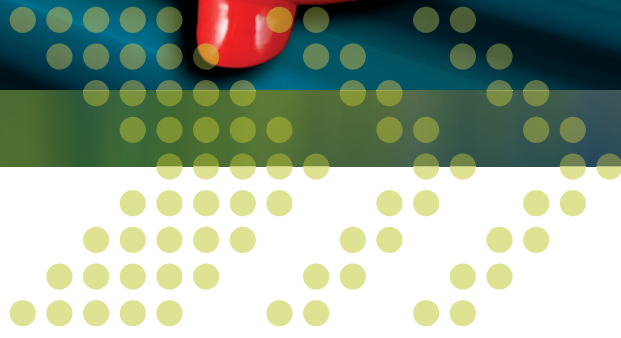


AN INTRODUCTION TO

# MEASURING & MONITORING PROMISES TO PAY



SMALL BUSINESS INFORMATION SERIES



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## How this guide can help you run your building business

We have already looked at how to measure cash payments (see “*An Introduction to Measuring ‘Cash Only’ Transactions (August 2010)*”).

This guide will show you how to measure and monitor “promises to pay”. It is set out in 3 parts and explains in simple terms:

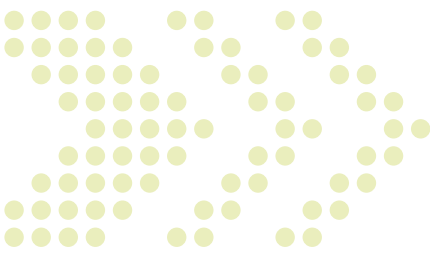
- What we mean by “promises to pay”
- How to measure promises to pay
- How to monitor promises to pay



You will get more out of this guide if you have already looked at the following guides:

- > *An Introduction to Accounting Concepts* (September 2010)
- > *An Introduction to Journal Entries* (December 2010)
- > *An Introduction to Record-Keeping Laws for Companies* (January 2011)





# 1 What we mean by “promises to pay”

All businesses buy and sell goods and/or services in exchange for money (either cash or a promise to pay) or “payment in kind”.

Each and every “exchange” is called a business transaction and every business must keep certain types of records in relation to each and every business transaction.

How a business records payments by way of “promises to pay” is slightly different from recording ‘cash only’ transactions in that there’s an extra step involved.

**What is a “promise to pay”?**

**“Promise to pay” refers to where a business agrees to provide goods and/or services to a customer and be paid by the customer some time after those goods and services were provided.**

A customer can be another tradesperson (for example, a sub-contractor) or it can be a **homeowner**.

**How and when do I get paid?**

**At law, a business owner and its customer must agree on *how* and *when* payment is to be made.**

These details are called the “**Terms of Trade**” and by signing a contract, your client is agreeing to your terms of trade.

If you use an **HIA domestic building contract**, the terms of trade will already be in the contract (as they are usually set by law and cannot be changed).

## How and when do I get paid?

Similarly, **HIA's Period Trade and Project Trade contracts** contain a space for terms of trade together with a clause that requires the trade contractor to carry out and complete the trade works to the reasonable satisfaction of the principal contractor before being entitled to payment.

In relation to **purchasing goods from suppliers**, you can usually find the terms of trade in your original credit application or set out on the supplier's invoice.

## 2 types of "promises to pay"

There are 2 types, being a promise to pay made by:

- 1 **your business** to pay its suppliers; and
- 2 **your customers** to pay your business.



### Accounts payable

**This refers to promises made by your business to its suppliers to pay them at a later date.**

Suppliers who have been promised payment (at a later date) by your business are called "**creditors**".

The total amount owed by your business to your suppliers is recorded in the account called "**accounts payable**", which is a **liability**.

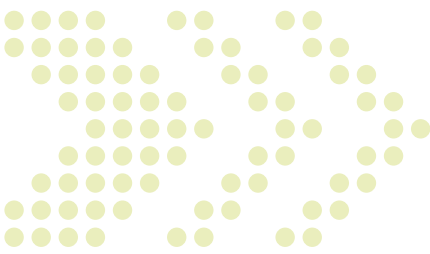


### Accounts receivable

**This refers to promises made to your business by its customers to pay your business at a later date.**

Customers who have promised to pay your business (at a later date) are called "**debtors**".

