

Solutions manual
to accompany
Financial Accounting

11th edition

by

Hoggett, Medlin, Chalmers, Hellmann, Beattie
and Maxfield

**Prepared by
Keryn Chalmers**

WILEY

*Not for distribution in full. Instructors may post selected solutions
for questions assigned as homework to their LMS.*

© John Wiley & Sons Australia, Ltd 2021

Chapter 2: Financial statements for decision making

Case Study: Techtopia Pty Ltd

Case study Q2.1 – decision making:

David Johnson has decided to start a business and is a new client of your small public accounting practice called Trent Accounting Services. He has come to seek your advice about what form of business organisation/structure he should use, to set up his business given his circumstances.

David Johnson is a computer technician and was working for a computer repair company. He would now like to be his own boss, so he plans to start up a business in that field with the objective of later developing the business into one that also sells a variety of electronic items such as phones, tablets, notebooks, laptops, PlayStation equipment and games. The business name he would like to use if possible is Electronic Emporium. He estimates his turnover in the first year of operation will be around \$60,000 and he does not anticipate employing any staff until business turnover increases.

David and his wife Jasmine live in a country town. They do not have any children as yet. He would like to include his wife in the business but she is currently employed full time. He is also concerned about putting the family home and a rental property at risk should the business fail. Both properties are held in David's name.

Required

Of the three main forms of business organisation (sole proprietorship, partnership, company) covered in chapter one, which form(s) would you recommend to David for his business and which would you not recommend, and why? In reaching a conclusion, your answer should include at least two advantages and two disadvantages for each of these business structures with reference to David's particular circumstances.

Case study Q2.1 – suggested answer:

Sole trader

Advantage(s)

- It is quick and inexpensive to set up and wind down.
- There are few legal and tax formalities.
- You are in complete control of your business.
- All the assets and profits belong to you.

Disadvantage(s)

- You are legally responsible for all aspects of the business – including any debts your business incurs.
- Depending on the level of profits you may pay higher taxes on the profits than under a different business structure.
- Possible limitations on expansion due to lack of appropriate skills or capital.

Conclusion

This would be the simplest and easiest structure for David to begin trading as, but given that he has concerns about putting his personal assets at risk, and a lot of new businesses do fail in the first few years of operation, it is probably not the best structure for him to use.

Partnership

Advantage(s)

- It is relatively inexpensive to set up and operate and although a formal partnership agreement is useful, because it sets out in writing the division of profits and losses where they are not equal, they are not essential as there is a Partnership Act that governs this type of entity.
- Responsibilities and control or management of the business is shared.
- Can bring together people with different skills that can aid the business.
- Can be a source of additional capital for the business.
- Income and losses are shared among the partners, which can be a tax advantage by reducing income tax for each partner.

Disadvantage(s)

- Each partner is responsible for the debts of the partnership, even if they did not directly incur or cause the debt.
- A partnership has a limited life, because if a partner dies or wishes to leave the partnership a new partnership must be formed.
- Control or management of the business is shared and this can cause disputes between the partners, perhaps resulting in the collapse of the partnership and/or business.
- Income and losses are shared among the partners who sometimes feel aggrieved because he or she feels they deserve more because they do more work.

Conclusion

If he made his wife a partner he could split the profits between them and it would reduce the amount of tax he would have to pay. However, because his wife is working full time it would likely increase the amount of tax she would have to pay, thereby nullifying that advantage. If his marriage failed, the partnership would cease to exist and he could lose the business. They would still be liable for the debts of the business should it fail and his personal assets would be at risk. Therefore, probably not the best business structure to use.

Company

Advantage(s)

- A company is a business that is a legal entity in its own right, formed under the *Corporations Act 2001 (Cwlth)* in Australia or the *New Zealand Companies Act 1993 (Public Act)* and separate from its shareholders.
- The company owns all its assets and liabilities, therefore the shareholder's responsibility for any debts are generally limited to the amount they have invested as share capital in the business.
- A company can sue and be sued and enter into contracts in its own name.
- A company provides some asset protection but directors can be legally liable for their actions and, in some cases, the debts of a company.
- A company has indefinite life.
- A company's operations are controlled by its directors and the company is owned by its shareholders. This is an advantage where the owners do not have the expertise required to run the day-to-day operations of a larger business.
- A flat rate of tax (currently 30% in Australia and 28% in New Zealand) can reduce tax payable when profits are substantial.

Disadvantage(s)

- A company is a complex business structure, with higher set-up costs and administrative costs because of additional reporting requirements.
- A company's operations are controlled by its directors and the company is owned by its shareholders. This can mean loss of the control and decision-making power afforded by being a sole trader.
- A flat rate of tax can mean a higher tax payable than that of a sole trader when profits are small.

Conclusion

With this business structure his assets would be safe, provided he as a director did not misbehave (misrepresentation or misleading or deceptive conduct of a director lifts the corporate veil). He can incorporate a sole director/shareholder proprietary limited company which means that he still has total control of the operations of the business, or he could include his wife as a director and/or shareholder (in the event of a marriage breakdown that could be costly) as the company pays the tax on the profits, not the individuals. This is probably the business structure that would give him more peace of mind.

Case study Q2.2 – research and report

In addition to advice about which business structure David should use, he has asked for advice on how to go about setting up the business. David would like to understand any legal requirements for each of the business structures.

Required

Research the requirements for setting up each of the three forms of business organisation previously discussed.

In your report explain the requirements for:

- (a) registering a business name and/or incorporating a company
- (b) registering for income tax purposes and the goods and services tax
- (c) name the relevant authorities involved for parts (a) and (b)

Hint: prepare a report on the requirements applicable in either Australia or New Zealand, whichever country you reside.

The following URLs are provided to assist you.

Australia:

<https://www.ato.gov.au/Business/Starting-and-running-your-small-business/Starting-your-business/>

<http://www.business.gov.au/Pages/default.aspx>

<http://www.asic.gov.au/for-business/registering-a-business-name/>

<http://www.asic.gov.au/for-business/starting-a-company/>

New Zealand:

<http://www.business.govt.nz/starting-and-stopping/entering-a-business/starting-a-business>

<http://www.business.govt.nz/companies/learn-about/starting-a-company>

Case Study Q1.2 – suggested answer:

Australia – sole trader:

Registering a business name

Business name registration is handled by the Australian Securities and Investments Commission (ASIC). If you wish to carry on a business under a business name, you must register your business name with ASIC. You do not need to register a business name if the entity is an individual and the business name is the individual's name (e.g. John Smith).

Before applying for a business name you should check to see if your proposed name already exists or is similar to a currently registered name, otherwise your application may be rejected.

You should check whether anyone else is using a trade mark, brand or logo that is identical or similar to your proposed business name and that can be done through IP Australia.

Tax file number (TFN)

As a sole trader, you use your individual tax file number (TFN) when you lodge your income tax return. Tax file number applications are handled by the Australian Taxation Office (ATO).

Australian business number (ABN)

If you carry on an enterprise in Australia as a sole trader, you can apply for an ABN for your business and use this number for all your business dealings. Applications can be made online at www.abr.gov.au for an ABN. The Australian Business Register handles these applications and you will need an ABN before you can apply for a business name.

Goods and services tax (GST)

You can register for goods and services tax (GST) if you carry on an enterprise. You must be registered for GST if your annual GST turnover is \$75,000 or more or if you provide taxi travel or are a car hire operator. If your annual turnover is less than \$75,000 registration is voluntary. Registration can be done on the ABN application form or through the ATO.

Australia – partnership:

Registering a business name

Business name registration is handled by the Australian Securities and Investments Commission (ASIC). If you wish to carry on a business under a business name, you must register your business name with ASIC. You do not need to register a business name if the entity is a partnership and the business name consists of all of the partners' names (e.g. John Smith & Tom Watt).

Before applying for a business name you should check to see if your proposed name already exists or is similar to a currently registered name, otherwise your application may be rejected.

You should check whether anyone else is using a trade mark, brand or logo that is identical or similar to your proposed business name and that can be done through IP Australia.

Tax file number (TFN)

If you operate your business as a partnership, it needs its own TFN that you use when lodging its annual business income tax return. You can apply for this on the ABN application form or directly from the ATO.

