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Bachelor of Commerce (B2001) | Level 1 • Part A Core | Monash University

Introduction to financial accounting

Course Code: ACC1100 • Module 3 Notes

Module 3: Adjusting Entries, Closing Process, Inventory & Non-Current Assets

1. Accrual vs Cash Accounting, Periodicity, and Adjusting Entries

1.1 Periodicity Assumption and the Australian Financial Year

Although the economic life of a company is continuous under the going concern assumption, investors, lenders, and regulators cannot wait until an entity winds up to evaluate its performance. The **periodicity (time-period) assumption** divides an entity's economic life into artificial, equal reporting intervals—typically twelve months, supplemented by half-year reports for ASX-listed disclosing entities. In Australia, the statutory financial and taxation year for most entities runs from **1 July to 30 June**, although subsidiaries of foreign multinationals and certain retailers occasionally adopt a 31 December or 52/53-week balance date under *Corporations Act 2001* rules.

Because business operations rarely begin and end neatly on 30 June, multi-period transactions—such as an annual insurance premium paid in March, a two-year service contract collected in advance, or a fortnightly payroll straddling 30 June—create timing differences between cash movements and economic performance.

1.2 Accrual Basis vs Cash Basis Accounting

Under the **cash basis of accounting**, revenue is recorded only when cash is received and expenses are recorded only when cash is paid. While cash-basis records are simple for micro-businesses, they frequently distort operating performance by ignoring credit sales, unpaid supplier bills, and multi-year assets consumed over time.

Consequently, `AASB 101 Presentation of Financial Statements` (para. 27) mandates the **accrual basis of accounting** for all financial statements except the Statement of Cash Flows:

- **Revenue Recognition (`AASB 15 Revenue from Contracts with Customers`):** Income is recognised when (or as) the entity satisfies a performance obligation by transferring control of a promised good or service to a customer, regardless of when cash is collected.
- **Expense Recognition (Matching / Consumption):** Expenses are recognised in the reporting period in which economic benefits are consumed or liabilities are incurred in generating revenue, regardless of when cash is disbursed.

1.3 The Four Classes of Adjusting Entries

At the end of every reporting period, before financial statements are compiled from the ledger, an accountant prepares **adjusting entries** to bring asset, liability, income, and expense accounts up to date under the accrual basis. Every adjusting entry exhibits two invariant properties: (1) it affects at least one *Statement of Profit or Loss* account (Income or Expense) and one *Statement of Financial Position* account (Asset or Liability), and (2) it **never involves Cash at Bank** (because cash was already paid/received earlier for deferrals, or will be paid/received later for accruals). Furthermore, in Australia, adjusting entries generally do **not** include GST because GST is accounted for when the underlying tax invoice is issued or received.

Category	Sub-Type	Timing Sequence	Adjusting Entry Pattern	Effect on Profit if Omitted
Deferral	Prepaid Expense	Cash paid *before* expense incurred	Dr Expense; Cr Prepaid Asset	Profit overstated (Expenses understated)
Deferral	Unearned Revenue	Cash received *before* revenue earned	Dr Unearned Revenue Liability; Cr Revenue	Profit understated (Revenue understated)
Accrual	Accrued Expense	Expense incurred *before* cash paid	Dr Expense; Cr Accrued Liability	Profit overstated (Expenses understated)

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Category	Sub-Type	Timing Sequence	Adjusting Entry Pattern	Effect on Profit if Omitted
Accrual	Accrued Revenue	Revenue earned *before* cash received	Dr Accrued Receivable Asset; Cr Revenue	Profit understated (Revenue understated)

Worked Numerical Examples of the Four Adjusting Entries (30 June 2026)