The total amount owed by your customers to your business is recorded in the account called "**accounts receivable**", which is an **asset**.



# 2 How to measure “promises to pay”

## 2 parts

There are 2 parts to measuring promises to pay, being:

1 the promise; and

2 the payment.

The steps to follow for each are:

- > **Step 1:** File the **source document**;
- > **Step 2:** Enter the details into a **journal**; and
- > **Step 3:** Post those details to a **ledger**.

If you have accounting software, once you have entered the relevant details, it will perform steps 2 and 3 for you.



## The promise

*On 1 March 2011, ABC Builders Pty Ltd submits a progress claim for \$11,000.00 to its customer, Derek Eastman for renovation work done on Derek’s house.*

### The promise to pay is recorded at the time when the debt is created.

The debt is created as soon as your business has (as agreed in the contract):

- > carried out the building work; and
- > submitted the progress claim that relates to that building work

#### Step 1: file the source document

The source document is the duplicate progress claim (the original is handed to the client).

#### Step 2: enter the details into a journal

The journal entry should look like this:

01.03.11	Dr	A/c Receivable	\$11,000.00	
		Cr Contract income		\$10,000.00
		Cr GST Received		\$1,000.00
<i>(Progress claim dated 01.03.11 for Derek Eastman)</i>				



## The promise

'GST Received' is the GST component of the progress payment. In effect, you have collected this GST 'on behalf of' the ATO. It is because this money doesn't belong to your business, that we suggest you keep all GST Received (or 'collected') in a separate bank account.

If a business has to record lots of transactions in relation to one of its accounts, then it would probably need to keep a **special journal** for that account. Examples include a *Cash Receipts Journal* and a *Cash Payments Journal*.

### The reason for keeping such a journal is to streamline the record-keeping process.

For example, every **general journal** entry for making cash payments would contain:

- > a "credit" against the "Cash at Bank" account; and
- > "debit" entries to whatever asset or expense account is affected plus the account that relates to the GST component.

Instead of having to include the "Cr Cash at Bank" part of the journal entry over and over again, with the **special journal**, being the Cash Payments Journal, you only have to enter details of the "debit" side of the equation.

**The special journal would be written up every day and the total amounts would be calculated periodically (weekly or monthly) so a general journal entry can be made.**

### Step 3: post the relevant details to the ledgers

There would be 3 ledgers here, each called a "**general ledger**". Each general ledger relates to an account that will ultimately appear in the financial statements.



## The promise

Using the ABC Builders Pty Ltd example, the general ledgers would look like this:

<i>A/c Receivable</i>		
1/3	\$11,000.00	
<i>Contract Income</i>		
		1/3      \$10,000.00
<i>GST Received</i>		
		1/3      \$1,000.00

As was the case with the journals, if a business has to record lots of transactions in relation to one of its accounts, then it would probably need to keep a **subsidiary ledger** for each customer or supplier.



## The payment

**Keeping a subsidiary ledger helps a business keep a closer eye on a particular debtor or creditor.**

Therefore, using this example, the **general ledger** would be the “A/c Receivable” ledger where every single customer’s promise to pay your business (and subsequent payment) would be recorded in a subsidiary ledger.

Here, the **subsidiary ledger** would be “A/c receivable – Derek Eastman”.

*On 7 March 2011, ABC Builders Pty Ltd’s bank account has \$11,000 electronically transferred to it by Derek Eastman in payment of the progress claim.*

### Step 1: file the source document

ABC Builders Pty Ltd’s source documents would be:

- > the **bank statement** – showing that the money had been received; and
- > a copy of the **receipt** issued to Derek – acknowledging to Derek that this money was received.



## The payment

### Step 2: enter the details into a journal

ABC Builders would make an entry in the Cash Receipts Journal where, as well as showing \$11,000 as the total amount received, it would show the amount of \$10,000 being shown in the “Contract Income” column, the amount of \$1,000 in the GST column, and the details of who made the payment in the “details” (or “description”) section.

### Step 3: post the relevant details to the ledgers

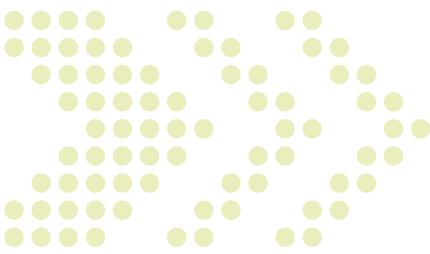
The important ledger here is the general ledger called “A/c receivable”. Alternatively, ABC Builders Pty Ltd may keep subsidiary ledgers for each debtor and each creditor.