Australian business number (ABN)

If you carry on an enterprise as a partnership in Australia, you can apply for an ABN for the partnership and use it for all the partnership's business dealings. Applications can be made online at www.abr.gov.au for an ABN. The Australian Business Register handles these applications and you will need an ABN before you can apply for a business name.

Goods and services tax (GST)

As a member of a partnership, you can apply for GST registration for the partnership if it is carrying on an enterprise. A partnership must be registered for GST if its annual GST turnover is \$75,000 or more. If turnover is less than \$75,000 registration is voluntary. You can apply for registration on the ABN application form or through the ATO.

Australia – company:

Incorporation and/or business name registration

Incorporation and registration of business names is handled by the Australian Securities and Investments Commission (ASIC). If you wish to carry on a business under a business name, you must register your business name with ASIC. You do not need to register a business name if the entity is a registered company and the business name is the company's name (e.g. ABC Pty Ltd)

Before applying for a company and/or business name you should check to see if your proposed name already exists or is similar to a currently registered name, otherwise your application may be rejected.

You should check whether anyone else is using a trade mark, brand or logo that is identical or similar to your proposed business name and that can be done through IP Australia.

Tax file number (TFN)

A company needs to apply for a TFN and use it when lodging its annual tax return. You can apply for a TFN for the company on the ABN application form or directly from the ATO.

Australian business number (ABN)

A company registered under the Corporations Act 2001 is entitled to an ABN. A company that is not registered under the Corporations Act may register for an ABN if it is carrying on an enterprise in Australia.

Goods and services tax (GST)

A company can register for GST if it is carrying on an enterprise. A company must be registered for GST if its annual GST turnover is \$75,000 or more. The registration threshold for non-profit organisations is \$150,000. Turnover of less than \$75,000 is voluntary. Application can be done on the ABN application form or directly from the ATO.

New Zealand – sole trader:

Registering a business name

You don't register a business name in New Zealand. You can usually use any name you like unless, of course, someone else already is. If you wish to operate as a sole trader there is no central register. Check the IPONZ (The Intellectual Property Office of New Zealand) to see if there is a similar registered trademark or brand name to the one you want already in use. ONECheck is an online search tool that combines a company name, domain and trade mark search all in one place.

Sole traders don't have any protection over their business names. However, they can apply for a trade mark from IPONZ for their brand or logo to give them exclusive rights to use it in a unique way.

Inland Revenue Department number (IRD)

If you're carrying on business as a sole trader you should return your business income under your personal IRD number. IRD number applications are handled by Inland Revenue (IR).

Goods and services tax (GST)

Businesses must become registered for GST once they reach (or expect to reach in the next 12 months) an annual turnover of more than \$60,000. If your turnover is under \$60,000 you may choose to register voluntarily. Registration is handled by IR.

New Zealand – partnership:

Registering a business name

You don't register a business name in New Zealand. You can usually use any name you like unless, of course, someone else already is. Check the IPONZ (The Intellectual Property Office of New Zealand) to see if there is a similar registered trademark or brand name to the one you want already in use. ONECheck is an online search tool that combines a company name, domain and trade mark search all in one place.

Partnerships don't have any protection over their business names. However, they can apply for a trade mark from IPONZ for their brand or logo to give them exclusive rights to use it in a unique way.

Inland Revenue Department number (IRD)

If you're carrying on business as a partnership you should return business income under your partnership IRD number. IRD number applications are handled by Inland Revenue (IR).

Goods and services tax (GST)

Businesses must become registered for GST once they reach (or expect to reach in the next 12 months) an annual turnover of more than \$60,000. If your turnover is under \$60,000 you may choose to register voluntarily. Registration is handled by IR.

New Zealand – company:

Incorporation and/or business name registration

Every company in New Zealand has to be incorporated – or registered – with the Companies Office (the national registrar of companies). The Registrar of Companies is responsible for the approval and reservation of company names. As soon as a business name is reserved on the companies register, it is impossible for others to reserve the same or a similar name within the next 20 days. That name protection becomes permanent once the company is registered.

This protection only stops other companies being registered in New Zealand under the same name and should not be confused with the intellectual property protection offered by a patent, trade mark or copyright.

Inland Revenue Department number (IRD)

If your business will be run through a company, you need to get an IRD number for it. However, rather than going through Inland Revenue, you can do this through the Companies Office when you register your company for incorporation.

Goods and services tax (GST)

Businesses must become registered for GST once they reach (or expect to reach in the next 12 months) an annual turnover of more than \$60,000. If your turnover is under \$60,000 you may choose to register voluntarily. Registration is handled by IR.

Questions and solutions which have a GST version in the textbook:

- Exercise 2.11
- Problem 2.25
- Problem 2.27

Discussion questions

- 1. Explain the basic differences between a sole trader (or single proprietorship), a partnership and a company. Discuss the factors that need to be considered in selecting an appropriate structure if you set up a chatbot agency to service marketing, sales and customer services teams.**

The three basic business structures are:

- Sole traders are where individuals conduct business in their own capacity. They would be contributing their own capital or equity to the business and would be borrowing money in the name of the business in their own name. They would be liable to repay the outstanding debt of the business and, if unable to repay, the bank, would have access to their own personal assets to repay the outstanding debt. This business structure is suitable for small operations with small staff and turnover. The sole trader has sole responsibility and control for the business operations and activities. This structure is suitable for small businesses which require minimal capital to set up and have relatively low running costs and risk.
- A partnership is two or more persons in business together, operating under a partnership agreement which may or may not be a formally written document. Partnerships have the advantage over sole traders in that they have a larger base for capital contribution and are able to share the risks and responsibilities associated with running a business. The partnership is treated as a separate entity for accounting purposes but is not a separate legal entity. This means that the underlying assets and liabilities of a partnership belong to the individual partners in the proportion agreed upon as part of the partnership agreement. Therefore, if the business activities prove to be unsuccessful, creditors have the right to access the personal assets of the individual partners in the event the business is unable to repay any outstanding debt. For this reason, the partnership structure is usually used where there is a low element of risk to the business or where the law dictates that the business entity must be run by the individuals providing the service. For example, work completed by professionals including accountants and lawyers.
- The company is a separate legal entity with ownership of a company attributed to shares held. The owners of the company are known as shareholders. The advantage of this business structure is that, as a separate legal entity, the assets and liabilities belong to the company. In the event the business is unable to repay its debt, the creditors only have access to company assets for repayment of the debt. The investment in the company by its shareholders is limited only to the shareholders' capital contribution, i.e. what the shareholder pays for the shares. This business structure is more appropriate for entities requiring larger capital contribution, which have a large number of overheads and employees and has a higher business risk. The disadvantages include higher set up and ongoing costs and possible reduction in control over the business operations where shareholders are not directly involved in the business operations.

Factors that you need to consider in selecting an appropriate structure for your chatbot agency include:

- Simplicity in setting up the business: sole traders and small partnerships are easier to set up compared to companies.
- Establishment costs and ongoing costs: companies are more expensive to establish compared to sole traders and partnerships and generally incur higher annual costs due to reporting and tax requirements.
- Liability issues: sole traders and partnerships have unlimited liability, which means owners and partners are personally liable for their business' debts, including those resulting from lawsuits or the actions of other partners. If unlimited liability is a concern, then you may want to consider setting up a company instead of being a sole trader or partnership.
- Tax: tax reporting requirements for companies are far greater than for sole traders and partnerships.

- Control of the business: as an owner of a sole trader, you would have complete control over your business. If you choose to partner with someone through a partnership, you will need to discuss business matters with your partner. If you decide to set up a company and employ a management team, you may not have as much control in running the business as it will be the responsibility of the management team.
- Access to capital: the access to finance for a sole trader is limited to the owner's resources. On the other hand, a partnership has greater access to capital from resources of all partners, and a company has even far greater access to capital from various shareholders.

2. Principles for Responsible Management Education (PRME) is a 'not-for-profit' entity. It engages business schools to ensure they provide future leaders with the skills needed to balance economic and sustainability goals, while drawing attention to Sustainable Development Goals (SDGs). Discuss what it means to be a 'not-for-profit' entity.