1. **Prepaid Expense (Commercial Insurance):** On 1 March 2026, *Geelong Freight Pty Ltd* paid A$7,920 cash (GST-inclusive) for a 12-month commercial vehicle insurance policy covering 1 March 2026 to 28 February 2027. At payment, the GST-exclusive cost of A$7,200 (7,920 ÷ 1.1) was debited to Prepaid Insurance (an asset), and A$720 was debited to GST Paid.
   30 June Adjustment: By 30 June 2026, 4 months of coverage (March–June) have expired. Expired expense = $7,200 \times \frac{4}{12} = 2,400$ (A$2,400), leaving A$4,800 unexpired as an asset.
   Journal Entry: Dr Insurance Expense A$2,400; Cr Prepaid Insurance A$2,400. (Note: GST was already claimed on 1 March.)
2. **Unearned Revenue (Annual Software Support):** On 1 April 2026, *Docklands Cloud Pty Ltd* received A$13,200 cash (GST-inclusive) from a client for a 12-month maintenance contract running 1 April 2026 to 31 March 2027. On 1 April, the company recorded Dr Cash A$13,200; Cr Unearned Service Revenue A$12,000; Cr GST Collected A$1,200.
   30 June Adjustment: Three months of support services (April–June) have been delivered by balance date. Revenue earned = $12,000 \times \frac{3}{12} = 3,000$ (A$3,000), leaving A$9,000 as a current liability.
   Journal Entry: Dr Unearned Service Revenue A$3,000; Cr Service Revenue A$3,000.
3. **Accrued Expense (Wages Straddling Balance Date & Loan Interest):** Employees of a Clayton warehouse earn A$1,800 per working day across a 5-day week (Monday–Friday), paid every second Friday. The last payday was Friday 26 June 2026; 30 June 2026 falls on a Tuesday, meaning 2 working days (Monday 29 June and Tuesday 30 June) have been worked but remain unpaid at year-end. Additionally, a A$60,000 bank loan at 7.5% p.a. has accrued 2 months of unpaid interest at 30 June.
   Calculation: Accrued wages = $2 \times 1,800 = 3,600$ (A$3,600). Accrued interest = $60,000 \times 0.075 \times \frac{2}{12} = 750$ (A$750).
   Journal Entries: Dr Wages Expense A$3,600; Cr Accrued Wages Payable A$3,600; and Dr Interest Expense A$750; Cr Accrued Interest Payable A$750.
4. **Accrued Revenue (Unbilled Consulting Services):** During the final week of June 2026, a Melbourne advisory firm completed 25 billable hours at A$220/hour (GST-exclusive) for a client who will not be invoiced until 5 July 2026.
   Calculation: Accrued revenue = $25 \times 220 = 5,500$ (A$5,500).
   Journal Entry: Dr Accrued Consulting Receivable A$5,500; Cr Consulting Revenue A$5,500. (When the formal tax invoice is raised on 5 July, A$550 GST Collected is recorded alongside A$6,050 Accounts Receivable.)

1.4 Alternative Initial Recording Methods for Deferrals

In Australian commercial bookkeeping, preparers may initially record cash prepayments and advance customer receipts in one of two ways: the **Balance Sheet (Asset/Liability) initial approach** illustrated above, or the **Income Statement (Expense/Revenue) initial approach**. Provided the correct year-end adjusting entry is posted, both approaches yield the *exact same* final account balances on the Statement of Profit or Loss and Statement of Financial Position.

Stage (Geelong Freight 12-Month Insurance, A$7,200 excl. GST)	Asset-Initial Approach	Expense-Initial Approach
1 March 2026 (Cash Paid)	Dr Prepaid Insurance 7,200 Dr GST Paid 720 Cr Cash at Bank 7,920	Dr Insurance Expense 7,200 Dr GST Paid 720 Cr Cash at Bank 7,920

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Stage (Geelong Freight 12-Month Insurance, A$7,200 excl. GST)	Asset-Initial Approach	Expense-Initial Approach
30 June 2026 (Adjusting Entry — 4 mos. expired, 8 mos. unexpired)	Dr Insurance Expense 2,400 Cr Prepaid Insurance 2,400	Dr Prepaid Insurance 4,800 Cr Insurance Expense 4,800
Resulting 30 June 2026 Balances	Insurance Expense: A$2,400 Prepaid Insurance: A$4,800	Insurance Expense: A$2,400 Prepaid Insurance: A$4,800

The identical symmetry applies to Unearned Revenue: if Docklands Cloud Pty Ltd initially credited Service Revenue for the full A$12,000 on 1 April 2026, its 30 June adjusting entry would debit Service Revenue A$9,000 and credit Unearned Service Revenue A$9,000 for the 9 unexpired months, leaving identical year-end balances (Service Revenue A$3,000; Unearned Service Revenue A$9,000).

2. Adjusted Trial Balance, Closing Process, and Reversing Entries

2.1 Temporary (Nominal) vs Permanent (Real) Accounts

Once all adjusting entries are posted, an **Adjusted Trial Balance** is extracted to confirm ledger equality and serve as the direct input for preparing the Statement of Profit or Loss and Statement of Financial Position. Before commencing the new financial year on 1 July, however, the ledger must undergo the **closing process**.

Ledger accounts fall into two structural categories:

- **Permanent (Real) Accounts:** Asset, Liability, Share Capital, Reserves, and Retained Earnings accounts. Their balances carry forward cumulatively from one reporting period to the next and are never closed to zero.
- **Temporary (Nominal) Accounts:** Income, Expense, Contra-Revenue, and Dividends Declared accounts. They measure performance and distributions for a *single* reporting period only and must be reset to zero at period-end so they begin the new financial year at A$0.