The **general ledger** would look like this:

<i>A/c Receivable</i>			
1/3	\$11,000.00	7/3	\$11,000.00

## In summary

- > If the job for Derek Eastman was the only job in March 2011 for ABC Builders Pty Ltd and the progress claim (& payment) the only one submitted (& received) by ABC Builders Pty Ltd during March 2011, then, at the end of March, the **A/c Receivable** (or “**debtors**”) ledger would be “ruled off” with the month end balance being “NIL”.
- > In relation to the other accounts, assuming there were no other business transactions that took place in the month of March 2011, the balances will have:
  - **Cash at Bank** (asset) – ↑ by \$11,000.00;
  - **GST Received** (liability) – ↑ by \$1,000.00; and
  - **Contract Income** (income) – ↑ by \$10,000.00.



# 3

## How to monitor “promises to pay”

### The importance of ledgers

The key to monitoring promises to pay is through your ledger.

Let’s use promises made by customers to your business as an example.

So far, we have shown you the simplest of ledgers, being the “T account”. However, it is more meaningful if you set out your ledgers as a table with columns and a running balance.

For example, a debtors’ ledger for the month of March 2011, where the terms of trade are “payable within 7 days”, could look like this:

A/C RECEIVABLE (also known as “Debtors”) LEDGER

Date	Ref	Client	Due	Debit	Credit	Balance
1 Mar	100815	Allenby	8 Mar	\$385.00		\$385.00
2 Mar	100840	Zarathustra	9 Mar	550.00		935.00
2 Mar	100853	Smith	9 Mar	165.00		1,100.00
3 Mar	100854	Jones	10 Mar	330.00		1,430.00
7 Mar	EFT	Allenby			\$385.00	1,045.00
18 Mar	100857	Brown	25 Mar	2,200.00		3,245.00
24 Mar	100858	Bennett	31 Mar	770.00		4,015.00
31 Mar	100860	Humperdinck	7 Apr	1,650.00		5,665.00
<b>Totals</b>				<b>\$6,050.00</b>	<b>\$385.00</b>	<b>\$5,665.00</b>



The due dates can be marked into your calendar so you can keep an eye on when money should be coming in.

You may wish to add more details such as:

- > **GST details** (GST-inclusive amount, GST amount & GST-exclusive amount);
- > **Contact details for the debtor** (eg mobile number or email address); and
- > **Job reference** (eg site address or job number), or keep these details separately.

From this example, you can see that the total amount owing to this business as at 31 March is \$5,665.00.

## An “aged debtors’ schedule”

Another tool is the “aged debtors” schedule, which is very helpful for keeping track of your cash flow and for identifying “problem” clients.

For example, one of your clients may be a habitual late payer. You will be able to pick this up through your aged debtors’ schedule. Then, once aware of the problem, you will be able to take whatever action is necessary to protect your cash flow (such as insisting on COD terms for delivery of materials).

You can do the same thing with your creditors, to see which ones need to be paid sooner rather than later.

Using the debtors’ ledger example from the previous page, the aged debtors schedule would look like this:

AGED DEBTORS SCHEDULE (as at 1 April 2011)

Client	Due By	Current (w/e 01/04)	>1 week (w/e 25/03)	>2 weeks (w/e 18/03)	>3+ weeks (to 11/03)
Zarathustra	09/03				550.00
Smith	09/03				165.00
Jones	10/03				330.00
Brown	25/03		\$2,200.00		
Bennett	31/03	\$770.00			
Humperdinck	07/04	1,650.00			
<b>TOTALS</b>		<b>\$2,420.00</b>	<b>\$2,200.00</b>		<b>\$1,045.00</b>
<b>% OF \$5,665</b>		<b>43%</b>	<b>39%</b>		<b>18%</b>

Note – that terms of trade are “payable within 7 days”. Therefore, you would base your “aging” on a weekly basis.

As you can see, almost 20% of the debtors in this schedule are extremely overdue. This should be ringing alarm bells to the business owner who would be wise to make collecting those debts a priority.

Conducting this exercise on a regular basis would mean that you can monitor your cash flow and be proactive rather than reactive.

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