Solution Manual

to accompany

Accounting 8e

by

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WILEY

John Wiley & Sons Australia, Ltd 2012

CHAPTER 2
FINANCIAL STATEMENTS FOR DECISION MAKING

DISCUSSION QUESTIONS SOLUTIONS

1. *Discuss the meaning of 'performance' for both business entities and not-for-profit entities. Is performance able to be expressed totally in financial terms?*

   "Performance" for a business entity means its ability to use its assets efficiently and effectively to achieve business goals. Key indicators for business financial goals include profit, total income and expenses, total assets and liabilities. "Performance" for not-for-profit entities may be the achievement of a social or moral goal rather than maximisation of shareholders' profit. To assess an entity's performance would be to compare its activities or transactions for the period compared to its stated goals or mission statement.

2. *Define the terms, assets, liabilities, and equity. Are these terms related in any way? If so, how?*

   Assets are defined in the *Framework* as resources controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.

   Liabilities are defined in the *Framework* as present obligations of an entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits. Liabilities require future payments from assets, generally in the form of cash, or the performance of services to cancel them.

   Equity is the owner's claim to (or the residual interest in) the assets of the entity after deducting all its liabilities. The basic accounting equation (Assets = Liabilities + Equity) indicates the relationship between assets, liabilities and equity. From the equation, the total assets of the entity equal the total claims against those assets by creditors and owners. Creditors' claims take precedence over owners' claims, and owners are seen as the ultimate risk-takers in the entity. Thus, equity is a residual claim on the assets of the entity after liabilities are fully paid, and the basic accounting model which expresses this idea clearly is:

   Assets - Liabilities = Equity

3. *A local restaurant is noted for its fine food, as evidenced by the large number of customers. A customer was heard to remark that the secret of the restaurant's success was its fine chef. Would you regard the chef as an asset of the business? If so, would you include the chef on the balance sheet of the business and at what value?*

   Suggested topics of discussion:

- Asset definition – "Assets are resources controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity." Does the chef provide future economic benefits to the entity? Yes. Is the chef controlled by the entity? In many cases, it is evident that he/she could not be controlled by the entity (e.g. he/she can resign when he/she likes, can take sick days). He/she cannot be "acquired" or "sold" by the business, i.e. they do not have rights to possess him/her.
- How would you value the chef as an asset? Usually you have some idea of the "life" of the asset, however, the restaurant would not know how long the chef would be working for them (this argument relates back to controlling the asset).

4. *The local parkland is owned and maintained by the local government council. Is the parkland an asset of the council and should it be included on its balance sheet?*

   Suggested topics of discussion: (This answer goes well beyond what is expected of students, but it should provide thought for good discussion.)

   Local parklands are frequently referred to as 'heritage assets'. In terms of accounting for such assets, government bodies are required to follow accounting standards. Therefore, AASB 116 *Property, Plant and Equipment*, and AASB136 *Impairment of Assets* (Amongst others) would apply to the accounting for such assets. Assets are defined in the *Framework for the Preparation and Presentation of Financial Statements* as "a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity". Assets can be recognised when: (a) it is probable that the future economic benefits embodied in the asset will eventuate; and (b) the asset possesses a cost or other value that can be measured reliably.

   The local parkland is a physical asset that a community intends on preserving because of cultural, historic or environmental associations. There has been much debate about the correct accounting treatment for these assets. Some would argue that the parkland does not meet the definition of an asset, since it is not possible to quantify the economic benefits embodied in the asset, if indeed there are any economic benefits. The benefits that arise from such assets are essentially intangible. Others argue that such assets can be reliably measured (at fair value), provide benefits to a community, and should therefore be recognised.

5. *Moonshine Enterprises hired an accountant at the rate of $1 000 per week. The person is to commence duty on 1 February. On 1 February, does the business have a liability in respect of the accountant's salary? Explain*

Suggested topics for discussion re Moonshine Enterprises:

- On 1 February, the business does not have a liability because, at this stage, they are not presently obliged to sacrifice future economic benefits. The liability will only arise when the expense has been inccurred, and this will not take place until the services are provided by the accountant.
- The contract remains unperformed by both parties until the work is completed by the employee.

6. *Discuss the significance of the following assumptions in the preparation of an entity's financial statements:*

   (a) entity assumption

   (b) accrual basis assumption

   (c) going concern assumption

   (d) period assumption

(a) Entity Assumption

If the transactions of an entity are to be recorded, classified and summarised into financial statements, the accountant must be able to identify clearly the boundaries of the entity being accounted for. Under the accounting entity assumption, the entity is considered a separate entity distinguishable from its owner and from all other entities. It is assumed that each entity controls its assets and incurs its liabilities. The records of assets, liabilities and business activities of the entity are kept completely separate from those of the owner of the entity as well as from those of other entities.

The accounting entity assumption is important since it leads to the derivation of the accounting equation.

(b) The Accrual Basis Assumption

Under the accrual basis of accounting, the effects of transactions and events are recognised in accounting records when they occur, and not when the cash is received or paid. Hence, financial statements report not only on cash transactions but also on obligations to pay cash in the future and on resources that represent receivables of cash in future. It is argued in the *Framework* that accounting on an accrual basis provides significantly better information about the transactions and other events for the purpose of decision making by users of financial statements than does the cash basis.

(c) The Going Concern Assumption

According to the *Framework*, financial statements are prepared on the assumption that the existing entity is expected to continue operating into the future. It is assumed that the assets of the entity will not be sold off and that the entity will continue its activities; hence, liquidation values (prices in a forced sale) of the entity's assets are not generally reported in financial statements, as this assumes that an entity is to be wound up.

When management plans the sale or liquidation of the entity, the going concern assumption is then set aside and the financial statements are prepared on the basis of estimated sales or liquidation values. The significance of the going concern assumption is in the valuation placed on the assets of an entity in the entity's financial statements. The statements should identify clearly the basis upon which asset values are determined – going concern? Or liquidation?

(d) The Period Assumption

For financial reporting purposes, it is assumed that the total life of an entity can be divided into equal time intervals. Hence, the financial performance of the entity can be determined for a given time period, and the financial position of the entity can be determined on the last day of that reporting period.

As a result of this assumption, profit determination involves a process of recognising the income for a period and deducting the expenses incurred for that same period. Together, the period assumption and accrual basis assumption lead to the requirement for making balance day adjustments on the last day of the reporting period. These adjustments will be considered in a later chapter.

7. *What is meant by the terms "relevance" and "reliability/faithful representation" in the context of information to be included in financial statements?*

Relevance

Relevance means that the information contained in financial statements is able to influence the economic decisions made by users. For example, the information may help users to *predict* future events, such as future cash flows, from alternative courses of action under consideration. Also, information is relevant if it is able to help decision makers evaluate past decisions. The information may *confirm* that a previous decision was correct, or it could show that the results of a previous decision were undesirable and that a new decision is necessary. Thus, relevant information is said to play a predictive role and a confirmatory or feedback role.

A further aspect of relevance is that the information must be presented by the accountant to the user (internal or external) in time for a decision to be made. The *timeliness* of information is an important factor in ensuring that information is relevant.

Reliability/Faithful representation

Reliability, as discussed in the current *Framework*, means that the user is assured that the information presented represents faithfully, without bias or undue error, the underlying transactions and events being reported in the financial statements. Accountants require information to be reliable, which means that the information reported represents economic reality as closely as possible.

The International Accounting Standards Board's amended *Conceptual Framework* introduces the concept of faithful representation. Faithful representation is attained when the depiction of an economic event is complete, neutral, and free from material error. Financial information that faithfully represents an economic phenomenon depicts the economic substance of the underlying transaction, event or circumstances, which is not always the same as its legal form.

In the IASB's amended *Conceptual Framework*, relevance and faithful representation are identified as the fundamental qualitative characteristics of useful financial information. Comparability, verifiability, timeliness and understandability are identified as the qualitative characteristics that enhance the usefulness of information that is relevant and faithfully represented.

8. *Distinguish between the concepts of consistency and comparability? Should the same accounting method be always applied consistently in financial statements?*

The International Accounting Standards Board's amended *Conceptual Framework* states that comparability is an *enhancing characteristic* of information i.e. it enhances the usefulness of financial reporting information in making economic decisions. Comparability is the quality of information that enables users to identify similarities in and differences between two sets of economic data. Consistency refers to use of the same accounting policies and procedures, either from period to period within an entity or in a single period across entities. The amended *Framework* argues that comparability is the goal, and that consistency of policies and procedures helps to achieve the goal.

In general, the same accounting methods (policies) should be used consistently in financial statements. However, it is not acceptable for policies to be applied consistently if the information that they produce is no longer relevant or a faithful representation of economic reality. An entity would therefore change its policies if the existing policies are no longer acceptable, or if a new or amended accounting standard is issued that requires a policy to be changed.