The Australian Accounting Standards proposed (June 2019) definition for a not-for-profit entity is 'an entity whose primary objective is to provide goods or services for community or social benefit and where any equity has been provided with a view to supporting that primary objective rather than for a financial return to equity holders' (ED291). This means that a not-for-profit entity can still generate profits, however any profit generated by the entity must be used to further the entity's objectives rather than serve the interests of the members or owners. For example, PRME is a not-for-profit entity as any surplus or profit made from its operations will be used to achieve its purpose, which is to transform business and management education, research and thought leadership globally, while promoting awareness about the Sustainable Development Goals, and developing responsible business leaders of tomorrow.

For tax purposes, not-for-profit entities in Australia can be categorised as charities or other not-for-profit organisations (such as sporting and recreational clubs, community service organisations, professional and business associations and cultural and social societies). Performance of not-for-profit entities can be assessed by comparing their activities to their objectives and stated goals for the period.

3. Entities are expected to perform in the spheres of profit, people and the planet. List some key performance indicators applicable to each sphere.

The sphere of profit relates to financial performance and business strategies of the entities. Examples of key performance indicators under the profit sphere include:

- profit margin
- profit after tax
- return on assets
- return on equity
- asset turnover
- EPS growth
- sales growth.

The sphere of people relates to the entities' employees and involvement in the community. Examples of key performance indicators under the people sphere include:

- employee turnover rate
- employee absenteeism
- number of workplace accidents
- percentage of female employees
- donations to charities
- programs run by the entities for the community.

The sphere of planet relates to the impact of the entities' operations on the environment. Examples of key performance indicators the planet sphere includes:

- carbon gas emissions
- water and electricity usage
- recycling program
- waste management.

- 4. The manager of a call centre team was trying to motivate the team at the start of the month. He said: 'Our team is like any organisation. We must have goals, we must practise the usual management functions, and we must make use of all relevant information'. Explain if you agree with the manager? If not, explain your position.**

The manager of a team such as a call centre must have goals and these will be represented by metrics such as service level, average handle time, call abandonment, call resolution, and use of key phrases.

The manager of a team must plan, organise, direct, and control the team's efforts and generally operate like any other business organisation. This will involve careful selection of the team, support and training for the team and individuals (e.g. use of monitoring software, speech analytics), effective communication with the team and individuals, including feedback, and providing a productive work environments.

In order to plan team performance, the manager would need some relevant available information (the key metrics) to plan performance, develop a plan, direct staff, and gather information so that an analysis of performance may lead to improved future performance. The manager's aim is to build a culture of continuous improvement among the team.

Some discussion could take place on how a team would operate without such management principles being used.

- 5. Discuss why the payment for an entity's telephone bill is an expense, yet the cash paid to the owner is not an expense.**

The *Conceptual Framework* defines expenses as 'decreases in assets, or increases in liabilities, that result in decreases in equity, other than those relating to distributions to holders of equity claims' (CF, par4.69). In other words, for an item to be classified as an expense, there must be decreases in assets which result in decreases in equity, but the decrease must not be related to a distribution to an owner. The cash payment for the telephone bill is a decrease in asset (reduced cash at bank) that reduces equity. Since this payment is not a payment to the owner, it thus meets the definition of an expense. Cash paid to an owner is also a decrease in an asset (reduced cash at bank) that thus reduces equity, however it does not meet the definition of an expense as it is a distribution to an owner (often referred to as a distribution or drawings).

6. Discuss whether an asset needs to be legally owned to be recorded as an asset on the statement of financial position.

Assets are defined in the *Conceptual Framework* as ‘a present economic resource controlled by the entity as a result of past events’ (para. 4.3). That is, to be recorded as assets, the entity must have the ability to benefit from the use of the assets and deny access of others to the benefits (i.e. control).

Although, in most cases, legal ownership will give the entity control over an asset, certain types of lease arrangements can result in the entity controlling the asset. For example, finance leases transfer the risks and benefits of ownership to the lessee, which means the leased asset is now controlled by the lessee. Subsequently, the leased asset should be recorded as an asset on the lessee’s Statement of financial position, even though the lessee does not legally own the asset just yet.

Furthermore, following the qualitative characteristics of faithful representation in the *Conceptual Framework*, it is important that the economic substance rather than the legal form of the transaction is reported. In a finance lease, legal title to the leased asset still remains with the lessor until the end of the relevant lease term when the lessee has made all lease payments. However, the lessee has use of and earns economic benefits from the leased asset for this time period (i.e. economic substance), and hence the leased asset should be recorded as an asset in the lessee’s Statement of financial position during the period of the lease term.

In summary, an asset does not need to be legally owned by the entity to be recorded as an asset on the Statement of financial position. As long as the entity controls the asset, then the asset must be reported on the entity’s Statement of financial position.

7. A local football club has won the premiership for the past four years. Accordingly, the club has a very strong supporter base. Rationalise if the players would be regarded as an asset of the business to be recognised on the statement of financial position.

To be recognised as an asset on the Statement of financial position, an item must satisfy definition and recognition criteria specified in the *Conceptual Framework*. An asset is defined in the Framework as a present economic resource controlled by the entity as a result of past events. The three definition criteria must be satisfied if the players were to be recognised on the Statement of financial position as assets to the football club:

- **Present economic benefits:** the players do provide economic benefits to the football club through the use of their skills. The benefits could be in the form of ticket sales to see the players, winning the premiership, strong supporter base, product's endorsements, sponsorships, etc.
- **Control:** control is the ability to benefit from the use of the assets and deny access of others to the benefits. It could be argued that the football club does not have sufficient control over its players. Although the players might have signed a contract with the club, they can still leave the club and play somewhere else. The club does not own its players and the players' skills that are used to generate future economic benefits ultimately belong to the players, not the club.
- **Past events:** these are past transactions that give rise to control. Since the football club does not have control over its players, there is no past transaction that gives rise to control. Signing a contract or giving a lump sum amount as 'advance payment' does not give the club control over the players.

In addition to the definition criteria, recognition criteria must also be satisfied for an asset to be recorded on the Statement of financial position centred around relevance (the information about the asset must be relevant to the users of financial statements) and whether information about the asset can be a faithful representation. These hinge on existence uncertainty and measurement uncertainty.

- **Probable occurrence:** this means that the economic benefits are more like (than less likely) to flow into the football club. It can be argued that future economic benefits as mentioned above are likely to flow to the club as a result of players using their skills.
- **Measurement uncertainty:** to be recognised on the Statement of financial position, the players must have value that can be measured with reliability. In this case, there is no reliable system that can be applied to measure how much players are worth. Each player is unique, and hence it is very difficult to assign an objective value to each player.

To be recorded on the financial statements, the definition criteria must be met and recognising the asset must provide the users of financial statements with useful information. From the explanation above, it can be seen that players do not satisfy the definition and recognition criteria of assets. Subsequently, they cannot be recorded as assets on the Statement of financial position. It should be noted that it is not necessary to work through the recognition criteria if it is determined that the item does not satisfy the definition criteria. All aspects of the definition and recognition criteria must be satisfied for the item to be recognised on the Statement of financial position.

8. As the accountant at a local council, explain to the Chief Executive Officer if the land under roads is an asset that should be recorded on the Council's statement of financial position.

AASB 1051 *Land Under Roads* prescribes that local governments, government departments, government sectors and whole of governments may elect to recognise (subject to the satisfaction of asset recognition criteria) or not to recognise as an asset land under roads acquired before the end of the first reporting period ending on or after 31 December 2007. The final decision of whether to recognise or not shall be made effective as at the first day of the next reporting period following the end of the first reporting period ending on or after 31 December 2007.

Assuming the Council has a reporting period ending 30 June, AASB 1051 mandates that the Council is required to choose whether it would recognise (or not) land under roads acquired on or before 30 June 2008. Land acquired after 30 June 2008 is to be treated as an asset of the Council in accordance with the AASB 116 *Property Plant & Equipment*.

9. Moonshine Enterprises hired an accountant at the rate of \$5000 per week. The person is to commence duty on 1 February. Explain if the business has a liability in respect of the accountant's salary as at 31 January.

Suggested topics for discussion re Moonshine Enterprises:

- On 31 January, the business does not have a liability because, at this stage, they are not presently obliged to transfer an economic resource (wage) to the accountant.
- The contract remains unperformed by both parties until the accountant commences work with Moonshine Enterprises.

10. 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) Reporting period**

(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 *Conceptual 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 *Conceptual 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 reporting 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 end-of-period adjustments on the last day of the reporting period. These adjustments will be considered in chapter 4.