2.2 The Four-Step Corporate Closing Sequence

Under Australian corporate reporting, closing entries transfer the balances of all temporary accounts into **Retained Earnings** via an intermediate clearing account called **Profit and Loss Summary**:

1. **Step 1 — Close all Income accounts (credit balances):** Debit each Income account (Sales Revenue, Service Revenue, Interest Revenue) for its balance and Credit *Profit and Loss Summary* for total income.
2. **Step 2 — Close all Expense and Contra-Revenue accounts (debit balances):** Credit each Expense account (Cost of Sales, Wages, Rent, Depreciation, Interest, Sales Returns) for its balance and Debit *Profit and Loss Summary* for total expenses.
3. **Step 3 — Close Profit and Loss Summary to Retained Earnings:** The resulting credit balance in Profit and Loss Summary equals Net Profit (or a debit balance equals Net Loss). Debit *Profit and Loss Summary* and Credit *Retained Earnings* for Net Profit (reverse if Net Loss).
4. **Step 4 — Close Dividends Declared to Retained Earnings:** Debit *Retained Earnings* and Credit *Dividends Declared* (note that Dividends Declared bypasses Profit and Loss Summary because dividends are distributions of equity, not expenses).

After posting all four closing entries, a **Post-Closing Trial Balance** is prepared. Only permanent accounts (Assets, Liabilities, Share Capital, Reserves, and updated Retained Earnings) retain non-zero balances.

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2.3 End-to-End Worked Adjusting & Closing Schedule: *Southern Cross Logistics Pty Ltd*

Consider the Unadjusted Trial Balance of *Southern Cross Logistics Pty Ltd* as at 30 June 2026 (in A$), together with four year-end adjustments:

- **(a) Supplies on hand:** Physical count on 30 June reveals A$1,400 of packaging supplies remaining from the A$4,800 unadjusted balance → Supplies Expense = $4,800 - 1,400 = 3,400$ (A$3,400).
- **(b) Prepaid Insurance:** A$3,000 of the A$6,000 unadjusted Prepaid Insurance has expired during FY2026 → Dr Insurance Expense A$3,000; Cr Prepaid Insurance A$3,000.
- **(c) Depreciation on Delivery Vehicles:** Annual depreciation is A$12,000 → Dr Depreciation Expense A$12,000; Cr Accumulated Depreciation – Vehicles A$12,000.
- **(d) Accrued Wages & Unearned Freight Revenue:** Unpaid wages at 30 June total A$2,500 (Dr Wages Expense A$2,500; Cr Accrued Wages Payable A$2,500), and A$4,000 of Unearned Freight Revenue has now been earned (Dr Unearned Freight Revenue A$4,000; Cr Freight Revenue A$4,000).

Account Title	Unadj. Dr	Unadj. Cr	Adj. Dr	Adj. Cr	Adjusted Dr	Adjusted Cr	Post-Close
Cash at Bank	38,200	—	—	—	38,200	—	38,200 Dr
Accounts Receivable	24,500	—	—	—	24,500	—	24,500 Dr
Packaging Supplies	4,800	—	—	3,400 (a)	1,400	—	1,400 Dr
Prepaid Insurance	6,000	—	—	3,000 (b)	3,000	—	3,000 Dr
Delivery Vehicles	90,000	—	—	—	90,000	—	90,000 Dr
Accum. Depr. – Vehicles	—	18,000	—	12,000 (c)	—	30,000	30,000 Cr
Accounts Payable	—	14,500	—	—	—	14,500	14,500 Cr
Unearned Freight Revenue	—	9,000	4,000 (d)	—	—	5,000	5,000 Cr
Accrued Wages Payable	—	0	—	2,500 (d)	—	2,500	2,500 Cr
Share Capital	—	60,000	—	—	—	60,000	60,000 Cr
Retained Earnings (1 Jul 2025)	—	21,000	—	—	—	21,000	45,100 Cr
Dividends Declared	8,000	—	—	—	8,000	—	0 (Closed)
Freight Revenue	—	145,000	—	4,000 (d)	—	149,000	0 (Closed)
Wages Expense	76,000	—	2,500 (d)	—	78,500	—	0 (Closed)
Rent Expense	20,000	—	—	—	20,000	—	0 (Closed)
Supplies Expense	0	—	3,400 (a)	—	3,400	—	0 (Closed)
Insurance Expense	0	—	3,000 (b)	—	3,000	—	0 (Closed)
Depreciation Expense	0	—	12,000 (c)	—	12,000	—	0 (Closed)
Totals	**267,500**	**267,500**	**24,900**	**24,900**	**282,000**	**282,000**	**157,100 = 157,100**