9. *What is meant by the requirement that information to be included in financial statements should be 'material'?*

The concept of materiality relates to the extent to which information can be omitted, misstated or grouped with other information without misleading the report users when they are making their economic decisions. Thus, the prices paid for insignificant items are not shown separately in the financial statements because they could "clutter" the financial statements with heaps of insignificant, or immaterial, information in the overall context of the decision being made by the user. However, it is important, when assessing materiality, to be aware of the particular decision being made by the user. The same information may be material for one decision and immaterial for another. Thus, considerable judgement is needed in order to assess which information is material and which is immaterial for the particular decision at hand.

According to the IASB amended *Framework*, materiality relates to faithful representation, in addition to relevance.

Materiality should be considered as a screen or filter to determine whether information is sufficiently significant to influence decisions of users in the context of the entity, rather than a qualitative characteristic itself.

10. *Explain the concept of "double-entry" in the preparation of financial statements.*

As a result of adopting the entity assumption, the accounting equation has been developed. This equation represents a statement of the entity's financial position at a point in time. One format of the accounting equation is:

Assets = Liabilities + Equity

The equation points out that when one of the entity's elements e.g. assets, is increased, there must be also a change in another element: either liabilities must increase or equity must increase, or another asset must decrease. The equation must always be in balance after recording every transaction. This phenomenon, whereby a change in one element (asset) causes a change in another (either liability or equity or another asset) is referred to as "double-entry". "Double entry accounting" is the name given to this dual recording process, which is developed further in chapter 3.

EXERCISE SOLUTIONS

Exercise 2.1 Preparing a balance sheet

JILL JORDAN'S EVENT MANAGEMENT SERVICES

Required:

A. Use these items to prepare a balance sheet similar to the one in figure 2.2. (Note that a major item is missing in the list.)

B. Recast the statement to present it in narrative form as in figure 2.3.

A.

JILL JORDAN'S EVENT MANAGEMENT SERVICES
Balance Sheet
as at 31 March 2013

ASSETS		LIABILITIES	
Cash at bank	$66 000	Accounts payable	$64 000
Accounts receivable	72 000	Mortgage payable	580 000
Office supplies	18 000		644 000
Office equipment	120 000		
Land	240 000	EQUITY	
Building	600 000	Jill Jordan, Capital	472 000
	$1 116 000		$1 116 000

B.

JILL JORDAN'S EVENT MANAGEMENT SERVICES **Balance Sheet** **as at 31 March 2013**	
ASSETS	
Cash at bank	$66 000
Accounts receivable	72 000
Office supplies	18 000
Office equipment	120 000
Land	240 000
Building	600 000
TOTAL ASSETS	$1 116 000
LIABILITIES	
Accounts payable	$64 000
Mortgage payable	580 000
TOTAL LIABILITIES	644 000
NET ASSETS	$472 000
EQUITY	
Jill Jordan, Capital	$472 000
TOTAL EQUITY	$472 000

Exercise 2.2 Income statement and analysis

JENNY'S SITTERS

Required:

A. Prepare an income statement for the year for Jenny's Sitters.

B. Who made more out of the personnel business – Jenny or her personal assistant? What action might Jenny take to increase the profitability of the business in the year ended 30 June 2014?

JENNY'S SITTERS Income Statement for the year ended 30 June 2014		
INCOME		
Services income		$695 000
EXPENSES		
Wages	$504 000	
Office Rental	27 000	
Electricity Costs	8 550	
Salary	69 000	
		608 550
PROFIT		$86 450

B.

The personal assistant's salary of $69 000 is less than Jenny's reported profit for the year. Although the profit was greater than the personal assistant's salary, the difference is not that great, especially considering Jenny has the additional responsibilities of running the business, ensuring the services are of a high standard, complying with legal and other requirements, marketing the business and employing babysitters. Jenny also bears all the risk of the business success or failure.

To improve profitability, Jenny needs to either increase income or decrease expenses. To increase income, Jenny would need to try to take on more clients, which may require more staff (this would also increase her business expenses). Increasing the charge out rate would also be another option. The possibility of increasing the charges for baby-sitting should be examined carefully, as it could result in fewer clients and a drop in revenue rather than the desired increase. Alternatively, Jenny could decrease the hours of the personal assistant or other employees, and take a more active role, but she would need to consider her availability for the extra hours, and the impact that would have on her other responsibilities.

Exercise 2.3 Analysis of Equity

CATHY OAKES

Required:

A. If Cathy did not contribute to or withdraw from the business during the year 2013-14, what was the profit/loss for the year?

B. If Cathy had withdrawn $24 000 during the year, calculate the profit/loss for the year.

C. If Cathy had contributed $30 000 and withdrawn $16 000, prepare a statement of changes in equity for the year ended 30 June 2014.

Calculation of Equity as at 30 June 2013 is $33 000
(i.e. $75 000 - $42 000)

Calculation of Equity as at 30 June 2014 is $42 000
(i.e. $78 000 - $36 000)

A. Capital Contributions and Drawings are nil for the year.
Ending Equity $42 000 – Beginning Equity $33 000
= Profit of $9 000.

B. Capital Contributions nil and drawings $24 000 for the year.
Ending Equity $42 000 - Beginning Equity $33 000
= movement of $9 000 + Drawings $24 000
= Net Profit $33 000.

C.

CATHY OAKES – PIANO TEACHER Statement of Changes in Equity for the year ended 30 June 2014	
Cathy Oakes, Capital – 1 July 2013	$33 000
Add: Capital contribution for the year	30 000
Less: Loss for the year*	(5 000)
	58 000
Less: Drawings during the year	16 000
Cathy Oakes, Capital – 30 June 2014	$42 000

* Loss is the balancing item

Exercise 2.4 Determining profit from equity balances

BURKE'S FINANCIAL SERVICES

Required:
Determine profit/loss earned by the business in each of the 2 years ended 30 June 2013 and 30 June 2014.

BURKE'S FINANCIAL SERVICES		
Profit for years ended 30 June	**2013**	**2014**
Beginning Capital	$140 000	$150 000
+ Additional Capital Contributions	-	45 000
- Withdrawals of Capital	(30 000)	-
- Drawings	(90 000)	(100 000)
Profit	**130 000**	**41 500**
Ending Capital	$150 000	$136 500

Exercise 2.5 Operating, investing and financing activities

Required:
Classify each of the following activities as being either operating, investing or financing for the purpose of preparing a statement of cash flows. Indicate whether there is an inflow (I) or outflow (O) of cash:

(a) sale of plant and equipment for cash
(b) payment of rent for offices
(c) withdrawal of cash by the owner
(d) repayment of a bank loan
(e) cash purchase of a truck by a manufacturing company
(f) cash purchase of a fleet of motor vehicles by a car dealership
(g) borrowing of money from a finance company on a long-term basis
(h) cash collected from the customers of the business

(a)	Investing	[I]
(b)	Operating	[O]
(c)	Financing	[O]
(d)	Financing	[O]
(e)	Investing	[O]
(f)	Operating	[O]
(g)	Financing	[I]
(h)	Operating	[I]

Exercise 2.6 Elements in financial statements

T-TIME

Required:
Indicate whether these items would appear in T-Time's balance sheet, income statement, statement of changes in equity and/or statement of cash flows. For those items included in the cash flow statement, indicate whether the item relates to operating activities, investing activities, or financing activities. (Hint: Some items may appear in more than one financial statement.)

(a) Balance sheet, statement of changes in equity, and statement of cash flows (Financing activity – treated as a contribution of capital)
(b) Balance sheet only
(c) Income statement, balance sheet and statement of cash flows (Operating activity)
(d) Income statement, balance sheet and statement of cash flows (Operating activity)
(e) Not reported in the financial statements as not part of the accounting entity "T-Time"
(f) Income statement, balance sheet and statement of cash flows (Operating activity)
(g) Balance sheet (reduction of capital), statement of cash flows (Financing activity as part of owner's drawings of capital from the business), statement of changes in equity
(h) Balance sheet and statement of cash flows (cash or cash equivalent balance).
(i) Balance sheet and statement of cash flows (Financing activity – for loan amount), (Investing activity– for purchase of shop fittings)

Exercise 2.7 Assumptions and characteristics of information

Required:
Identify by letter the assumption or characteristic of information which best represents the situations given.

