customers for any reason are recorded as sales returns, which is offset against sales revenue for the period. This results in net sales.<sup>2</sup>
2. **Cost of goods sold** accumulates all the costs associated with the inventories sold.
3. **Gross profit** is determined by subtracting cost of goods sold from net sales revenue.

### 5.1.2 Aspects of similarity in reporting for merchandising and service firms

1. The expenses sections of both income statements of a merchandiser and a retail firm generally contain the same types of accounts, including items such as telephone, electricity and other general expenses.
2. Both service and merchandising firms are subject to a goods and services tax (see Appendix B for the recording of processes).

### 5.1.3 The relative importance of inventory as a proportion of total assets

For some companies inventory represents their most valuable asset. The following companies listed on the Australian Stock Exchange show significant differences in the reported value of inventory as a proportion of total assets. For example, compare Woolworth Ltd (22.1 per cent) with Qantas Ltd (1.83 per cent). Note also that some companies report that they have inventories classified as non-current assets reflecting the long-term nature of the inventory as it is to be retained by the company beyond one accounting period.<sup>3</sup>

Company*	Current	Inventory (\$M)		Inventory as % of total assets
		Non-current	Total assets	
Coles Myer Ltd	3 155.0	—	93 464.0	33.80
Foster's Group Ltd	1 497.5	439.0	11 745.3	16.50
Qantas Airways Ltd	333.0	—	18 134.0	1.83
Woolworth Ltd	1 977.0	—	8 958.0	22.10

\*Results drawn from 2005 annual reports.

## Pause and reflect

### Effect of 'news' on share price

Positive news has positive effect:

#### Rising gold puts a shine on under-producing Newcrest

A rising gold price took the edge off Newcrest Mining's latest bad news that it won't meet its gold production target at the much-troubled Telfer mine. Gold lifted more than \$US5103 to around \$US644 in Asian trading after a good close in New York on Friday. Newcrest's shares sank initially on the Telfer announcement but, after the kneejerk phase had subsided and the gold price was factored in the stock rebounded to end \$1.10 up at \$20.4—helped also by Newcrest's reassurance to the market that its profit guidance still stood.

Source: *The Australian*, 6 June 2006, p. 21

#### Woodside over moon on Pluto

Woodside is planning to spend up to \$5 billion on its first independent liquefied natural gas plant based on its newly discovered Pluto field on the North West Shelf.

Woodside shares vaulted \$1.53 higher to close at a record \$31.92.

Source: *The Australian*, 9 August 2005, p. 19

Negative news has negative effect:

#### When numbers all add up to a big reaction

Sometime before lunch on Tuesday May 4, Coca-Cola Amatil boss Terry Davis blew a sizeable hole in the softdrink bottlers' stock...Davis noted profit growth for the half would be 'about 10 per cent' instead of 'double digit'.

During the intra-day trading, the share price fell by as much as 14 per cent and closed down 7.2 per cent.

Source: *Australian Financial Review*, 18 July 2005, p. 53

#### Show growth hits Fairfax's second half

The heavy exposure of John Fairfax Holdings to the slow-growth states of New South Wales and Victoria and the weakening New Zealand dollar could slice as much as 7 per cent off its second half earnings. Shares in Australia's second biggest newspaper group fell to a 20-month low yesterday, closing down 9c at \$3.73 after Fairfax warned it was battling 'revenue weakness'.

Source: *The Australian*, 6 June 2006, p. 23

## 5.2 Recording inventory for a merchandiser: contrasting perpetual and periodic systems

There are a number of inventory systems. We shall discuss two of these available for use by the merchandiser:

1. The perpetual inventory system.
2. The periodic inventory system.

The choice of system is determined by the characteristics of the business, including type, value and volume of inventory sold.

### 5.2.1 The periodic inventory system

This system of recording inventory does not require continuous updating of the inventory account. This means that when the inventory is bought, it is put on the shelves, and when it is sold or used, it is taken off the shelves. The firm does not keep a constant record of the quantities or values of the inventory on hand at any one period of time. When the financial statements are prepared the company takes a physical count of inventory by counting the quantities of merchandise on the shelves. This count (stocktake) is used to determine the inventory on hand at the end and, by deduction, the cost of the number of units sold, called the **cost of goods sold**. The following is an example of this process.