11. List and define the fundamental and enhancing characteristics of financial information.

The two fundamental characteristics of financial information are:

- **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.
- **Faithful representation:** faithful representation is attained when the depiction of an economic event is complete (i.e. all information necessary to represent the event are included), neutral (i.e. free from bias), and accurate (i.e. free from material error). In addition, financial information that faithfully represents an economic phenomenon should depict the economic substance of the underlying transaction, event or circumstances, rather than its legal form.

The four enhancing characteristics of financial information are:

- **Comparability:** comparability is the quality of information that enables users to identify similarities in and differences between two sets of economic data. For financial information to be comparable, users need to be able to compare information of an entity over time, and between entities at one time and over time.
- **Verifiability:** if financial information is verifiable, it means that different independent observers would reach general agreement that the information represents economic event it purports to represent without material error or bias.
- **Timeliness:** to be relevant for decision-making, financial information must be available in a timely manner. If there is undue delay in reporting the information to users, then the information will lose its capacity to influence decisions (i.e. no longer relevant).
- **Understandability:** the Conceptual Framework defines understandability as the quality of information that enables users who have a reasonable knowledge of business and economic activities and financial accounting, and who study the information with reasonable diligence, to comprehend its meaning.

12. Distinguish between the concepts of consistency and comparability and discuss if the same accounting method should always be applied consistently in financial statements.

The *Conceptual Framework* makes the distinction between comparability and consistency. Comparability is an enhancing characteristic of financial information as it makes the information more useful for users when making economic decisions. It enables users to identify and understand similarities in, and differences among, items. The comparison may be with similar information about other entities or with similar information about the same entity for another period or another date. It does not mean uniformity.

Consistency, while related, is not the same. It 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 *Conceptual*

Framework notes that comparability is the goal, and that consistency of policies and procedures is a means to an end that helps to achieve the goal. However, it is not satisfactory for policies and procedures to be applied consistently if the information that they produce is no longer relevant or a faithful representation of economic reality.

13. Your landlord knows that you are studying accounting. She has recently received the annual report for a company in which she is a shareholder. The financial report within the annual report is lengthy and your landlord requests your advice as to whether she should contact the company to complain that the financial information is not understandable. Advise your landlord.

According to the *Conceptual Framework*, understandability is the quality of information which enables users who have a reasonable knowledge of business and economic activities and financial accounting, and who study the information with reasonable diligence, to comprehend its meaning. It should be clear that, even though it is desirable for financial statements to be expressed in simple language, relevant information should not be excluded merely because it may be too complex or difficult for some untrained users to understand.

Understandability does not mean simplicity. If users cannot understand the information contained in financial statements, they should seek the help of a trained adviser. Therefore, it is advised that the landlord should not contact the company to complain that the financial report is not understandable. Instead, she should seek help from her accountant or financial planner to help her understanding the information in the financial report.

14. Management expert Professor Henry Mintzberg has argued that a manager's work can be characterised by ten common roles falling into three categories: informational (managing by information), interpersonal (managing through people), and decisional (managing through action). Provide an example of activity in each of these three categories.

The informational category (managing by information) involves managers' roles in **processing** information. Examples of activities under the informational category include:

- Seeking out information related to the organisation and industry, and looking for relevant changes in the environment in which the organisation operates.
- Monitoring employees in terms of their productivity and well-being.
- Communicating potentially useful information to colleagues and employees.
- Transmitting information about the organisation to people outside the organisation (i.e. being a spokesperson).

The interpersonal category (managing through people) involves managers' roles in **providing** information and ideas. Examples of activities under the interpersonal category include:

- Providing leadership to the team or organisation.
- Managing performance and responsibilities of employees within the organisation.
- Providing inspiration to subordinates and being a figurehead.
- Building effective networking with people inside and outside the organisation.

The decisional category (managing through action) involves managers' roles in **using** information. Examples of activities under the decisional category include:

- Generating new ideas and implementing them.
- Solving problems and mediating disputes.
- Allocating resources.
- Taking part in negotiations.

15. 'Faithful representation' is a fundamental characteristic of financial information. This term replaced 'reliable' in the 2010 revisions to the *Conceptual Framework*. Discuss the rationale for this change.

In the IASB Exposure Draft *An Improved Conceptual Framework for Financial Reporting: Chapter 2: Qualitative Characteristics and Constraints of Decision-useful Financial Reporting Information* issued in May 2008, the IASB observed that there are a variety of views of what reliability means. For example, some focus on verifiability or free from material error to the virtual exclusion of the faithful representation aspect of reliability. On the contrary, to others reliability apparently refers primarily to precision. Because the meaning of reliability was not clear to constituents, the IASB proposed that it should be replaced by the concept of faithful representation. Accordingly, faithful representation encompasses all of the qualities that the previous frameworks included as aspects of reliability. Faithful representation is the depiction in financial reports of the economic phenomena they purport to represent. It replaced reliable as a fundamental qualitative characteristic of financial reporting.

Exercises

Exercise 2.1

Preparing a statement of financial position LO4

Financial items for George Karatsis IT Services on 31 May 2021 are presented below in alphabetical order.

Accounts payable	\$ 64 000	Land	\$250 000
Accounts receivable	70 000	Mortgage payable	710 000
Building	520 000	Office equipment	180 000
Cash at bank	61 000	Office supplies	34 000

Required

- (a) Prepare a statement of financial position similar to the one in figure 2.2. (*Note: a major item is missing in the list.*)
- (b) Reformat the statement to present it in narrative form as in figure 2.3.

(a)

GEORGE KARATSIS IT SERVICES Statement of financial position as at 31 May 2021			
ASSETS		LIABILITIES	
Cash at bank	\$61 000	Accounts payable	\$64 000
Accounts receivable	70 000	Mortgage payable	710 000
Office supplies	34 000		774 000
Office equipment	180 000		
Land	250 000	EQUITY	
Building	520 000	George Karatsis, Capital	341 000
	\$1 115 000 0		\$1 115 000

(b)

GEORGE KARATSIKIS IT SERVICES	
Statement of financial position	
as at 31 May 2021	
ASSETS	
Cash at bank	\$61 000
Accounts receivable	70 000
Office supplies	34 000
Office equipment	180 000
Land	250 000
Building	520 000
TOTAL ASSETS	\$1 115 000
LIABILITIES	
Accounts payable	\$64 000
Mortgage payable	710 000
TOTAL LIABILITIES	774 000
NET ASSETS	\$341 000
EQUITY	
George Karatsis, Capital	\$341 000
TOTAL EQUITY	\$341 000

Exercise 2.2**Statement of financial performance, and analysis LO1, 3, 5**

During the year ended 30 June 2021, Skilled Services, a provider of temporary secretary personnel, had collected receipts from clients for a total value of \$250 000. Wages of \$136 000 had been paid to the temporary workers, rental of office space and electricity costs were \$12 000 and \$13 700 respectively for the year, and the owners withdrew \$20 000 for their personal use.

Required

- (a) Prepare a statement of financial performance for the year for Skilled Services.
 (b) Skilled Services is a sole proprietor. Compare the liability of a sole proprietor with that of a company shareholder.

(a)

SKILLED SERVICES Statement of financial performance for the year ended 30 June 2021		
INCOME		
Services income		\$250 000
EXPENSES		
Wages	\$136 000	
	0	
Office Rental	12 000	
Electricity Costs	13 700	
		161 700
PROFIT		
		\$88 300

(b) The concept of limited liability means that shareholders are not personally liable for the debts of the company in the event of the company's liquidation. In other words, the liability of shareholders to contribute to the assets of the company is limited to the amount unpaid on the shares held in the company. This is contrary to sole traders and partnerships in which creditors are able to take away the owners/partners' personal assets to settle for the business' debts if the business is liquidated.

Exercise 2.3

Analysis of equity LO5

Katie Joss operates an online beauty store business from her home. She keeps her accounting records for business activities completely separate from her records for personal activities. At 30 June 2020, Katie had business assets and liabilities worth \$35 500 and \$23 000 respectively. At 30 June 2021, Katie had business assets and liabilities worth \$65 000 and \$29 000 respectively.