A. - Accounting entity assumption
B. - Accrual basis assumption
C. - Going concern assumption
D. - Period assumption
E. - Relevance
F. – Reliability/Faithful representation
G. - Materiality
H. - Comparability

F. 1. The reporting of accounting information should be free from personal bias.
A. 2. In a single proprietorship, the owner's house and car are not recorded in the records of the business.
G. 3. The cost of stationery is not shown separately in the income statement.
B. 4. Services provided by a business entity are recorded before the receipt of cash.
E. 5. Machinery held by the business under a long-term lease arrangement is recorded by the business as its own asset.
D. 6. An expense is recorded in the year in which an asset or benefit is consumed in the process of carrying on the entity's business.
C. 7. Assets are not recorded at liquidation prices.
H. 8. Consistent accounting policies and methods are used in the preparation of financial statements from one year to another.

Exercise 2.8 Business transactions

For each of the following, describe a transaction that would have the stated effect on the accounting equation:

1. *Increase an asset and increase a liability*
2. *Increase one asset and decrease another asset*
3. *Decrease an asset and decrease equity*
4. *Increase an asset and increase equity*
5. *Decrease a liability and decrease an asset.*

1. Purchase an asset on credit
2. Purchase an asset for cash
3. Owner withdraws cash from the business for personal use.
4. Owner contributes cash to the business.
5. The business pays cash to its creditors.

Students may have many other possible examples in each of 1-5.

Exercise 2.9 Preparation of a balance sheet

NELSON PENNOCK, ACCOUNTANT

Required:

A. Determine the balance in Nelson Pennock's Capital account at the end of each month

B. Assuming that Nelson made no additional investments and did not withdraw any money from the business during the three months, determine the profit for November and December.

C. Prepare a balance sheet for the business at the end of December 2013. (The heading should read: Nelson Pennock, Accountant.)

A.

Based on the accounting equation: Assets less Liabilities = Equity

31 October Capital Balance = $(18 200 + 32 200 + 1 400 + 59 600 + 82 000 + 6 000) – $(20 200 + 10 200 + 69 400) = $99 600

30 November Capital Balance = $(7 800 + 30 000 + 3 600 + 59 400 + 81 600 + 6 000) –$(6 200 + 8 200 + 68 600) = $105 400

31 December Capital Balance = $(6 000 + 16 100 + 3 200 + 78 600 + 81 200 + 6 000) –$(6 000 + 9 600 + 67 800) = $107 700

B.

Profit for November = $105 400 - $99 600 = $5 800
Profit for December = $107 700 - $105 400 = $2 300

C.

NELSON PENNOCK, ACCOUNTANT

Balance Sheet

as at 31 December 2013

ASSETS	
Cash at bank	$6 000
Accounts receivable	16 100
Prepaid insurance	3 200
Office equipment	78 600
Land	6 000
Building	81 200
TOTAL ASSETS	$191 100
LIABILITIES	
Accounts payable	$6 000
Wages payable	9 600
Mortgage payable	67 800
TOTAL LIABILITIES	83 400
NET ASSETS	$107 700
EQUITY	
Nelson Pennock, Capital	$107 700
TOTAL EQUITY	$107 700

Exercise 2.10 Explaining account transactions

BRYAN KRUSE

Required:
The following schedule shows the effect of several transactions on the accounting equation of Bryan Kruse and the balance of each item in the equation after each transaction. Write a sentence to explain the nature of each transaction.

1. Bryan Kruse invested $30 000 into the business.

2. Purchased office equipment for cash $10 500.

3. Bryan Kruse invested a further $3 000 into the business, OR sold services for cash.

4. Performed services and billed clients for $9 000.

5. Office supplies of $4 500 were bought on credit.

6. $6 000 was received from clients for amounts owed (accounts receivable).

7. Bryan Kruse withdrew $12 000 from the business, or expense paid in cash.

8. $3 000 worth of office supplies were used.

9. Paid accounts payable $4 500 owed to them.

Exercise 2.11 Recording transactions

JEFF'S POOL REPAIRS

Required:

A. Prepare a schedule. List the following assets, liabilities and equity as column headings: Cash at Bank; Supplies; Equipment; Loan Payable; Accounts Payable; J. Drain, Capital.

B. Show the effects of each of the transactions on the accounts listed. Indicate totals after each transaction and complete the schedule.

C. Prepare an income statement and a statement of changes in equity for the month ended 31 August 2013, and a balance sheet as at 31 August 2013.

A and B

			Assets			=	**Liabilities**			+	**Equity**
	Cash at Bank	+	Supplies	+	Equipment	=	Accounts Payable	+	Loan Payable	+	Jeff Drain, Capital
(1)	+$50 000					=				+	$50 000
(2)	- 20 000			+	$30 000	=		+	$10 000		
	30 000			+	30 000	=		+	10 000	+	50 000
(3)	+ 6 000					=				+	6 000
	36 000			+	30 000	=		+	10 000	+	56 000
(4)	- 2 400					=				-	2 400
	33 600	+			30 000	=		+	10 000	+	53 600
(5)		+	2 740			=	2 740				
	33 600	+	2 740	+	30 000	=	2 740	+	10 000	+	53 600
(6)	- 1 540					=				-	1 540
	32 060	+	2 740	+	30 000	=	2 740	+	10 000	+	52 060
(7)	- 2 740					=	- 2 740				
	29 320	+	2 740	+	30 000	=	0	+	10 000	+	52 060
(8)		-	1 280			=				-	1 280
	29 320	+	1 460	+	30 000	=	0	+	10 000	+	50 780

C.

JEFF'S POOL REPAIRS Income Statement for the month ended 31 August 2013		
INCOME		
Services income		$6 000
EXPENSES		
Rent expense	$2 400	
Wages expense	1 000	
Electricity expense	540	
Supplies used	1 280	
		5 220
PROFIT		$780

JEFF'S POOL REPAIRS Statement of Changes in Equity for the month ended 31 August 2013	
Jeff Drain, Capital – 1 August 2013	$0
Add: Capital contribution	50 000
Profit for the month	780
	50 780
Less: Drawings during the month	0
Jeff Drain, Capital – 31 August 2013	$50 780

JEFF'S POOL REPAIRS Balance Sheet as at 31 August 2013	
ASSETS	
Cash at bank	$29 320
Supplies	1 460
Equipment	30 000
TOTAL ASSETS	$60 780
LIABILITIES	
Accounts payable	$0
Loan payable	10 000
TOTAL LIABILITIES	10 000
NET ASSETS	$50 780
EQUITY	
Jeff Drain, Capital	$50 780
TOTAL EQUITY	$50 780

Exercise 2.12 Preparation of income statement and balance sheet

PEBBLE BEACH CARAVAN PARK

Required:

A. Prepare an income statement for Beaut Beach Caravan Park for the year ended 30 June 2014.
B. Prepare a balance sheet for the business as at 30 June 2014.
C. Explain why you have used a particular valuation for the buildings in the balance sheet.

A.

PEBBLE BEACH CARAVAN PARK Income Statement for the year ended 30 June 2014		
INCOME		
Income -- camping		$185 000
Income -- cabins		272 000
		457 000
EXPENSES		
Salaries and wages expense	$220 000	
Other expenses	45 000	
Supplies used	71 000	
		336 000
PROFIT		$121 000

B.

PEBBLE BEACH CARAVAN PARK Balance Sheet as at 30 June 2014	
ASSETS	
Cash on hand	$20 000
Accounts receivable	8 000
Supplies	15 000
Buildings	420 000
Other equipment	63 000
TOTAL ASSETS	$526 000
LIABILITIES	
Accounts payable	$87 000
TOTAL LIABILITIES	$87 000
NET ASSETS	$439 000
EQUITY	
Peter and Anne Nesbit, Capital*	$439 000
TOTAL EQUITY	$439 000

* Normally, separate capital accounts are maintained for each partner in the business, but the question does not say whether they both contributed equally to the partnership, nor how they were sharing profits between themselves, so the capital amount has been shown as a single figure in this solution.

C.

Even though the market value of the buildings had risen to $500 000 by 30 June 2014, the valuation placed on the buildings in the balance sheet is their purchase price, or cost. This assumes that the business is a going concern and that the owners are not going to sell up and close the business down (going concern assumption). Hence, there is no need to reflect the current selling price in the balance sheet.

Nevertheless, if the owners wanted to revalue the buildings to $500 000, they could. The revaluation of buildings in the accounts of an entity is discussed in a later chapter.

Exercise 2.13 Effect of transactions on a balance sheet

JOYCE'S MANICURE SERVICE

Required:
Show the effects of business transactions on a balance sheet by preparing a new balance sheet for Joyce's Manicure Service after EACH transaction has occurred.