A reporting entity is defined by SAC1 as any entity:

*in respect of which it is reasonable to expect the existence of users dependent on financial statements for information which will be useful to them for making and evaluating decisions about the allocation of scarce resources (paragraph 40).<sup>4</sup>*

These users would include shareholders, potential investors, analysts, regulators, creditors, suppliers, employees and other users who rely on financial reports as a basis for assessing an entity's financial position, profitability and performance.

A. Wong, owner of Party Supplies, commences the year with 200 party hats on the shelves. During the year he purchases a further 1500 party hats. At the end of the financial year he counts the number of party hats on the shelves and discovers there are 150 hats left.

	Number of hats
Beginning inventory (count)	200
<i>plus</i> Purchases	1500
Number of party hats for sale	1700
<i>less</i> Ending inventory (count)	150
Equals Inventory sold (i.e. Cost of goods sold)	1550
(By deduction, the number of hats assumed to be sold)	1550

The IASB *Framework* defines the objectives of financial statements in terms of two qualities: economic decision making and managerial accountability (paragraphs 12–14):

1. *The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an enterprise that is useful to a wide range of users in making economic decisions.*

2. *Financial statements also show the results of the stewardship of management, or the accountability of management for the resources entrusted to it. Those users who wish to assess the stewardship or accountability of management do so in order that they may make economic decisions; these decisions may include, for example, whether to hold or sell their investment in the enterprise or whether to reappoint or replace the management.<sup>5</sup>*

The IASB *Framework* defines the following external users as being dependent on financial statements (paragraph 9):

- (a) *Investors: The providers of risk capital and their advisers are concerned with the risk inherent in, and return provided by, their investments. They need information to help them determine whether they should buy, hold or sell. Shareholders are also interested in information that enables them to assess the ability of the enterprise to pay dividends.*
- (b) *Employees: Employees and their representative groups are interested in information about the stability and profitability of their employers. They are also interested in information that enables them to assess the ability of the enterprise to provide remuneration, retirement benefits and employment opportunities.*
- (c) *Lenders: Lenders are interested in information that enables them to determine whether their loans, and the interest attaching to them, will be paid when due.*
- (d) *Public: Enterprises affect members of the public in a variety of ways. For example, enterprises may make a substantial contribution to the local economy in many ways, including the number of people they employ and their patronage of local suppliers. Financial statements may assist the public by providing information about the trends and recent developments in the prosperity of the enterprise and the range of its activities.<sup>6</sup>*

Companies such as hardware stores, supermarkets, and department stores that sell large quantities of low-value items have historically used periodic systems of recording inventory. However, with the advent of computers and optical scanners, it is now possible to track the movement of low-cost items, such as nails in hardware stores, confectionery in supermarkets, and socks and scarves in department stores. Consequently an increasing number of organisations use the perpetual inventory system of recording as it provides up-to-date information about stock levels. (Note that the recording and reporting processes for the **periodic inventory system** are covered in Appendix A to this chapter.)

### 5.2.2 The perpetual inventory system

The **perpetual inventory system** consists of a continuous record of inventory movement, usually maintained by computer. This system, in contrast to the periodic inventory system, maintains a constant record of inventory purchased and sold thus providing a balance at any time.

Using the same example of A. Wong, owner of Party Supplies, the following processing would occur for the purchase and sale of party hats.

The recording using a perpetual inventory approach has highlighted the incorrect assumption made in the periodic system that all party hats not on the shelves at the end must have been sold. In this example the damaged hats are recorded during the financial recording process thus revealing that only 1500 hats were sold, rather than 1550 as shown in the periodic system.

Before the growth of computer technology, a perpetual system was often limited to businesses making a small number of daily sales, such as car dealers and major appliance stores. Given the high cost of maintaining an ongoing record of transactions, the perpetual system was feasible because transactions were relatively few in number. Today, where there is widespread use of computing technology, the use of the perpetual system has significantly increased as it gives more timely and accurate information and is now more affordable. Accordingly, this chapter emphasises a perpetual system. Appendix A to

this chapter provides an analysis and recording of merchandising transactions using both periodic and perpetual inventory systems.