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Closing Entries & Reversing Entry Illustration

From the Adjusted Trial Balance above, Total Income = A$149,000 and Total Expenses = $78,500 + 20,000 + 3,400 + 3,000 + 12,000 = 116,900$ (A$116,900), generating Net Profit = $149,000 - 116,900 = 32,100$ (A$32,100). Closing entries on 30 June 2026 are:

1. Dr Freight Revenue A$149,000; Cr Profit and Loss Summary A$149,000.
2. Dr Profit and Loss Summary A$116,900; Cr Wages Expense A$78,500; Cr Rent Expense A$20,000; Cr Supplies Expense A$3,400; Cr Insurance Expense A$3,000; Cr Depreciation Expense A$12,000.
3. Dr Profit and Loss Summary A$32,100; Cr Retained Earnings A$32,100.
4. Dr Retained Earnings A$8,000; Cr Dividends Declared A$8,000.

Closing Retained Earnings becomes $21,000 + 32,100 - 8,000 = 45,100$ (A$45,100). Consequently, total Post-Closing Credits equal $30,000 + 14,500 + 5,000 + 2,500 + 60,000 + 45,100 = 157,100$ (A$157,100), matching total Post-Closing Debits ($38,200 + 24,500 + 1,400 + 3,000 + 90,000 = 157,100$).

On 1 July 2026, entities that use **reversing entries** for convenience reverse accrual adjustments such as Accrued Wages Payable (Dr Accrued Wages Payable A$2,500; Cr Wages Expense A$2,500) so that when the full fortnightly payroll of A$18,000 is paid on 10 July, payroll clerks can simply debit Wages Expense for the full A$18,000 and automatically leave A$15,500 as FY2027 expense.

3. Accounting for Inventories under AASB 102 Inventories

3.1 Scope and Initial Cost of Inventory

Under `AASB 102 Inventories`, inventories are assets held for sale in the ordinary course of business (finished goods / merchandise), in the process of production for such sale (work in progress), or in the form of materials or supplies to be consumed in production or rendering services. The initial cost of inventory comprises all **costs of purchase** (purchase price net of GST and trade/settlement discounts, import duties, non-recoverable taxes, transport/freight-in, and handling costs directly attributable to acquisition), costs of conversion, and other costs incurred in bringing inventories to their present location and condition. Selling costs, storage of finished goods, and abnormal wastage are expensed as incurred.

3.2 Perpetual vs Periodic Inventory Systems

Businesses track inventory flows using either a **perpetual** or a **periodic** system:

- **Perpetual Inventory System:** Updates the Inventory asset and Cost of Sales accounts continuously upon every purchase, purchase return, sale, and sales return using barcode/ERP scanning. A physical stocktake is still conducted at year-end to verify physical quantities and record any *Inventory Shrinkage / Loss* (Dr Cost of Sales or Inventory Loss; Cr Inventory).
- **Periodic Inventory System:** Records inventory purchases in a temporary *Purchases* account (plus Freight-In, less Purchase Returns & Allowances) without updating Inventory or Cost of Sales at each sale. Cost of Sales is determined only at period-end after a physical stocktake using the periodic cost-of-sales identity:

$$\text{COGS} = \text{Opening Inventory} + (\text{Gross Purchases} - \text{Purchase Returns} + \text{Freight-In}) - \text{Closing Inventory}$$

Where:

- COGS: Cost of Goods Sold (Cost of Sales expense for the period)
- Opening Inventory: Carrying amount of inventory on hand at the start of the period
- $\text{Gross Purchases} - \text{Purchase Returns} + \text{Freight-In}$: Net cost of inventory purchased and brought to the warehouse during the period
- Closing Inventory: Physical count of inventory on hand at period-end valued at cost (or lower NRV)

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Transaction (GST Excluded for Clarity)	Perpetual System Entry	Periodic System Entry
Credit purchase of merchandise (A$10,000)	Dr Inventory 10,000 Cr Accounts Payable 10,000	Dr Purchases 10,000 Cr Accounts Payable 10,000
Freight-in paid on purchase (A$400)	Dr Inventory 400 Cr Cash at Bank 400	Dr Freight-In 400 Cr Cash at Bank 400
Purchase return to supplier (A$1,200)	Dr Accounts Payable 1,200 Cr Inventory 1,200	Dr Accounts Payable 1,200 Cr Purchase Returns 1,200
Credit sale of merchandise (Price A$8,000; Cost A$5,000)	Dr Accounts Receivable 8,000; Cr Sales 8,000 Dr Cost of Sales 5,000; Cr Inventory 5,000	Dr Accounts Receivable 8,000; Cr Sales 8,000 *(No COGS entry recorded at sale)*
Year-end stocktake shrinkage (A$300 shortfall)	Dr Inventory Shrinkage / COGS 300 Cr Inventory 300	Absorbed automatically into periodic COGS formula via lower Closing Inventory.