1st September: Capital investment by owner, $350 000

JOYCE'S MANICURE SERVICE Balance Sheet as at 1 September 2013	
ASSETS	
Cash on hand	$350 000
TOTAL ASSETS	$350 000
EQUITY	
Joyce …, Capital	$350 000
TOTAL EQUITY	$350 000

2nd September: Purchase of premises for $180 000 cash

JOYCE'S MANICURE SERVICE Balance Sheet as at 2 September 2013	
ASSETS	
Cash on hand	$170 000
Premises	180 000
TOTAL ASSETS	$350 000
EQUITY	
Joyce …, Capital	$350 000
TOTAL EQUITY	$350 000

4th September: Purchase of equipment $60 000 for cash and $20 000 bank loan

JOYCE'S MANICURE SERVICE **Balance Sheet** **as at 4 September 2013**	
ASSETS	
Cash on hand	$130 000
Buildings	180 000
Manicure equipment	60 000
TOTAL ASSETS	$370 000
LIABILITIES	
Loan payable	$20 000
TOTAL LIABILITIES	$20 000
NET ASSETS	$350 000
EQUITY	
Joyce …, Capital	$350 000
TOTAL EQUITY	$350 000

6th September: Manicure services to customers, for $12 000 cash and $2 000 on credit

JOYCE'S MANICURE SERVICE	
Balance Sheet	
as at 6 September 2013	
ASSETS	
Cash on hand	$142 000
Accounts receivable	2 000
Buildings	180 000
Manicure equipment	60 000
TOTAL ASSETS	$384 000
LIABILITIES	
Loan payable	$20 000
TOTAL LIABILITIES	$20 000
NET ASSETS	$364 000
EQUITY	
Joyce …, Capital	$364 000
TOTAL EQUITY	$364 000

7th September: Wages paid to an employee $1 000 in cash

JOYCE'S MANICURE SERVICE	
Balance Sheet	
as at 7 September 2013	
ASSETS	
Cash on hand	$141 000
Accounts receivable	2 000
Buildings	180 000
Manicure equipment	60 000
TOTAL ASSETS	$383 000
LIABILITIES	
Loan payable	$20 000
TOTAL LIABILITIES	$20 000

NET ASSETS	$363 000
EQUITY	
Joyce …, Capital	$363 000
TOTAL EQUITY	$363 000

Exercise 2.14 Effect of transactions on financial statements

Indicate the effect of each of the following transactions upon any or all of the four financial statements of a business. Apart from indicating the financial statement(s) involved, use appropriate phrases such as "increase total assets", "decrease equity", "increase income", "decrease cash flow" to describe the transaction concerned.

1. *Purchase equipment for cash*
2. *Provide services to a client, with payment to be received within 40 days*
3. *Pay a liability*
4. *Invest additional cash into the business by the owner*
5. *Collect an account receivable in cash*
6. *Pay wages to employees*
7. *Receive the electricity bill in the mail, to be paid within 30 days*
8. *Sell a piece of equipment for cash*
9. *Withdraw cash by the owner for private usage.*
10. *Borrow money on a long-term basis from a bank*

1. In the balance sheet, increase an asset, equipment; decrease an asset, cash.
In the statement of cash flows, decrease cash flow (from investing activities).

2. In the balance sheet, increase an asset, accounts receivable; increase equity.
In the income statement, increase income.
In the statement of changes in equity, increase equity.

3. In the balance sheet, decrease an asset, cash; decrease a liability.
In the statement of cash flows, decrease cash (probably from operating activities).

4. In the balance sheet, increase an asset, cash; increase equity.
In the statement of cash flows, increase cash (from financing activities).
In the statement of changes in equity, increase equity.

5. In the balance sheet, increase an asset, cash; decrease an asset, accounts receivable.
In the statement of cash flows, increase cash (from operating activities).

6. In the balance sheet, decrease an asset, cash; decrease equity.
In the income statement, increase expenses.
In the statement of cash flows, decrease cash (from operating activities).
In the statement of changes in equity, decrease equity.

7. In the balance sheet, decrease equity; increase a liability, accounts payable.
In the income statement, increase expenses.
In the statement of changes in equity, decrease equity.

8. In the balance sheet, increase an asset, cash; decrease an asset, equipment, increase equity (if a profit was made on the sale).
In the income statement, increase income (if a profit was made on the sale).
In the statement of cash flows, increase cash (from investing activities).

In the statement of changes in equity, increase equity (if a profit was made on the sale).

9. In the balance sheet, decrease equity, decrease an asset, cash.
   In the statement of cash flows, decrease cash (from financing activities).
   In the statement of changes in equity, decrease equity.

10. In the balance sheet, increase an asset, cash; increase a liability, loan payable.
    In the statement of cash flows, increase cash (from financing activities).

Exercise 2.15 Determination of profit by examining equity changes

FRED BALLEW

Required:

By analysing the changes in equity each year, calculate the profit (loss) made by the business for each year ending 30 June, assuming the following events also occurred:

1. *On 1 January, 2012, Fred withdrew $40 000 in cash from the business for personal use*
2. *On 28 August 2012, Fred invested additional cash of $70 000 into the business.*
3. *On 31 July 2013, Fred invested additional cash of $50 000 into the business.*
4. *On 28 January 2014, Fred withdrew $30 000 in cash for personal use.*

FRED BALLEW'S BUSINESS			
Profit for years ended 30 June	**2012**	**2013**	**2014**
Beginning Capital 1 July	$300 000	$340 000	$470 000
+ Additional Capital Contributions	-	70 000	50 000
- Drawings	(40 000)		(30 000)
Profit	**80 000**	**60 000**	**40 000**
Ending Capital*30 June	$340 000	$470 000	$530 000

PROBLEM SOLUTIONS

Problem 2.1 Preparing financial statements

SAFETY HIRE

Required:
Prepare an income statement for the month of June and a balance sheet in account format for Safety Hire at 30 June 2013.

SAFETY HIRE
Income Statement

For the month ended 30 June 2013

INCOME		
Equipment hire income		$340 000
EXPENSES		
Wages expense	$150 000	
Advertising expense	60 000	
Electricity expense	36 000	
Telephone expense	15 000	
		261 000
PROFIT		$79 000

SAFETY HIRE

Balance Sheet

as at 30 June 2013

ASSETS		LIABILITIES	
Cash at bank	$90 000	Accounts payable	$80 000
Accounts receivable	126 000	Loan payable	100 000
Hire equipment	360 000	Mortgage payable	260 000
Building	170 000		440 000
Land	150 000	EQUITY	
		Amy Irving, Capital	456 000
	$896 000		$896 000

Problem 2.2 Preparing financial statements

PAM'S INTERIOR DECORATING

Required:

A. Prepare an income statement for the business for the year ended 30 June 2012

B. Prepare a balance sheet in narrative format as at 30 June 2012

A.

PAM'S INTERIOR DECORATING
Income Statement
for the year ended 30 June 2012

INCOME		
Decorating services income		$772 000
EXPENSES		
Advertising expense	$72 000	
Insurance expense	16 000	
Rent expense	66 000	
Supplies expense	25 200	
Telephone expense	24 400	
Electricity expense	34 000	
Wages expense	222 000	
		459 600
PROFIT		$312 400

B.

PAM'S INTERIOR DECORATING Balance Sheet as at 30 June 2012	
ASSETS	
Cash at bank	$45 600
Accounts receivable	235 200
Supplies	52 800
Equipment	251 200
TOTAL ASSETS	$584 800
LIABILITIES	
Accounts payable	67 400
TOTAL LIABILITIES	$67 400
NET ASSETS	$517 400
EQUITY	
Pam Jones, Capital	517 400
TOTAL EQUITY	$517 400

Problem 2.3 Determining missing elements in accounting equation

Required:
Calculate the two missing amounts for each independent case.

Case	Total Assets	Total liabilities	Total equity	Total income	Total expenses	Profit (loss)
A	$120 000	$69 000	**$51 000**	$123 000	**$66 000**	$57 000
B	$135 000	**$49 500**	$85 500	$124 500	$96 000	**$28 500**
C	**$151 500**	$66 000	$85 500	$135 000	**$150 000**	($15 000)
D	$75 000	**$43 500**	$31 500	**$22 500**	$34 500	($12 000)
E	**$144 000**	$60 000	$84 000	**$84 000**	$48 000	$36 000

Problem 2.4 Identifying transactions from balance sheet changes

MARK'S CAFE

Required:
Describe the nature of each of the four transactions that took place in June.

1. On 4 June 2012, Mark Fulcher invested $150 000 into the business, Mark's Café.

2. On 13 June 2012, equipment was purchased by the business for cash, $58 000.

3. On 18 June, 2012, land and a building were purchased for a total of $120 000. A loan payable of $80 000 and cash of $40 000 were given in exchange.

4. On 26 June 2012, food supplies of $36 000 were purchased by the business on credit.

Problem 2.5 **Preparation of financial statements**

HOLMAN INDUSTRIES

Required:

A. *Prepare an income statement for Dawson Industries for the year ended 31 December 2013.*
B. *Prepare a balance sheet as at 31 December 2013.*
C. *Prepare a statement of changes in equity for 2013.*

A.