Required

- (a) Assuming Katie did not contribute to or withdraw from the business during the financial year, determine the profit/loss for the year.**
- (b) Assuming Katie had withdrawn \$10 000 during the year, determine the profit/loss for the year.**
- (c) Assuming Katie had contributed \$25 000 and withdrawn \$15 000, prepare a statement of changes in equity for the year.**

- (a) Calculation of Equity as at 30 June 2020 is \$12 500
(i.e. \$35 500 – \$23 000)

Calculation of Equity as at 30 June 2021 is \$36 000
(i.e. \$65 000 – \$29 000)

Capital Contributions and Drawings are nil for the year.

Ending Equity \$36 000 – Beginning Equity \$12 500
= **Profit of \$23 500**

- (b) Capital Contributions nil and drawings \$10 000 for the year.

Ending Equity \$36 000 – Beginning Equity \$12 500 + Drawings \$10 000
= **Profit \$33 500**

(c)

KATIE JOSS – ONLINE BEAUTY STORE Statement of changes in equity for the year ended 30 June 2021	
Katie Joss, Capital – 1 July 2020	\$12 500
Add: Capital contribution for the year	25 000
Add: Profit for the year*	13 500
	51 000
Less: Drawings during the year	15 000
Katie Joss, Capital – 30 June 2021	\$36 000

* Profit is the balancing item.

Exercise 2.4

Determining profit from equity balances LO5

Equity balances for Sen Widyaya appearing in the statement of financial positions of Widyaya's Window Washing Services as at 30 June 2023, 2022 and 2021 are set out below.

	30 June 2023	30 June 2022	30 June 2021
EQUITY			
Sen Widyaya, capital	\$27 300	\$30 000	\$28 000

During 2021–2022, Sen withdrew \$15 000 for personal use and also contributed additional capital of \$10 000. During 2022–2023, he withdrew \$15 000 cash for his own use in anticipation of profits.

Required

(a) Determine the profit/loss earned by the business in each of the 2 years ended 30 June 2022 and 30 June 2023.

(a)

WIDYAYA'S WINDOW WASHING SERVICES		
Profit for years ended 30 June	2022	2023
Beginning Capital	\$28 000	\$30 000
+ Additional Capital Contributions	10 000	—
– Withdrawals of Capital	—	—
– Drawings	(15 000)	(15 000)
Profit	7 000	12 300
Ending Capital	\$30 000	\$27 300

Exercise 2.5**Operating, investing and financing activities**

Classify each of the following activities as being 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 land and buildings for cash**
 - (b) salary payment to employees**
 - (c) withdrawal of cash by the owner**
 - (d) draw down on a bank loan facility**
 - (e) lease of a truck by a manufacturing company**
 - (f) lease of a fleet of motor vehicles by a courier business**
 - (g) borrowing of money from a finance company on a long-term basis**
 - (h) cash received from customers for the sale of goods**
- (LO5)**

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

Exercise 2.6

Elements in financial statements LO3, 5

A friend who has established a new dance studio, Hip and Hop, has asked you to give some advice as to the contents of financial statements. Transactions of Hip Hop include:

- (a) contribution of cash by your friend to the business**
- (b) purchase of studio sound equipment on credit**
- (c) electricity costs paid**
- (d) studio fees received in cash**
- (e) the owner's house**
- (f) rental of a chilled water machine, paid in cash**
- (g) money withdrawn by your friend to pay university fees for a friend**
- (h) cash held by the business at the end of the year**
- (i) money borrowed for purchase of building.**

Required

Indicate whether these items would appear in Hip and Hop's statement of financial position, statement of financial performance, statement of changes in equity and/or statement of cash flows. For those items included in the statement of cash flows, indicate whether the item relates to operating activities, investing activities, or financing activities. [Hint: Some items may appear in more than one financial statement.] (LO3 and LO5)

- (a) Statement of financial position, statement of changes in equity, and statement of cash flows (Financing — treated as a contribution of capital)**
- (b) Statement of financial position only**
- (c) Statement of financial performance and statement of cash flows (Operating)**
- (d) Statement of financial performance and statement of cash flows (Operating)**
- (e) Not reported in the financial statements as not part of the accounting entity 'Hip and Hop'**
- (f) Statement of financial performance and statement of cash flows (Operating)**
- (g) Statement of financial position (reduction of capital), statement of cash flows (Financing as part of owner's drawings of capital from the business), statement of changes in equity**
- (h) Statement of financial position and statement of cash flows (cash or cash equivalent balance).**
- (i) Statement of financial position and statement of cash flows (Financing — for loan amount), (Investing — for purchase of building)**

Exercise 2.7

Assumptions and characteristics of information LO3

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. 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 statement of financial performance.
- 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. The period of time covered by the financial statements.
- 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

LO5

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

- (a) Increase an asset and increase a liability**
- (b) Decrease an asset and increase another asset**
- (c) Decrease an asset and decrease equity**
- (d) Increase an asset and increase equity**
- (e) Decrease a liability and decrease an asset**
- (f) Decrease an equity item and decrease an asset.**

- (a) Purchase an asset on credit.
- (b) Purchase an asset for cash.
- (c) Owner withdraws cash from the business for personal use.
- (d) Owner contributes cash to the business.
- (e) The business pays cash to its creditors.
- (f) The owners withdraw cash.

Students may have many other possible examples in each of (a)–(f).

Exercise 2.9**Preparation of a statement of financial position****LO3, 5**

Month-end statement of financial position amounts for the legal practice of Adam Booth, a local lawyer, for 3 consecutive months of 2021 are shown below. The information is complete except for the balance in the Capital account.

	October	November	December
Cash at bank	\$ 9 100	\$ 3 900	\$ 3 000
Accounts receivable	16 100	15 000	8 050
Prepaid insurance	700	1 800	1 600
Office equipment	29 800	29 700	39 300
Property	226 000	224 000	222 000
Accounts payable	10 100	3 100	3 000
Wages payable	5 100	4 100	4 800
Mortgage payable	134 700	134 300	133 900
Adam Booth, capital	?	?	?

Required

- Determine the balance in Adam Booth's Capital account at the end of each month.
- Assuming that Booth made no additional investments and did not withdraw any money from the business during the 3 months, determine the profit for November and for December.
- Prepare a statement of financial position for the business at the end of December 2021. (The heading should read: Adam Booth, Lawyer.)

(a)

Based on the accounting equation: Assets – Liabilities = Equity

$$\begin{aligned}
 \text{31 October Capital Balance} &= \$ (9\,100 + 16\,100 + 700 + 29\,800 + 226\,000) \\
 &\quad - \$ (10\,100 + 5\,100 + 134\,700) \\
 &= \mathbf{\$131\,800}
 \end{aligned}$$

$$\begin{aligned}
 \text{30 November Capital Balance} &= \$ (3\,900 + 15\,000 + 1\,800 + 29\,700 + 224\,000) - \$ (3\,100 + 4\,100 + 134\,300) \\
 &= \mathbf{\$132\,900}
 \end{aligned}$$

$$\begin{aligned}
 \text{31 December Capital Balance} &= \$ (3\,000 + 8\,050 + 1\,600 + 39\,300 + 222\,000) \\
 &\quad - \$ (3\,000 + 4\,800 + 133\,900) \\
 &= \mathbf{\$132\,250}
 \end{aligned}$$

(b)

$$\begin{aligned}\text{Profit for November} &= \$132\,900 - \$131\,800 \\ &= \mathbf{\$1100}\end{aligned}$$

$$\begin{aligned}\text{Loss for December} &= \$132\,250 - \$132\,900 \\ &= \mathbf{-\$650}\end{aligned}$$

(c)

ADAM BOOTH, LAWYER Statement of financial position as at 31 December 2021	
ASSETS	
Cash at bank	\$3 000
Accounts receivable	8 050
Prepaid insurance	1 600
Office equipment	39 300
Property	222 000
TOTAL ASSETS	\$273 950
LIABILITIES	
Accounts payable	\$3 000
Wages payable	4 800
Mortgage payable	133 900
TOTAL LIABILITIES	141 700
NET ASSETS	\$132 250
EQUITY	
Adam Booth, Capital	\$132 250
TOTAL EQUITY	\$132 250

Exercise 2.10**Explaining accounting transactions LO5**

The following schedule shows the effect of several transactions on the accounting equation of Photomania, a photography business, and the balance of each item in the equation after each transaction. Write a sentence to explain the nature of each transaction. (LO5)