### The recording process

The perpetual inventory system adopts an **asset approach** to inventory recording. This means that all goods purchased for sale are recorded as an asset on acquisition. When goods are sold, a decrease in the asset (inventory) and a corresponding increase in the expense (cost of goods sold) is recorded. Throughout the accounting period changes in the inventory account are recorded as buying and selling of inventory occurs. At any point in the accounting period it is possible to determine the cost of goods available for sale and the cost of goods sold to date. The actual position might be different, due to unrecorded movements in inventory levels attributable to spoilage, theft or clerical errors. These movements can be isolated because the perpetual system is accompanied by a physical inventory count at the end of the accounting period.

#### Purposes of physical count of inventory in a perpetual recording system

- The discrepancy between the actual and the recorded levels of inventory may provide management with an indication of the efficiency of inventory control, in terms of items remaining unsold at the end of the accounting period.
- The inventory count may also draw attention to the existence of obsolete or damaged inventory as staff inspects inventory items when conducting the count.

## Example 5.1

### Transaction Analysis: J. Dott

On 1 April 20XX J. Dott decided to open a painting business called J. Dott Painting Services. The following transactions took place during the first month of operating.

1. Owner J. Dott contributed \$20 000 cash to commence his business.
2. Charged customer for painting performed, \$9000.
3. Purchased painting supplies on credit for \$400.
4. Received \$4000 from customers charged in (2) above.
5. Purchased a van for \$8000 paying \$2000 in cash and obtaining a loan for the rest.
6. Paid \$100 off amount due for supplies from (3) above.
7. J. Dott withdrew \$1000 cash from the business for personal use.
8. Used \$100 worth of painting supplies previously purchased.
9. Paid expenses in cash (advertising \$300, telephone \$400, electricity \$300).
10. Paid \$2000 off loan for van in (5) above.

#### Required

- (a) Record the transactions in an accounting equation analysis table.
- (b) Prepare an income statement and balance sheet for the month.

#### Notes:

- Each transaction is analysed from the viewpoint of the effect on the accounting equation of the business.
- After each transaction is analysed, the accounting equation *must* remain in balance. To achieve this, there must be at least *two* effects identified for each transaction.

- All transactions involving capital contributions, revenues, expenses or drawings (C, R, E, D) in the following accounting equation analysis will always affect the owner's equity column since they reflect increases or decreases in the owner's claim on the entity, as explained previously.
- Before commencing each transaction the following questions should be addressed:
  - *Items affected.* What *specific items* from the financial statements are affected?
  - *Classification.* What *elements* of the equation do these specific item fit into? (i.e. asset, liability or owner's equity).
  - *Change.* Has that element *increased or decreased* as a result of the transaction?

### Solution to Example 5.1

#### (a) Analysis of transactions

1. Owner J. Dott contributed \$20 000 cash to commence his business.

Items affected	Classification	Change
Cash at bank	Asset	Increase
Capital	Owner's equity—capital	Increase

#### Explanation

The entity has gained cash, but must acknowledge the owner's claim on the entity.

Assets				=	Liabilities	+	Owner's equity
Cash at bank	Accounts receivable	Supplies	Van		Accounts payable		Loan payable
1. +20 000							+20 000 C*

\*C = Capital, R = Revenue, E = Expenses, and D = Drawings.

2. Charged customer for painting performed, \$9000.

Items affected	Classification	Change
Accounts receivable	Asset	Increase
Service revenue	Owner's equity—revenue	Increase

#### Explanation

The entity now has a legal right to receive resources from customers. Since revenue increases profit, the owner's claim on the entity increases.

## 5.3 Using source documents in the recording of inventory transactions

The **source documents** used in initiating the recording of transactions form an important part of the internal control within an organisation. These documents provide the input for processing of information in journals and ledgers. Some examples of source documents are invoices, receipts and payroll records. The data collected on the various documents are referred to as input. Typically the information on a source