HOLMAN INDUSTRIES **Income Statement** **for the year ended 31 December 2013**		
INCOME		
Service income		$295 000
EXPENSES		
Advertising expense	$25 000	
Insurance expense	5 000	
Rent expense	27 000	
Supplies expense	10 500	
Telephone expense	9 800	
Electricity expense	14 400	
Wages expense	88 000	
		179 700
PROFIT		$115 300

B.

HOLMAN INDUSTRIES **Balance Sheet** **as at 31 December 2013**	
ASSETS	
Cash at bank	$20 500
Accounts receivable	51 200
Supplies	22 000
Equipment	96 000
TOTAL ASSETS	$189 700
LIABILITIES	
Accounts payable	19 000
TOTAL LIABILITIES	$19 000
NET ASSETS	$170 700
EQUITY	
Alicia Holman, Capital	170 700
TOTAL EQUITY	$170 700

C.

HOLMAN INDUSTRIES **Statement of Changes in Equity** **for the year ended 31 December 2013**	
Alicia Holman, Capital – 1 January 2013	$102 200
Add: Capital contribution	0
Profit for the year	115 300
	217 500
Less: Drawings during the year	46 800
Alicia Holman, Capital – 31 December 2013	$170 700

Problem 2.6 Correction of financial statements

TINA'S TENNIS SCHOOL

Required:
A. Prepare a corrected income statement for the year ended 30 June 2012.
B. Prepare a corrected balance sheet in narrative form as at 30 June 2012.
C. Prepare a statement of changes in equity for the year ended 30 June 2012.

A.

TINA'S TENNIS SCHOOL Income Statement for the year ended 30 June 2012			
INCOME			
Tennis coaching fees			$238 000
EXPENSES			
Tennis court rental		$36 000	
Wages expense		94 200	
Supplies expense		19 200	
Electricity expense		13 500	
Depreciation expense			
- vehicle	6 400		
- equipment	8 600		
		15 000	
			177 900
PROFIT			$60 100

B.

TINA'S TENNIS SCHOOL **Balance Sheet** **as at 30 June 2012**		
ASSETS		
	Cash at bank	$25 200
	Accounts receivable	8 000
	Supplies on hand	13 200
	Equipment	44 600
	Vehicle	41 400
	TOTAL ASSETS	$132 400
LIABILITIES		
	Accounts payable	35 000
	Wages payable	8 200
	TOTAL LIABILITIES	$43 200
	NET ASSETS	$89 200
EQUITY		
	T. Ball, Capital*	89 200
	TOTAL EQUITY	$89 200

C.

TINA'S TENNIS SCHOOL **Statement of Changes in Equity** **for the year ended 30 June 2012**	
T. Ball, Capital – 1 July 2011*	$51 500
Add: Profit for the year	60 100
	111 600
Less: Drawings during the year	22 400
T. Ball, Capital – 30 June 2012	$89 200

*Beginning balance of capital is found by working backwards, i.e. $89 200 + $22 400 - $60 100. This assumes that the owner did not make a capital contribution during the year.

Problem 2.7 **Performance assessment from financial statements**

THE PARTY SHOP

Required:

A. Prepare an income statement for The Party Shop for the year ended 31 December 2013.

B. Prepare a statement of cash flows for The Party Shop for the year ended 31 December 2013.

C. Can a business operate profitably and still have a net cash outflow for the year? Which do you believe is a better indicator of the entity's performance – profit or cash flow? Explain.

A.

THE PARTY SHOP
Income Statement
for the year ended 31 December 2013

INCOME		
Party hire services		$420 000
EXPENSES		
Supplies and labour expense	$300 000	
Rent expense	49 500	349 500
PROFIT		$70 500

B.

THE PARTY HIRE SHOP
Statement of Cash Flows
for the year ended 31 December 2013

CASH FLOWS FROM OPERATING ACTIVITIES		
Cash received from customers	$420 000	
Cash paid to suppliers and employees	(349 500)	
Net cash from operating activities		$70 500
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase of vehicle	(48 000)	
Purchase of computer system	(75 000)	
Purchase of land	(120 000)	
Net cash used in investing activities		(243 000)
CASH FLOWS FROM FINANCING ACTIVITIES		
Bank loan	45 000	
Drawings by owner	-	
Net cash from financing activities		45 000
Net increase (decrease) in cash held		(127 500)
Cash at beginning of year		150 000
Cash at end of year		$22 500

C. Yes. In accrual accounting, cash flows do differ from income and expenses. For example, cash flows from investing and financing activities will affect cash outflows but are not income and expenses counted in calculating profit. Most cash flows from operating activities also result in income or expenses, but this may occur in different time periods. Many cash flows from investing and financing activities never result in income or expenses e.g. cash increases from borrowings. In terms of indicators of business performance, profit is more important – in the long run if profits are not made, the business will fail. However, liquidity can also cause major problems and cash flow is also important. A business can have positive cash flows while trading at a loss in the short term, but in the long term, profits and positive cash flows are both important. If a business is not able to generate positive cash flows from its operations in the long term, the business will not survive.

Problem 2.8 Recording transactions and preparing financial statements

MATINA HANA

Required:

A. *List the 30 June balances for assets, liabilities and equity in table form as shown below.*

B. *Record the effects of each transaction. Show the total of each column after recording each transaction.*

C. *Prepare an income statement, a statement of changes in equity and a statement of cash flows for the month ended 31 July 2013, and a balance sheet (account format) as at 31 July 2013.*

A. and B.

	Assets							=	Liabilities			+	Equity
	Cash at Bank	+	Accounts Receivable	+	Office Supplies	+	Equipment	=	Accounts Payable	+	Loans Payable	+	Matina Hana, Capital
	$22 000	+	$30 000	+	$3 000	+	$48 000	=	$7 000	+	$24 000	+	$72 000
(1)	+ 16 000		-16 000										
	38 000	+	14 000	+	3 000	+	48 000	=	7 000	+	24 000	+	72 000
(2)	- 3 600								- 3 600				
	34 400	+	14 000	+	3 000	+	48 000	=	3 400	+	24 000	+	72 000
(3)	-6 000						+16 200				+10 200		
	28 400	+	14 000	+	3 000	+	64 200	=	3 400	+	34 200	+	72 000
(4)			+12 600										+12 600
	28 400	+	26 600	+	3 000	+	64 200	=	3 400	+	34 200	+	84 600
(5)					+750				+ 750				
	28 400	+	26 600	+	3 750	+	64 200	=	4 150	+	34 200	+	84 600
(6)	-5 850												-5 850
	22 550	+	26 600	+	3 750	+	64 200	=	4 150	+	34 200	+	78 750
(7)	-4 000												-4 000
	18 550	+	26 600	+	3 750	+	64 200	=	4 150	+	34 200	+	74 750
(8)					-1 800								-1 800
	18 550	+	26 600	+	1 950	+	64 200	=	4 150	+	34 200	+	72 950

C.

MATINA HANA Income Statement for the month ended 31 July 2013		
INCOME		
Services income		$12 600
EXPENSES		
Wages expense	$3 300	
Electricity expense	1 650	
Advertising expense	900	
Supplies expense	1 800	
		7 650
PROFIT		$4 950

MATINA HANA Statement of Changes in Equity for the month ended 31 July 2013	
Matina Hana, Capital – 1 July 2013	$72 000
Add: Profit for the month	4 950
	76 950
Less: Drawings during the month	4 000
Matina Hana, Capital – 31 July 2013	$72 950

MATINA HANA Statement of Cash Flows for the month ended 31 July 2013		
CASH FLOWS FROM OPERATING ACTIVITIES		
Cash received from customers	$16 000	
Cash paid to suppliers and employees (1)	(9 450)	
Net cash from operating activities		$6 550
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase of equipment	(6 000)	
Net cash used in investing activities		(6 000)
CASH FLOWS FROM FINANCING ACTIVITIES		
Drawings by owner	(4 000)	
Net cash used in financing activities		(4 000)
Net decrease in cash held		(3 450)
Cash at beginning of year		22 000
Cash at end of year		$18 550

(1) Paid Accounts Payable $3 600 + Cash Expenses $5 850 = $9 450

MATINA HANA Balance Sheet as at 31 July 2013			
ASSETS		LIABILITIES	
Cash at bank	$18 550	Accounts payable	$4 150
Accounts receivable	26 600	Loan payable	34 200
Office supplies	1 950	EQUITY	
Equipment	64 200	Matina Hana, Capital	72 950
	$111 300		$111 300

Problem 2.9 Classifying items for financial statements

GARY'S MEN'S WEAR

Required:
A. Select a suitable name to describe each of the listed items
B. Classify each of the items as appropriate for inclusion in the balance sheet of the business.