	Assets					=	Liabilities	+	Equity
	Cash at bank	+	Accounts receivable	Photography equipment	Photography supplies	=	Accounts payable		Shea Christy, capital
(1)	+\$10 000			+7 000		=			+\$10 000
(2)	<u>-7 000</u>								
	3 000		+	7 000		=			10 000
(3)	<u>+5 000</u>								<u>+5 000</u>
	8 000		+	7 000		=			15 000
(4)			<u>+6 000</u>						<u>+6 000</u>
	8 000	+	6 000	+	7 000	=			21 000
(5)			<u>6 000</u>		<u>+3 000</u>		<u>+3 000</u>		
	8 000	+	-6 000	+	7 000	+	3 000	+	21 000
(6)	<u>+6 000</u>								
	14 000	+		+	7 000	+	3 000	+	21 000
(7)	<u>-8 000</u>								<u>-8 000</u>
	6 000	+		+	7 000	+	3 000	+	13 000
(8)					<u>-1 500</u>				<u>-1 500</u>
	6 000	+		+	7 000	+	1 500	+	11 500
(9)	<u>-3 000</u>						<u>-3 000</u>		
	<u>\$ 3 000</u>	+	<u>\$ 0</u>	+	<u>\$7 000</u>	+	<u>\$ 0</u>	+	<u>\$11 500</u>

- (1) \$20 000 was invested into the business by the owner.
- (2) Purchased office equipment for cash \$7000.
- (3) A further \$2000 was invested into the business, or sold services for cash.
- (4) Performed services and billed clients for \$6000.
- (5) Office supplies of \$3000 were bought on credit.
- (6) \$4000 was received from clients for amounts owed (accounts receivable).
- (7) \$8000 was withdrawn from the business, or expense paid in cash.
- (8) \$2000 worth of office supplies were used.
- (9) Paid accounts payable \$3000 owed to them.

Exercise 2.11

Recording transactions

LO3, 5

Trans Phone Repairs began operations on 1 December 2021 and completed the following transactions during the first month.

- 1. Jeremy Tran deposited \$15 000 of his personal funds in a current account at a bank opened in the name of the business.**
- 2. Phone repair equipment was purchased at a cost of \$2 000, all of which was paid in cash.**
- 3. Jeremy collected \$2000 from customers for repair services performed.**
- 4. Shop rent was paid for the month of August, \$1500.**
- 5. Jeremy purchased \$800 of iPhone and iPad accessories.**
- 6. Wages of \$500 were paid as well as an account for electricity, \$250.**
- 7. Jeremy paid for the accessories purchased in (5) above.**

Required

- (a) Prepare a schedule similar to that shown for Cynthia's Beauty Services for transactions 8, 9 and 10 earlier in this chapter. List the following assets, liabilities and equity as column headings: Cash at bank; Accessories; Equipment; Accounts payable; J. Tran, capital. Show the effects of each of the transactions on the accounts listed. Indicate totals after each transaction and complete the schedule as shown earlier in this chapter, for Cynthia's Beauty Services for transactions 8, 9 and 10.**
- (b) Prepare a statement of financial performance and a statement of changes in equity for the month ended 31 December 2021, and a statement of financial position as at 31 December 2021.**

(a) and (b)

	Assets				=	Liabilities			+	Equity	
	Cash at Bank	+	Supplies	+	Equipment	=	Accounts Payable	+	Loan Payable	+	J. Tran, Capital
(1)	\$15 000					=					\$15 000
(2)	−2 000	+			\$2 000						
	13 000	+			2 000	=					15 000
(3)	+ 2 000									+	2 000
	15 000	+			2 000	=					17 000
(4)	−1 500									−	1 500
	13 500	+			2 000	=					15 500
(5)		+	800				+800				
	13 500	+	800	+	2 000	=	800	+			15 500
(6)	− 750									−	750
	12 750	+	800	+	2 000	=	800	+			14 750
(7)	− 800						−800				
	11 950	+	800	+	2 000	=	0	+			14 750

(c)

TRAN'S PHONE REPAIRS		
Statement of financial performance		
for the month ended 31 December 2021		
INCOME		
Services income		\$2 000
EXPENSES		
Rent expense	\$1 500	
Wages expense	500	
Electricity expense	250	
		2 250
PROFIT/(LOSS)		(\$250)

TRAN'S PHONE REPAIRS Statement of changes in equity for the month ended 31 December 2021	
J. Tran, Capital – 1 December 2021	\$0
Add: Capital contribution	15 000
Loss for the month	250
	<u>14 750</u>
Less: Drawings during the month	0
J. Tran, Capital – 31 December 2021	<u><u>\$14 750</u></u>

TRAN'S PHONE REPAIRS Statement of financial position as at 31 December 2021	
ASSETS	
Cash at bank	\$11 950
Supplies	800
Equipment	2 000
TOTAL ASSETS	<u>\$14 750</u>
LIABILITIES	
Accounts payable	\$—
TOTAL LIABILITIES	<u>—</u>
NET ASSETS	<u>\$14 750</u>
EQUITY	
J. Tran, Capital	\$14 750
TOTAL EQUITY	<u>\$14 750</u>

Exercise 2.12**Preparation of statement of financial performance and statement of financial position****L03, 4**

Toby and Talea McKellar are the joint owners of Beaut Beach Caravan Park, which is near a swimming beach popular during the summer months. The park provides not only camping facilities for caravans and tents but also up-market cabins with kitchenettes and ensuites. For the year ended 30 June 2021, Toby and Talea determined the following financial information for their business:

Cash on hand	\$ 20 000	Accounts payable	\$ 87 000
Buildings purchased	420 000	Accounts receivable	8 000
Income — cabins	272 000	Income — camping	185 000
Salaries and wages	220 000	Supplies on hand	15 000
Supplies used	71 000	Other expenses	45 000
Other equipment purchased	63 000		

A real estate agent valued the buildings at \$500 000 on 30 June 2021.

Required

- Prepare a statement of financial performance for Beaut Beach Caravan Park for the year ended 30 June 2021.
- Prepare a statement of financial position for the business as at 30 June 2021.
- Explain why you have used a particular valuation for the buildings in the statement of financial position.

(a)

BEAUT BEACH CARAVAN PARK		
Statement of financial performance		
for the year ended 30 June 2021		
INCOME		
Income — camping		\$185 000
Income — cabins		<u>272 000</u>
		457 000
EXPENSES		
Salaries and wages expense	\$220 000	
Other expenses	45 000	
Supplies used	<u>71 000</u>	
		<u>336 000</u>
PROFIT		<u>\$121 000</u>

(b)

BEAUT BEACH CARAVAN PARK	
Statement of financial position as at 30 June 2021	
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	
Toby and Talea McKellar, 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.

(c) Even though the market value of the buildings had risen to \$500 000 by 30 June 2021, the valuation placed on the buildings in the statement of financial position is their purchase price. 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 statement of financial position.

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 statement of financial position LO5**

The following events occurred during the month of September 2021 for the business of Shruti's Webdesign Service.

Sept.	1	Shruti deposited \$40 000 cash into the business bank account.
	2	A computer, telephone system and printer were purchased at a cost of \$10 000 cash.
	4	A part-time receptionist was hired to commence in October.
	6	Web design services were provided to clients for \$12 000. The clients were invoiced but have not as yet paid.
	7	Advertising for the week amounts to \$1000 cash.
	8	A customer paid \$3000 in advance for web design services scheduled for October.

Required

- (a) Determine the effects of business transactions on a statement of financial position by preparing a statement of financial position for Shruti's Webdesign Service after each transaction has occurred.
 (b) Discuss the expected tasks of Shruti as the manager of Shruti's Webdesign Service.
 (LO5)

(a) Effect of each business transaction on statement of financial position:

Sept. 1 Capital investment by owner, \$40 000.

SHRUTI'S WEBDESIGN SERVICE		
Statement of financial position as at 1 September 2021		
ASSETS		
Cash on hand		\$40 000
TOTAL ASSETS		\$40 000
EQUITY		
Shruti, Capital		\$40 000
TOTAL EQUITY		\$40 000

Sept. 2 Purchase of computer, telephone system and printer for \$10 000 cash.