3.3 Inventory Cost Formulas under AASB 102 (FIFO & Weighted Average)

When identical inventory units are acquired at different unit prices during a period, `AASB 102` (paras 23–27) permits three cost-flow assumptions: **Specific Identification** (mandatory for unique, high-value items such as motor vehicles or custom jewellery), **First-In, First-Out (FIFO)**, and **Weighted Average Cost (WAC)**. Crucially, the **Last-In, First-Out (LIFO)** method is strictly **prohibited** under `AASB 102` and IFRS.

Under **FIFO**, the earliest units purchased are assumed to be sold first, leaving the most recently purchased costs in Closing Inventory. Notably, FIFO produces the *exact same* Cost of Sales and Closing Inventory under both Perpetual and Periodic systems. Under **Weighted Average Cost**, however, Periodic WAC computes a single period-wide average unit cost at period-end, whereas Perpetual (Moving) WAC recalculates a new average unit cost after every purchase:

$$\text{Moving Average Unit Cost} = \frac{\text{Cost of Inventory on Hand} + \text{Cost of New Purchase}}{\text{Units on Hand} + \text{Units Purchased}}$$

Where:

- Cost of Inventory on Hand: Total carrying cost of units in stock immediately before the new purchase
- Cost of New Purchase: Total landed cost (GST-exclusive) of the incoming batch
- Units on Hand + Units Purchased: Combined physical units available immediately after the purchase

Worked Numerical Comparison: FIFO vs Moving Weighted Average (Perpetual)

Melbourne Tech Distributors Pty Ltd trades commercial wireless routers (GST-exclusive figures). During May 2026, it records the following inventory movements:

- **1 May:** Opening Inventory: 100 units @ A$80 = A$8,000.
- **6 May:** Purchase: 150 units @ A$90 = A$13,500.
- **12 May:** Sale: 180 units sold at A$140 each (Revenue = A$25,200).
- **19 May:** Purchase: 100 units @ A$100 = A$10,000.
- **26 May:** Sale: 90 units sold at A$145 each (Revenue = A$13,050).

Total units available for sale = $100 + 150 + 100 = 350$ units; Cost of Goods Available for Sale (COGAFS) = $8,000 + 13,500 + 10,000 = 31,500$ (A$31,500). Total units sold = $180 + 90 = 270$ units; Closing Inventory = $350 - 270 = 80$ units; Total Sales Revenue = $25,200 + 13,050 = 38,250$ (A$38,250).

Date	FIFO (Perpetual & Periodic Identical)	Moving Weighted Average (Perpetual)
1 May	Balance: 100 @ A$80 = A$8,000	Balance: 100 @ A$80.00 = A$8,000
6 May	Balance: 100 @ A$80 + 150 @ A$90 = A$21,500	250 units total cost A$21,500 → Avg = $21,500 \div 250 = 86.00$ (A$86.00/unit)
12 May (Sale 180)	COGS: (100 × A$80) + (80 × A$90) = **A$15,200**. Remaining: 70 @ A$90 = A$6,300.	COGS: 180 × A$86.00 = **A$15,480**. Remaining: 70 @ A$86.00 = A$6,020.
19 May	Balance: 70 @ A$90 + 100 @ A$100 = A$16,300	170 units total cost $6,020 + 10,000 = 16,020$ → Avg = $16,020 \div 170 = 94.2353$ (A$94.24/unit)
26 May (Sale 90)	COGS: (70 × A$90) + (20 × A$100) = **A$8,300**. Closing Inv.: 80 @ A$100 = **A$8,000**.	COGS: 90 × A$94.2353 = **A$8,481** (rounded). Closing Inv.: $16,020 - 8,481 = 7,539$ (**A$7,539**).
Summary	Total COGS = $15,200 + 8,300 = 23,500$ (**A$23,500**) Closing Inventory = **A$8,000** Gross Profit = $38,250 - 23,500 = 14,750$ (**A$14,750**)	Total COGS = $15,480 + 8,481 = 23,961$ (**A$23,961**) Closing Inventory = **A$7,539** Gross Profit = $38,250 - 23,961 = 14,289$ (**A$14,289**)

By comparison, under **Periodic Weighted Average**, the single period-wide unit cost is $31,500 \div 350 = 90.00$ (A$90.00/unit), yielding Periodic COGS = $270 \times 90.00 = 24,300$ (A$24,300) and Closing Inventory = $80 \times 90.00 = 7,200$ (A$7,200). Notice that in a period of rising purchase prices (A$80 → A$90 → A$100), FIFO reports the highest Closing Inventory (closest to current replacement cost) and highest Gross Profit, whereas Weighted Average smooths out price fluctuations.