A. and B.

1. For the business, this is the initial investment by the owner. In the balance sheet of the business, cash increases and the equity of the owner increases.

2. Store equipment. Shown in the balance sheet as an asset.

3. There is no building asset for the business here. The building does not belong to the business. In the balance sheet, an asset for Prepaid Rent would be recorded if the rent is paid by the business each month in advance.

4. Men's wear items are Inventory to the business. In the balance sheet inventory is recorded as an asset.

5. Accounts payable. Appears in the balance sheet as a liability.

6. Prepaid insurance. Shown in the balance sheet as an asset.

7. Drawings. Shown in the balance sheet as a reduction in equity, against Gary's capital account.

8. Wages Expense. Does not appear in the balance sheet as a separate item but reduces owner's equity by reducing the net profit.

9. Long-term Loan Payable. Shown in the balance sheet as a liability, and the cash received as an asset, Cash.

10. Income or Revenue from Sales. Does not appear in the balance sheet as a separate item but increases owner's equity by increasing net profit.

11. Cash on hand. Shown in the balance sheet as an asset.

Problem 2.10 Recording transactions and preparing financial statements

XIU MIAO, SOLICITOR

Required:

A. List the 30 June balances for assets, liabilities and equity in table form.

B. Record the effects of each transaction. Show the total of each column after recording each transaction as illustrated in the text.

C. Prepare an income statement and a statement of changes in equity for the month and a balance sheet in account format as at 31 July 2013.

A. and B.

			Assets					=	**Liabilities**			+	**Equity**
	Cash at Bank	+	Accounts Receivable	+	Office Supplies	+	Office Equipment	=	Accounts Payable	+	Loan Payable	+	Xiu Miao, Capital
.	$16 000	+	$26 500	+	2 000	+	$39 750	=	$4 850	+	$17 500	+	$61 900
(1)	-4 720								- 4 720				
	11 280	+	26 500	+	2 000	+	39 750	=	130	+	17 500	+	61 900
(2)	+14 800		-14 800										
	26 080	+	11 700	+	2 000	+	39 750	=	130	+	17 500	+	61 900
(3)	-3 000					+	12 400			+	9 400		
	23 080	+	11 700	+	2 000	+	52 150	=	130	+	26 900	+	61 900
(4)		+	11 640									+	11 640
	23 080	+	23 340	+	2 000	+	52 150	=	130	+	26 900	+	73 540
(5)				+	680				+ 680				
	23 080	+	23 340	+	2 680	+	52 150	=	810	+	26 900	+	73 540
(6)	-9 300											-	9 300
	13 780	+	23 340	+	2 680	+	52 150	=	810	+	26 900	+	64 240
(7)				-	1 440							-	1 440
	13 780	+	23 340	+	1 240	+	52 150	=	810	+	26 900	+	62 800
(8)	+ 13 500	-	13 500										
	27 280	+	9 840	+	1 240	+	52 150	=	810	+	26 900	+	62 800
(9)	-1 200											-	1 200
	26 080	+	9 840	+	1 240	+	52 150	=	810	+	26 900	+	61 600

C.

XIU MIAO- SOLICITOR Income Statement for the month ended 31 July 2013		
INCOME		
Legal services earned		$11 640
EXPENSES		
Wages expense	$4 100	
Rent expense	4 000	
Advertising expense	1 200	
Supplies expense	1 440	
		10 740
PROFIT		$900

XIU MIAO – SOLICITOR Statement of Changes in Equity for the month ended 31 July 2013	
Xiu Miao, Capital – 1 July 2013	$61 900
Add: Profit for the month	900
	62 800
Less: Drawings during the month	1 200
Xiu Miao, Capital – 31 July 2013	$61 600

XIU MIAO – SOLICITOR Balance Sheet as at 31 July 2013			
ASSETS		LIABILITIES	
Cash at bank	$26 080	Accounts payable	$810
Accounts receivable	9 840	Loan payable	26 900
Office supplies	1 240	EQUITY	
Office equipment	52 150	Xiu Miao, Capital	61 600
	$89 310		$89 310

Problem 2.11 Identifying transactions from balance sheet changes

E. BRANTLEY, CHIROPRACTOR

Required:
Write an appropriate statement describing each of the five transactions that occurred during July 2013.

1. On 1 July, 2013, E. Brantley invested $170 000 in the business.

2. On, 8 July, the business purchased land and building for $190 000. This was financed with a cash payment of $70 000 and a loan payable of $120 000.

3. On 15 July, the business bought office supplies on credit, $7 000.

4. On 22 July, the business repaid $10 000 on the loan payable.

5. On 31 July, the proprietor, E. Brantley, withdrew $8 000 cash for her own use or paid expenses of $8 000.

Problem 2.12 Recording transactions and preparing financial statements

GERALD'S SHOE REPAIRS

Required:

A. *Prepare a schedule. List the following assets, liabilities and equity as column headings: Cash at Bank; Supplies; Equipment; Loan Payable; Accounts Payable; G. Hirst, Capital.*

B. *Show the effects of each of the transactions on the accounts listed. Indicate totals after each transaction and complete the schedule.*

C. *Prepare an income statement, a statement of cash flows and a statement of changes in equity for the month ended 31 August 2014.*

D. *Prepare a balance sheet as at 31 August 2014.*

A. and B.

	Assets					=	Liabilities			+	Equity
	Cash at Bank	+	Supplies	+	Equipment	=	Loan payable	+	Accounts Payable	+	G. Hirst, Capital
(1)	+$24 000									+	$24 000
(2)	-10 000				+16 000		+6 000				
	14 000	+	0	+	16 000	=	6 000	+	0	+	24 000
(3)	+3 000									+	3 000
	17 000	+	0	+	16 000	=	6 000	+	0	+	27 000
(4)	-1 200									-	1 200
	15 800	+	0	+	16 000	=	6 000	+	0	+	25 800
(5)		+	1 700						+1 700		
	15 800	+	1 700	+	16 000	=	6 000	+	1 700	+	25 800
(6)	- 750									-	-750
	15 050	+	1 700	+	16 000	=	6 000	+	1 700	+	25 050
(7)	- 1 700							-	1 700		
	13 350	+	1 700	+	16 000	=	6 000	+	0	+	25 050
(8)		-	280							-	280
	13 350	+	1 420	+	16 000	=	6 000	+	0	+	24 770

C.

GERALD'S SHOE REPAIRS
Income Statement
for the month ended 31 August 2014

INCOME		
Services Income		$3 000
EXPENSES		
Rent expense	$1 200	
Wages expense	500	
Electricity expense	250	
Supplies expense	280	
		2 230
PROFIT		$770

GERALD'S SHOE REPAIRS
Statement of Cash Flows
for the month ended 31 August 2014

CASH FLOWS FROM OPERATING ACTIVITIES		
Cash received from customers	$3 000	
Cash paid to suppliers and employees*	(3 650)	
Net cash used in operating activities		(650)
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase of equipment	(10 000)	
Net cash used in investing activities		(10 000)
CASH FLOWS FROM FINANCING ACTIVITIES		
Cash from owner	24 000	
Net cash from financing activities		24 000
Net increase in cash held		13 350
Cash at beginning of year		0
Cash at end of year		$13 350

* Cash paid to suppliers = $1 200 + $500 + $250 + $1 700

GERALD'S SHOE REPAIRS **Statement of Changes in Equity** **for the month ended 31 August 2014**	
Gerald Hirst, Capital - 1 August 2014	$24 000
Add: Profit	770
Gerald Hirst, Capital - 31 August 2014	$24 770

D.

GERALD'S SHOE REPAIRS **Balance Sheet** **As at 31 August 2014**			
ASSETS		LIABILITIES	
Cash at bank	$13 350	Loan payable	$6 000
Supplies	1 420	EQUITY	
Equipment	16 000	Gerald Hirst, Capital	24 770
	$30 770		$30 770

Problem 2.13 Correcting errors and preparing financial statements

BAKER'S BREAD SHOP

Required:

A. Assuming that the amounts above are correct, prepare a corrected balance sheet in narrative form.

B. Determine the amount of profit (loss) made by the business during the period of its first few weeks of existence, assuming that the owner had invested an additional $20000 into the business just before the amounts were calculated by the record-keeper.

C. Prepare a statement of changes in equity for the period.

A.

BAKER'S BREAD SHOP Balance Sheet as at ? April 2013	
ASSETS	
Cash at bank	$31 000
Accounts receivable	20 000
Baking supplies	5 600
Land	43 200
Buildings	100 000
Furniture	12 000
TOTAL ASSETS	$211 800
LIABILITIES	
Accounts payable	37 100
Mortgage payable	40 000
Loan payable	20 700
TOTAL LIABILITIES	$97 800
NET ASSETS	$114 000
EQUITY	
A. Baker, Capital*	114 000
TOTAL EQUITY	$114 000

* Capital contribution of $150 000, less drawings of $36 000.