SHRUTI'S WEBDESIGN SERVICE	
Statement of financial position	
as at 2 September 2021	
ASSETS	
Cash on hand	\$30 000
Equipment	10 000
TOTAL ASSETS	\$40 000
EQUITY	
Shruti, Capital	\$40 000
TOTAL EQUITY	\$40 000

Sept. 4 Hire of part-time receptionist (no change on Statement of financial position).

SHRUTI'S WEBDESIGN SERVICE	
Statement of financial position as at 4 September 2021	
ASSETS	
Cash on hand	\$30 000
Equipment	10 000
TOTAL ASSETS	\$40 000
EQUITY	
Shruti, Capital	\$40 000
TOTAL EQUITY	\$40 000

Sept. 6 Webdesign services provided to clients for \$12 000, but not yet been paid.

SHRUTI'S WEBDESIGN SERVICE		
Statement of financial position as at 6 September 2021		
ASSETS		
Cash on hand		\$30 000
Accounts receivable		12 000
Equipment		10 000
TOTAL ASSETS		\$52 000
EQUITY		
Shruti, Capital		\$52 000
TOTAL EQUITY		\$52 000

Sept. 7 Advertising paid for \$1000 in cash.

SHRUTI'S WEBDESIGN SERVICE		
Statement of financial position as at 7 September 2021		
ASSETS		
Cash on hand		\$29 000
Accounts receivable		12 000
Equipment		10 000
TOTAL ASSETS		\$51 000
EQUITY		
Shruti, Capital		\$51 000
TOTAL EQUITY		\$51 000

Sept. 8 Customer paid \$3000 in advance for web design services scheduled for October.

SHRUTI'S WEBDESIGN SERVICE	
Statement of financial position as at 8 September 2021	
ASSETS	
Cash on hand	\$32 000
Accounts receivable	12 000
Equipment	10 000
TOTAL ASSETS	\$54 000
LIABILITIES	
Unearned revenue	\$3 000
TOTAL LIABILITIES	3 000
NET ASSETS	\$51 000
EQUITY	
Shruti, Capital	\$51 000
TOTAL EQUITY	\$51 000

(b) The expected tasks of Shruti as the manager of Webdesign Service.

As the owner-manager of Shruti's Webdesign Service, Shruti needs to ensure that her business achieves satisfactory financial performance (e.g. achieves its target profit and has adequate cash to trade). Although Shruti's Webdesign Service is small sole trader, Shruti (as the manager) is still required to perform some managerial tasks as follow.

- **Planning:** in order for her business to be successful, Shruti needs to plan for future by setting goals to be achieved and making sure that future operations of the business are both effective and efficient. As part of planning, Shruti must decide what action the business should take in the future and what strategies should be implemented to achieve the business' goals. For example, Shruti might want to expand the business. In order to do that, she would need to plan how this can be done, e.g. how to get more capital (from her own finance or bank loan), how many more employees she needs to hire to help her doing clients' orders, and whether to move to bigger premises.
- **Organising:** as the sole manager in the business, Shruti needs to do a lot of organising so that the business is able to operate effectively and efficiently. Some of the things Shruti needs to organise would include: purchasing supplies and equipment required, paying bills, hiring and training new employees, and negotiating with clients.
- **Directing:** this managerial function deals with the day-to-day management of the business. As a manager, Shruti needs to be able to communicate the business' goals to her employees and provide direction/guidance for them to achieve the goals. This includes answering questions from her employees and resolving problems/disagreements with them.
- **Controlling:** to make sure that the actual performance of the business is in line with the business' goals, Shruti's role as a manager requires her to regularly evaluate her business' performance and compare it with the target. If there are significant variations from expected results, then actions need to be taken to improve the efficiency and effectiveness of business operations. For example, Shruti may want to compare the actual time spent in finishing clients' orders to the expected time. If the evaluation shows that it mostly takes longer for her employees to finish the orders, she would need to investigate causes of the variation and take actions accordingly (e.g. provide more training to current employees, hire more employees).

Exercise 2.14

Effects of transactions on financial statements

List 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.

- (a) Purchase equipment for cash**
 - (b) Provide services to a client, with payment to be received within 40 days**
 - (c) Pay a liability**
 - (d) Invest additional cash into the business by the owner**
 - (e) Collect an account receivable in cash**
 - (f) Pay to register a business name**
 - (g) Receive the electricity bill in the mail, to be paid within 30 days**
 - (h) Sell a piece of equipment for cash**
 - (i) Withdraw cash by the owner for private usage.**
 - (j) Borrow money on a long-term basis from a bank**
- (a) In the statement of financial position, increase an asset, equipment; decrease an asset, cash.
In the statement of cash flows, decrease cash flow (from investing activities).
 - (b) In the statement of financial position, increase an asset, receivables; increase equity.
In the statement of financial performance, increase income.
In the statement of changes in equity, increase equity.
 - (c) In the statement of financial position, decrease an asset, cash; decrease a liability.
In the statement of cash flows, decrease cash (probably from operating activities).
 - (d) In the statement of financial position, increase an asset, cash; increase equity.
In the statement of cash flows, increase cash (from financing activities).
In the statement of changes in equity, equity is increased.
 - (e) In the statement of financial position, increase an asset, cash; decrease an asset, accounts receivable.
In the statement of cash flows, increase cash (from operating activities).
 - (f) In the statement of financial position, decrease an asset, cash; decrease equity.
In the statement of financial performance, increase expenses.
In the statement of cash flows, decrease cash (from operating activities).
In the statement of changes in equity, decrease equity.
 - (g) In the statement of financial position, decrease equity; increase a liability, accounts payable.
In the statement of financial performance, increase expenses.
In the statement of changes in equity, decrease equity.
 - (h) In the statement of financial position, increase an asset, cash; decrease an asset, equipment, increase equity (if a profit was made on the sale).
In the statement of financial performance, 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).
 - (i) In the statement of financial position, 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.

- (j) In the statement of financial position, 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 **LO4, 5**

Sameer Soth began a food truck business on 1 July 2021 by depositing \$25 000 into a business bank account. On 30 June for the next 3 years, the assets and liabilities of the business were as follows:

30 June	Total assets	Total liabilities
2022	\$58 000	\$35 000
2023	65 000	37 000
2024	74 000	42 000

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:

- (a) On 1 January 2022, Sameer withdrew \$12 000 in cash from the business for personal use.
 - (b) On 28 August 2022, Sameer invested additional cash of \$25 000 into the business.
 - (c) On 31 July 2023, Sameer invested additional cash of \$25 000 into the business.
 - (d) On 28 January 2024, Sameer withdrew \$40 000 in cash for personal use.
- (LO4 and LO5)

SAMEER SOTH'S BUSINESS			
Profit for years ended 30 June	2022	2023	2024
Beginning Capital 1 July	\$25 000	\$23 000	\$28 000
+ Additional Capital Contributions	—	25 000	25 000
– Drawings	(12 000)		(40 000)
Profit/Loss	10 000	(20 000)	19 000
Ending Capital*30 June	\$23 000	\$28 000	\$32 000

* Assets minus liabilities at the end of each year

Problems

Problem 2.16

Preparing financial statements

Financial data for Safety Hire as of 30 June 2021 are:

Accounts receivable	\$ 63 000	Wages expense	\$ 75 000
Equipment hire income	170 000	Advertising expense	30 000
Accounts payable	40 000	Land	75 000
Michael Donato, capital	?	Hire equipment	180 000
Cash at bank	45 000	Loan payable	50 000
Mortgage payable	130 000	Electricity expense	18 000
Building	85 000	Telephone expense	7 500

Required

- Prepare a statement of financial performance for the month of June and a statement of financial position in account format for Safety Hire as at 30 June 2021.
- Discuss if, and how, the financial reports that you have prepared would change if you were aware that the wages expense included \$20 000 of drawings by the owner of Safety Hire.
(LO3, LO4 and LO5)

(a) Statement of financial performance and statement of financial position for Safety Hire:

SAFETY HIRE			
Statement of financial performance for the month ended 30 June 2021			
INCOME			
Equipment hire income			\$170 000
EXPENSES			
Wages expense	\$75 000		
Advertising expense	30 000		
Electricity expense	18 000		
Telephone expense	7 500		
			<u>130 500</u>
PROFIT			<u>\$39 500</u>

SAFETY HIRE

Statement of financial position as at 30 June 2021

(b) Effects on financial report if wages expense included \$20 000 drawings by owner:

The *Conceptual Framework* defines expenses as decreases in assets or increases in liabilities that result in decreases in equity, other than those relating to distributions to holders of equity claims (para. 4.69). Applying this definition, drawings is not an expense as it is a decrease in an asset (which decreases equity) as a result of distribution to the holder of an equity claim (i.e. owner).