3.4 Lower of Cost and Net Realisable Value (NRV) under AASB 102

AASB 102 (para. 9) mandates that inventories be measured at the **lower of cost and net realisable value (NRV)** on an item-by-item (or homogeneous group) basis. If inventory becomes damaged, obsolete, or faces falling market prices such that its recoverable net selling value falls below historical cost, it must be written down immediately so assets are not carried in excess of future cash inflows:

> $$\text{NRV} = \text{Estimated Selling Price} - \text{Estimated Costs to Complete} - \text{Estimated Selling Costs}$$

Where:

- Estimated Selling Price: Expected market sale price in the ordinary course of business (GST-exclusive)
- Estimated Costs to Complete: Any additional manufacturing, assembly, or repair costs needed before sale
- Estimated Selling Costs: Sales commissions, delivery charges, and direct marketing costs required to execute the sale

Worked NRV Write-Down Example

At 30 June 2026, *Melbourne Tech Distributors Pty Ltd* holds 80 routers valued at FIFO cost of A$100 each (A$8,000 total). A next-generation Wi-Fi standard has just launched, forcing the company to discount the older routers to an estimated selling price of A$95 each, with A$7 per unit in online marketplace fees and shipping costs to make the sale.

1. **Compute Unit NRV:** $\text{NRV} = 95 - 0 - 7 = 88$ (A$88/unit), or $80 \times 88 = 7,040$ (A$7,040) total.
2. **Apply Lower of Cost and NRV:** Since NRV (A$7,040) is below Cost (A$8,000), a write-down of $8,000 - 7,040 = 960$ (A$960) is required.

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3. **Journal Entry (30 June 2026):** Dr Inventory Write-Down Expense (or Cost of Sales) A$960; Cr Inventory (or Allowance for Inventory Obsolescence) A$960.

4. Property, Plant and Equipment and Depreciation under AASB 116

4.1 Initial Recognition and Measurement at Cost

Under `AASB 116 Property, Plant and Equipment`, tangible items held for use in production, supply of goods/services, rental to others, or administrative purposes—and expected to be used during more than one period—are recognised as PPE when it is probable that future economic benefits will flow to the entity and cost can be measured reliably. At initial recognition, PPE is measured at **cost**, comprising:

- Purchase price (net of trade discounts, rebates, and recoverable GST), plus import duties and non-refundable purchase taxes (e.g., stamp duty on commercial property).
- Directly attributable costs of bringing the asset to the location and condition necessary for intended operation (site preparation, initial delivery and handling, installation, assembly, and professional testing fees).
- The initial estimate of costs of dismantling, removing, and restoring the site on which the asset is located, where an obligation exists at acquisition.

Costs incurred *after* acquisition are capitalised into the asset's carrying amount only if they meet the recognition criteria (extending useful life, increasing productive capacity, or substantially improving output quality—a **capital expenditure**). Routine servicing, oil changes, and minor part replacements merely maintain existing capability and are expensed immediately as **revenue expenditure** (Repairs & Maintenance Expense).

4.2 Depreciation Fundamentals and Calculation Methods

Depreciation is the systematic allocation of the *depreciable amount* of a tangible asset over its *useful life*. It is a process of **cost allocation** matching asset consumption to revenue generation—it is *not* an attempt to measure current market value or accumulate a cash replacement fund. Three factors govern depreciation: (1) **Cost** (or revalued amount), (2) **Residual Value** (estimated net amount obtainable at the end of useful life), where $\text{Depreciable Amount} = \text{Cost} - \text{Residual Value}$, and (3) **Useful Life** (expected period of use or total service units).