B. and C.

Profit calculation determined in the statement of changes in equity, as below.

BAKER'S BREAD SHOP Statement of Changes in Equity for the few weeks ended ? April 2013	
A. Baker, Capital – 1 April 2013	$100 000
Add: Additional capital contribution	20 000
Add: Profit for the period	30 000
	150 000
Less: Drawings during the period	36 000
A. Baker, Capital – end of period	$114 000

Problem 2.14 Analysing financial statement elements

DA DESIGNS

Required:

A. Without preparing formal financial statements, calculate the following:
   1. profit/loss for the year
   2. total assets at the end of the year
   3. total liabilities at the end of the year
   4. Dylan Andrews' capital balance at the end of the year
   5. net cash inflow/outflow for the year.

B. If Dylan had withdrawn \$6 000 in cash during the year, what effect would this have (increase, decrease, no change) on the figures you calculated in requirement A.

A.

1. Profit = Income – Expenses
   Total Income = Web design Income \$19 500.
   Total Expenses = Office supplies expense \$1 680 + Telephone expense \$510 + Motor vehicle expense \$660 + Advertising expense \$1 020 = \$3 870
   Profit = \$19 500 – \$3 870 = \$15 630

2. Total Assets = Office supplies \$3 000 + Accounts receivable \$3 000 + Cash at bank \$16 890 + Computer equipment \$16 500 = \$39 390
   Total Assets = \$39 390

3. Total liabilities = Bank loan \$15 000 + Accounts payable \$2 160 = \$17 160
   Total Liabilities = \$17 160

4. Closing Capital = Opening capital \$6 600 + Additional contributions \$0 + Profit \$15 630 – Drawings \$0 = \$22 230
   Closing Capital = \$22 230

5. Net Cash Inflow/(Outflow) = Cash flow from operations + Cash flow from investing activities + Cash flow from financing activities + Initial contribution
   Cash flow from operations = Web design receipts \$16 500 – Payment to suppliers \$4 710 = \$11 790
   Cash flow from investing activities = Purchase of equipment (\$16 500)
   Cash flow from financing activities = Bank loan received \$18 000 – Bank loan repayment \$3 000 = \$15 000
   Net Cash Inflow/(Outflow) = Cash flow from operations \$11 790 + Cash flow from investing activities (\$16 500) + Cash flow from financing operations \$15 000 + Initial contribution \$6 600 = \$16 890
   Net Cash Inflow = \$16 890

B.

1. Profit / loss for the year: no change.
   Profit = $19 500 – $3 870 = $15 630

2. Total Assets = Office supplies $3 000 + Accounts receivable $3 000 + Cash at bank $10 890 + Computer equipment $16 500 = $33 390
   Total Assets = $33 390

3. Total liabilities: no change.
   Total liabilities = Bank loan $15 000 + Accounts payable $2 160 = $17 160
   Total Liabilities = $17 160

4. Closing capital balance will change.
   Closing Capital = Opening capital $6 600 + Additional contributions $0 + Profit $15 630 – Drawings $6 000 = $16 230
   Closing Capital = $16 230.

5. Net cash inflow / outflow will change.
   Net Cash Inflow/(Outflow) = Cash flow from operations + Cash flow from investing activities + Cash flow from financing activities + Initial contribution
   Cash flow from operations = Web design receipts $16 500 – Payment to suppliers $4 710 = $11 790
   Cash flow from investing activities = Purchase of equipment ($16 500)
   Cash flow from financing activities = Bank loan received $18 000 – Bank loan repayment $3 000 – Drawings $6 000 = $9 000
   Net Cash Inflow/(Outflow) = Cash flow from operations $11 790 + Cash flow from investing activities ($16 500) + Cash flow from financing operations $9 000 + Initial contribution $6 600 = $10 890
   Net Cash Inflow = $10 890

Problem 2.15 **Preparation of financial statements**

Required:

A. Prepare an income statement for Fit Pro for the 6-month period from 1 September 2013 to 28 February 2014 from the information provided.
B. Prepare a balance sheet for Fit Pro as at 28 February 2014, and a statement of changes in equity for the 6-month period from the information provided.
C. Based on the financial statements prepared, do you believe Ryan should continue with his business venture? Why or why not?

A.

FIT PRO **Income Statement** **for the six months ended 28 February 2014**		
INCOME		
Fitness income earned		$9 800
EXPENSES		
Rent expense	$750	
Electricity expense	850	
Telephone expense	560	
Water expense	350	
Advertising expense	500	
		3 010
PROFIT		$6 790

B.

FIT PRO **Balance Sheet** **as at 28 February 2014**			
ASSETS		LIABILITIES	
Cash at bank	$16 500	Accounts payable	$460
Accounts receivable	800	EQUITY	
Fitness equipment	4 000	Ryan Stallard, Capital	$20 840
	$21 300		$21 300

FIT PRO **Statement of Changes in Equity** **for the six months ended 28 February 2014**	
Ryan Stallard, Capital – 1 September 2013	$15 000
Add: Profit for the six months	6 790
	21 790
Less: Drawings during the six months	950
Ryan Stallard, Capital – 28 February 2014	$20 840

C. The income statement shows that Ryan made a profit for the six months of $6,790. Although he has only drawn out $950 in this period, he does still have $16,500 in the business bank account at the end of the first 6 months. Whether he continues with his business venture or not depends on whether he believes he will be able to improve the profits in the future, and also on what alternatives he has available. It is common for businesses starting out to make losses initially, or to start with very modest profits until they build up a client base and a reputation. At this stage there is no reason why Ryan shouldn't persevere for a while longer and try to build his business. On the other hand, Ryan may have determined that, given the maximum number of hours he can work each day, it is not possible for him to generate sufficient profits to give him the income he was hoping to get from his business, and he may decide to close it down and seek alternative employment or business opportunities.

CASE STUDY SOLUTIONS

Decision Case — Gavin Mackie financial statements

Required:

A. Using the information Gavin has provided, prepare an income statement and a balance sheet for the year ended 30 June 2013.
B. Discuss the elements of the financial statements you have prepared in part A. above which the bank manager might be interested in when assessing whether or not to grant loan facilities to Gavin.
C. What information, in addition to the income statement and balance sheet, might the bank manager be interested in looking at before making a decision?

A.

GAVIN MACKIE, CONSULTANT
Income Statement
for the year ended 30 June 2013

INCOME		
Consulting fee income		$400 000
EXPENSES		
Engineering sub-contract expenses	$140 000	
Other expenses (including rent)	152 500	
Motor vehicle running expenses	5 000	
Electricity and telephone expenses	4 000	
		301 500
PROFIT		$98 500

GAVIN MACKIE, CONSULTANT
Balance Sheet
as at 30 June 2013

ASSETS		LIABILITIES	
Cash at bank	$3 000	Accounts payable	$22 500
Accounts receivable	10 000	EQUITY	
Motor vehicle	30 000	Gavin Mackie, Capital	$45 500
Equipment	25 000		
	$68 000		$68 000

B. The following are some suggested discussion points for this part of the question (there are many other relevant points which could be raised here):

The bank manager is interested in establishing whether the business will be in a position to repay the loan, and also be able to pay interest on the loan. To make this assessment, the manager might look at the following:

a. The profits of the business – although a profit was made, it is not much for a whole year. The bank manager may want to establish whether the expenses include a salary paid to Gavin by the business, or whether he has not drawn money out of the business and relies on the profits as a return on his investment
b. The income and expenses, to establish whether the expenses paid are likely to increase in the future, and what the business income is likely to be for the next few years. In particular, the bank manager will want to enquire whether there are any contracts that have already been awarded for the next few years (and therefore constitute more certain income)
c. The accounts receivable amount, and enquire as to whether it is likely that Gavin will recover the money from the customers
d. The business currently owes suppliers more than it is owed by customers, which will place an additional pressure on the business cash flows
e. How old the motor vehicle and equipment assets are, and when it is likely that they will have to be replaced, as this will require a further cash outflow
f. How long the office lease is for, and whether it is likely the business will have to find alternative office space (and possibly at a higher rental which will reduce the amount of cash available)

C. Other information which the bank manager would be interested in might include:

a. The cash flow forecast for the business for the next year or more
b. The expected income and expenses for the next year
c. The wages that would be paid to the graduates, and whether the additional income that is generated would at least cover the added costs
d. Whether Gavin has personal assets that could be offered as security for the loan
e. How Gavin anticipates making the loan and interest payments

Critical Thinking

Sporting glory – the great intangible

Required:

Discuss whether rugby players are 'valuable assets' of an organisation, or an expense. Use the definitions of assets and expenses to show which of the elements of the financial statements "human resources" should be classified under.

'Human resources' refers to the people employed by a business and includes their talent, knowledge, intelligence, experience, understanding of the organisation's culture and its history. Assets are defined as resources controlled by an entity as a result of past events and from which future economic benefits are expected to flow to the entity. Human resources such as rugby players could certainly be said to provide future economic benefits through the future gate receipts obtained by the organisation. The employment and training of such players would also constitute a valid past event. However, are rugby players "controlled" by the entity, as a result of some contract? Are the players able to leave whenever they like (unless they are slaves)? Hence, human resources, if not controlled, do not meet the definition of an asset. Further, even if rugby players do meet the definition of an asset, it would be difficult to measure the cost or other value of the players, and therefore to record them as assets.

An expense is a decrease in equity (apart from drawings) representing decreases in economic benefits in the form of an outflow or depletion of assets or the incurrence of liabilities in the form of reductions in assets or increases in liabilities". Expenditure on salaries and wages fall within this definition as cash or other benefits have had to be paid for the work of the players. Expenditure on human resources therefore is therefore usually classified as an expense.

Communication / Group Activity **Preparing balance sheets**

Required:
In groups of three or four, consider the following people and their situations:

- *A student who has just completed secondary school and started at University and is living at home with parents*
- *An adult who works full time.*

For each situation, prepare a list of assets the person would typically own, and estimate the cost of each asset in dollars. Then prepare a list of liabilities and estimate the cost of each liability in dollars. Using the accounting equation, calculate the equity of each of the two people and draw up a statement of financial position for each. Display them on overhead transparencies and compare them with those developed by the other groups in your class.

Below are examples of the types of assets and liabilities that students or adults might typically have. The amounts for each will vary significantly depending on the city they live in, socio-economic group etc. The idea of the exercise is to demonstrate the accounting equation to students and to highlight the fact that once assets, liabilities and equity are defined the way they are by accountants it is not possible for the accounting equation not to hold, even for an individual.

Student at University

Typical Assets:
- Text books
- Clothes
- CDs/DVDs/iPods
- Mobile phone
- Guitar
- Computer
- Used car

Typical Liabilities
- Loan from parents
- Mobile phone Account
- Higher Education Contribution Scheme (HECS) debt
- Credit card
- Loan from a financial institution

Student’s equity = typical assets – typical liabilities

Adult working full time

Typical Assets:
- Clothing
- Furniture, including electrical goods
- Car

- House
- Shares
- Superannuation scheme

Typical Liabilities

- HECS debt
- Credit card debts
- Loan from financial institution e.g. bank
- Mortgage

Adult equity = typical assets – typical liabilities

Ethical Issues Kickbacks

Required:
A. In the article, who are the stakeholders in this situation?
B. What ethical issues are involved?
C. If it is normal business practice to bribe officials in a country that you are dealing with but not in your country, do you believe it is ethical to do so?
D. Do you believe one country has the right to impose its values on another in this regard? Consider how you would feel if another country tried to impose its values on your country and consider what overriding human rights issues might be relevant.

A. The stakeholders in this article are the Shanghai Shenmei Bottling company, the employees of the company, the government officials, the police investigating the allegations, the owners of the company and the former employees accused of corruption.

B. The ethical issues involved include:

- Two former employees have been accused of corruption involving kickbacks
- The kickbacks allegedly involved bribing of government officials
- If government officials are bribed, the company (and also the employees involved) may enjoy advantages and preferential treatment over its competitors who acted ethically
- There may be laws in China against bribery and corruption which may be different from laws enforced in other countries in which many of their competitors may be based, and the former employees may have tried to take advantage of apparent loopholes in the domestic laws
- If the former employees are not held accountable for their actions, it may set a precedence of bribery and corruption which could potentially undermine the whole business community, and have negative repercussions on other countries wishing to do business in and with China

C. The answer to this will depend on the student’s own ethical stance. In Australia it is illegal to bribe someone either in Australia or when an Australian company does business in another country. If an Australian or Australian company is caught bribing anywhere in the world then they may be liable for prosecution under Australian laws. Many other countries have very strict anti-bribery and corruption laws, in an attempt to make global business transactions more transparent and equitable.

A good example of this is the relatively new British anti-bribery law, passed in 2010, which is regarded as being both broad and tough. It covers bribery within Britain as well as abroad, and can have significant implications for businesses trading overseas. Another example is the American Foreign Corrupt Practices Act (FCPA) which has resulted in a huge spike in enforcement and investigations in recent years.

D. This question attempts to get students to consider the other side of the ethical argument. Just because a particular action, such as bribery, may be considered unethical in Australia, do we have the right to impose our beliefs on another country or culture? Is it acceptable to engage in unethical behaviour in countries where such behaviour is seen as acceptable or commonplace, and to behave differently in countries that do not tolerate such behaviour? Encourage students to think about how they would feel if another country considered certain activities that we believe are acceptable to be unethical (e.g. women showing their heads, men and women swimming together, unmarried couples living together). Does another country have the right to tell us what is or is not ethical? Therefore, do we have the right to impose our ethical beliefs on another country?

It should also be noted that most organisations, and most professional bodies (in Australia and many other countries), have their own code of ethics that clearly define behaviour that is unacceptable (such as fraud, bribery and corruption), and spell out clearly the consequences of employees breaching the requirements of the code of conduct.

Financial Reporting Case **JB Hi-fi Limited**

Required:

1. *What does the directors' declaration state? What, if anything, does this declaration say about the going concern assumption?*
2. *What were the total assets at the end of the financial year?*
3. *What were the total liabilities at the end of the financial year?*
4. *What was the total amount of equity?*
5. *State the accounting equation for JB Hi-Fi Limited in dollar figures at balance date for the end and beginning of the last financial year.*
6. *Did the current assets increase or decrease over the year? By how much?*
7. *Did the current liabilities increase or decrease over the year? By how much?*
8. *Did non-current assets increase or decrease over the year? By how much?*
9. *What changes have occurred in the company's non-current liabilities over the year? Explain these changes.*
10. *Does the change in total assets equal the change in total liabilities plus the change in total equity? Explain.*

The solution below is based on the JB Hi-Fi Limited Annual Report for 2011, available on the JB Hi-Fi Ltd website: www.jbhifi.com.au.

1. The directors' declaration states that the financial statements presented are in accordance with the Australian Accounting standards, with the International Financial Reporting Standards (IFRS), and the Corporations Act. It also states that the financial statements, in the directors' opinion, give a true and fair view of the company's financial performance and financial position. The declaration also states that in the directors' opinion the company is in a position to pay its debts as and when they fall due (in effect, that the business is in their view a going concern).

2. From the balance sheet, total consolidated assets of the group at the end of the 2011 financial year were $767 139 000.

3. Total liabilities of the consolidated group at the end of the 2011 financial year were $614 826 000.

4. Total equity of the consolidated group at the end of the 2011 financial year amounted to $152 313 000.

5. Accounting equation: A – L = E
   In 2011, consolidated equity calculated as: $767 139 000 - $614 826 000 = $152 313 000
   In 2010, consolidated equity calculated as: $714 322 000 - $421 026 000 = $293 296 000

6. Current assets of the consolidated group increased from $454 508 000 in 2010 to $501 072 000 in 2011, an increase of $46 564 000.

7. Current liabilities of the consolidated group decreased from $363 139 000 in 2010 to $345 938 000 in 2011, a decrease of $17 201 000.

8. Non-current assets of the consolidated group increased from $259 814 000 in 2010 to $266 067 000. This represents an increase of $6 253 000.

9. Non-current liabilities of the group increased significantly from $57 887 000 in 2010 to $268 888 000 in 2011, an increase of $211 001 000. To see why these liabilities have increased, the balance sheet shows a major increase in borrowings of $197 958 000. Note 25 of the financial statements indicates that these are borrowings in the form of secured bank loans (secured by a fixed and floating charge over the Groups' assets). In addition, there was an increase in non-current provisions of $10 045 000, which is mostly due to a make-good provision raised for leased assets. This is discussed in note 26 of the financial statements.

10. The increase in total assets ($714 322 000 - $767 139 000 = $52 817 000) minus the increase in total liabilities ($421 026 000 - $614 826 000 = $193 800 000) or $52 817 000 – $193 800 000 = $140 983 000 equals the change in total equity calculated as $293 296 000 - $152 313 000 = $140 983 000. This must be so because of the accounting equation. We are effectively taking the difference in the financial position of the entity at two points in time, expressed in terms of either the net assets (Total Assets less Total Liabilities), or the equity of the entity.