`AASB 116` permits three primary depreciation methods reflecting the pattern in which future economic benefits are consumed:

$$\text{Straight-Line: } D_t = \frac{C - R}{n}$$

$$\text{Diminishing-Balance: } D_t = \text{CA}_{t-1} \times r, \qquad r = 1 - \left(\frac{R}{C}\right)^{1/n}$$

$$\text{Units-of-Production: } D_t = \left(\frac{C - R}{U_{\text{total}}}\right) \times U_t$$

Where:

- D_t: Depreciation expense for period t (in A$)
- C: Historical cost (GST-exclusive) of the asset (in A$)
- R: Estimated residual (salvage) value at the end of useful life (in A$)

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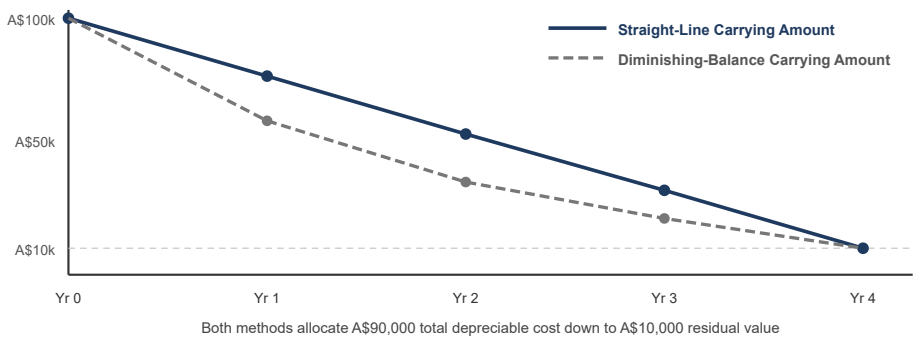
- n: Estimated useful life in years
- CA_{t-1}: Carrying amount ($\text{Cost} - \text{Accumulated Depreciation}$) at the beginning of period t
- r: Constant diminishing-balance annual depreciation rate (expressed as a decimal)
- U_{total}: Total estimated output or usage units over the asset's life (e.g., kilometres or machine hours)
- U_t: Actual units produced or consumed during period t

Worked 4-Year Depreciation Comparison (*Clayton Courier Services Pty Ltd*)

On 1 July 2025, *Clayton Courier Services Pty Ltd* purchases a commercial delivery van for A$110,000 (GST-inclusive). Because the company is GST-registered, the A$10,000 GST Paid is claimed on its BAS, giving a depreciable initial Cost $C = 100,000$ (A$100,000). Management estimates a 4-year useful life ($n = 4$), a residual value $R = 10,000$ (A$10,000), and total expected travel of $U_{\text{total}} = 200,000$ km (actual distance driven: Year 1 = 60,000 km; Year 2 = 55,000 km; Year 3 = 45,000 km; Year 4 = 40,000 km). For Diminishing-Balance, assume management applies a 40% annual rate ($r = 0.40$, approximating the exact formula $1 - (10,000/100,000)^{0.25} = 43.77\%$ rounded to standard policy rate 40%, capping Year 4 so Carrying Amount does not fall below Residual Value A$10,000).

Year Ended 30 June	Straight-Line Depr. (A$)	SL Closing CA (A$)	Diminishing-Bal. (40%) Depr. (A$)	DB Closing CA (A$)	Units-of-Prod. (A$0.45/km) Depr. (A$)	UOP Closing CA (A$)
2026 (Year 1)	$(100,000 - 10,000) \div 4 = 22,500$	77,500	$100,000 \times 40\% = 40,000$	60,000	$60,000 \times 0.45 = 27,000$	73,000
2027 (Year 2)	22,500	55,000	$60,000 \times 40\% = 24,000$	36,000	$55,000 \times 0.45 = 24,750$	48,250
2028 (Year 3)	22,500	32,500	$36,000 \times 40\% = 14,400$	21,600	$45,000 \times 0.45 = 20,250$	28,000
2029 (Year 4)	22,500	10,000	$21,600 - 10,000 = 11,600^{*}$	10,000	$40,000 \times 0.45 = 18,000$	10,000
Total Depr.	**90,000**	—	**90,000**	—	**90,000**	—

Note (*): In Year 4 under Diminishing-Balance, $21,600 \times 40\% = 8,640$ would leave a carrying amount of A$12,960 above the A$10,000 residual value, or if an accelerated rate of 43.77% ($r = 1 - 0.1^{0.25}$) is used, carrying amount reaches exactly A$10,000 smoothly; capping Year 4 ensures total accumulated depreciation equals the A$90,000 depreciable amount when the van is retired at A$10,000.



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4.3 Subsequent Measurement, Impairment, and Disposal of PPE

After initial recognition, AASB 116 allows an entity to choose either the **Cost Model** (carrying amount = Cost – Accumulated Depreciation – Accumulated Impairment Losses) or the **Revaluation Model** (carrying amount = Fair Value at revaluation date – subsequent Accumulated Depreciation and Impairment) for an entire class of PPE (such as Land & Buildings). Under the Revaluation Model, upward revaluations are credited to Other Comprehensive Income and accumulated in an equity reserve called **Asset Revaluation Surplus** (rather than Profit or Loss), unless reversing a prior revaluation decrease of the same asset.

Regardless of the model selected, AASB 136 Impairment of Assets requires entities to assess at each reporting date whether an asset's carrying amount exceeds its **recoverable amount** (the higher of fair value less costs of disposal and value in use). Any excess is recognised immediately as an impairment loss.

Worked Disposal of PPE Example

Assume *Clayton Courier Services Pty Ltd* (using Straight-Line depreciation) sells the delivery van on 31 December 2027—exactly 2.5 years after purchase—for A$48,400 cash (GST-inclusive).

1. **Step 1 — Update Depreciation to Date of Disposal:** At 30 June 2027 (2 full years), Accumulated Depreciation = $2 \times 22,500 = 45,000$ (A$45,000). For the 6 months from 1 July 2027 to 31 December 2027, record half-year depreciation of $22,500 \times \frac{6}{12} = 11,250$ (A$11,250):
   Dr Depreciation Expense A$11,250; Cr Accumulated Depreciation – Vehicles A$11,250.
2. **Step 2 — Determine Carrying Amount at Disposal:** Total Accumulated Depreciation = $45,000 + 11,250 = 56,250$ (A$56,250). Carrying Amount = $100,000 - 56,250 = 43,750$ (A$43,750).
3. **Step 3 — Compute Gain or Loss on Disposal (GST-Exclusive Proceeds):** GST Collected on sale = $48,400 \div 11 = 4,400$ (A$4,400); GST-exclusive proceeds = $48,400 \div 1.1 = 44,000$ (A$44,000). Since proceeds (A$44,000) exceed Carrying Amount (A$43,750), the company realises a **Gain on Disposal** of $44,000 - 43,750 = 250$ (A$250).
4. **Step 4 — Record Derecognition Journal Entry:**
   Dr Cash at Bank A$48,400; Dr Accumulated Depreciation – Vehicles A$56,250; Cr Delivery Vehicles A$100,000; Cr GST Collected A$4,400; Cr Gain on Disposal of Vehicle A$250.

Worked Revaluation and Impairment Illustration under AASB 116 and AASB 136

Suppose *Bayside Logistics Pty Ltd* owns commercial warehouse land in Dandenong purchased for A$400,000 on 1 July 2024 and accounts for Land under the AASB 116 Revaluation Model:

- **30 June 2025 (Upward Revaluation):** An independent registered valuer assesses fair value at A$460,000. Because this is an initial upward revaluation, the A$60,000 gain is recognised in Other Comprehensive Income and credited to equity: Dr Land A$60,000; Cr Asset Revaluation Surplus (OCI) A$60,000.
- **30 June 2026 (Subsequent Downward Revaluation):** Zoning changes reduce fair value to A$385,000—a A$75,000 decrease from the A$460,000 carrying amount. Under AASB 116, a revaluation decrease first reverses any existing Asset Revaluation Surplus for that same asset (A$60,000), and only the remaining excess (A$15,000) is expensed in Profit or Loss: Dr Asset Revaluation Surplus (OCI) A$60,000; Dr Loss on Revaluation of Land (P&L) A$15,000; Cr Land A$75,000.

4.4 Intangible Assets (AASB 138) and Goodwill Overview

Alongside tangible PPE, modern enterprises hold non-monetary assets without physical substance governed by AASB 138 Intangible Assets, including patents, software licences, copyrights, trademarks, and customer lists. To be recognised on the Balance Sheet, an intangible asset must be **identifiable** (separable or arising from contractual/legal rights), controlled by the entity, and capable of generating probable future economic benefits whose cost can be measured reliably. Crucially, **internally generated goodwill, brands, mastheads, and research phase costs** cannot be capitalised because their costs cannot be separated reliably from ongoing business operations; only *development phase* outlays meeting strict technical feasibility and commercial viability criteria under AASB 138 (para. 57) may be capitalised.

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Subsequent accounting depends on useful life: **finite-life intangibles** (such as a 5-year software licence costing A$50,000) are systematically allocated via **amortisation** (typically Straight-Line, Dr Amortisation Expense A$10,000; Cr Accumulated Amortisation – Software A$10,000 per year), whereas **indefinite-life intangibles** and **purchased goodwill** (arising in a business combination under `AASB 3` when purchase consideration exceeds the fair value of identifiable net assets) are *not amortised*, but tested annually for impairment under `AASB 136`.

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