If the wages expense of \$75 000 incurred by Safety Hire for the month ended 30 June 2021 includes \$20 000 of drawings by the owner, the \$20 000 drawings must be recorded separately from wages expense. As drawings is not an expense, it should not be recorded in the statement of financial performance. Rather, it should be recorded in the statement of changes in equity to determine the closing balance of capital as at 30 June 2021.

After separating drawings from wages expense, the total wages expense for the month would be \$55 000 (i.e. \$75 000 less \$20 000) and expenses \$110 500. Consequently, profit for the month would increase by \$20 000 to \$59 500, as shown in the revised statement of financial performance for Safety Hire as follow:

SAFETY HIRE		
Statement of financial performance for the month ended 30 June 2021		
INCOME		
Equipment hire income		\$170 000
EXPENSES		
Wages expense	\$55 000	
Advertising expense	30 000	
Electricity expense	18 000	
Telephone expense	7 500	
		<u>110 500</u>
PROFIT		<u><u>\$59 500</u></u>

The \$20 000 drawings is recorded in the statement of changes in equity to calculate the closing balance of capital as at 30 June 2021. Although profit has increased by \$20 000 as shown in the revised statement of financial performance above and this increases capital, the \$20 000 drawings would decrease capital by \$20 000. Hence, the closing balance of capital would remain the same at \$228 000 as at 30 June 2021.

Problem 2.17

Preparing financial statements ★ LO3, 4, 5

Asset, liability, equity, income and expense amounts for Tizannia's Property Styling at 30 June 2021 are presented below:

Cash at bank	\$ 11 500	Advertising expense	\$ 18 000
Accounts receivable	58 800	Insurance expense	4 000
Supplies	13 200	Rent expense	16 000
Furniture	62 800	Supplies expense	5 600
Accounts payable	16 800	Telephone expense	6 100
Tizannia, capital	?	Electricity expense	8 000
Decorating services income	193 000	Wages expense	50 000

Required

- Prepare a statement of financial performance for the business for the year ended 30 June 2021.
- Prepare a statement of financial position in narrative format as at 30 June 2021.
- Explain succinctly the differences in the information conveyed by a statement of financial performance and a statement of cash flows.

(a)

TIZANNIA'S PROPERTY STYLING			
Statement of financial performance for the year ended 30 June 2021			
INCOME			
Decorating services income			\$193 000
EXPENSES			
Advertising expense	\$18 000		
Insurance expense	4 000		
Rent expense	16 000		
Supplies expense	5 600		
Telephone expense	6 100		
Electricity expense	8 000		
Wages expense	50 000		
			<u>107 700</u>
PROFIT			<u><u>\$85 300</u></u>

(b)

TIZANNIA'S PROPERTY STYLING	
Statement of financial position as at 30 June 2019	
ASSETS	
Cash at bank	\$11 500
Accounts receivable	58 800
Supplies	13 200
Furniture	62 800
TOTAL ASSETS	\$146 300
LIABILITIES	
Accounts payable	16 800
TOTAL LIABILITIES	\$16 800
NET ASSETS	\$129 500
EQUITY	
Tizannia, Capital	129 500
TOTAL EQUITY	\$129 500

(c) A statement of financial performance reports the results of financial performance for a specific time period. It lists all income and expenses of the entity for the reporting period and shows profit/loss for the period as the difference between the income and expenses. A statement of cash flows reports the cash inflows and outflows of an entity for a specified time period resulting from operating activities (e.g. paying wages, receiving money from customer), investing activities (e.g. purchasing equipment in cash), and financing activities (e.g. borrowing money from bank, owner's drawing).

There is an overlap between statement of financial performance and statement of cash flows, in the sense that all cash income and expenses will be recorded in the statement of cash flows under operating activities. However, the statement of financial performance also includes income earned on credit (i.e. not yet received from customers) and expenses incurred on credit (i.e. not yet paid by the entity), which will not be recorded in the statement of cash flows. The statement of financial performance is prepared on an accrual basis. The statement of cash flows also includes cash inflows and outflows from other transactions other than income and expense related transactions in addition to cash income and cash expenses, for instance paying for equipment purchased and cash withdrawn by the owner for personal use.

In summary, the statement of financial performance conveys information about the entity's income and expenses for the period (both cash and credit), whereas the statement of cash flows conveys information about the entity's cash inflows and outflows which include cash income, expenses, and other cash transactions.

Problem 2.18

Determining missing elements in an accounting equation ★ LO5

Calculate the two missing amounts for each independent case below.

Case	Total assets	Total liabilities	Equity	Total income	Total expenses	Profit (loss)
A	\$ 90 000	\$37 000	?	\$76 000	?	\$ 24 000
B	110 000	?	\$ 82 000	45 000	\$56 000	?
C	?	18 000	53 000	80 000	?	(10 000)
D	93 000	?	50 000	?	32 000	(18 000)
E	?	55 000	120 000	?	60 000	31 000

(LO5)

Case	Total Assets	Total liabilities	Total equity	Total income	Total expenses	Profit (loss)
A	\$90 000	\$37 000	\$53 000	\$76 000	\$52 000	\$24 000
B	\$110 000	\$28 000	\$82 000	\$45 000	\$56 000	\$(11 000)
C	\$71 000	\$18 000	\$53 000	\$80 000	\$90 000	(\$10 000)
D	\$93 000	\$43 000	\$50 000	\$14 000	\$32 000	(\$18 000)
E	\$175 000	\$55 000	\$120 000	\$91 000	\$60 000	\$31 000

Problem 2.19**Identifying transactions from statement of financial position changes ★ ★ LO3, 4, 5**

During October 2021, Cleo launched a business, Cleo's Coffee, operating from a repurposed shipping container. After each October transaction, Cleo prepared a statement of financial position, as shown below.

(1)

CLEO'S COFFEE Statement of financial position as at 4 October 2021			
Assets		Equity	
Cash at bank	\$ 150 000	Cleo, capital	\$ 150 000

(2)

CLEO'S COFFEE Statement of financial position as at 13 October 2021			
Assets		Equity	
Cash at bank	\$ 40 000	Cleo, capital	\$ 150 000
Container, tables and chairs	<u>110 000</u>		
	\$ 150 000		<u>\$ 150 000</u>

(3)

CLEO'S COFFEE Statement of financial position as at 19 October 2021			
Assets		Liabilities and equity	
Cash at bank	\$ 40 000	Loan payable	\$ 30 000
Container, tables and chairs	110 000	Cleo, capital	150 000
Coffee machines	<u>30 000</u>		
	\$ 180 000		<u>\$ 180 000</u>

(4)

CLEO'S CAFE Statement of financial position as at 26 October 2021			
Assets		Liabilities and equity	
Cash at bank	\$ 40 000	Accounts payable	\$ 12 000
Supplies	12 000	Loan payable	30 000
Coffee machines	30 000		42 000
Container, tables and chairs	<u>110 000</u>	Cleo, capital	<u>150 000</u>
	\$ 192 000		<u>\$192 000</u>

Required

- (a) Describe the nature of each of the four transactions that took place during October.**
- (b) Comment on the type of financial information conveyed in a statement of financial position.**
- (c) Write a retort to the statement that ‘a statement of financial position should only be prepared once a year’.**

(a) The four transactions that took place during October are as follows:

- (i) On 4 October 2021, Cleo invested \$150 000 into the business, Cleo’s Cafe.
- (ii) On 13 October 2021, Container, tables and chairs were purchased by the business for cash, \$110 000.
- (iii) On 19 October 2021, coffee machines were purchased for a total of \$30 000. The machines were purchased using \$30 000 cash obtained from a bank loan.
- (iv) On 26 October 2021, supplies of \$12 000 were purchased by the business on credit.

(b) A statement of financial position is a report that lists the items that the business owns and owes to external parties and internal parties (owners). It reports the assets, liabilities, and equity at a specific point in time, usually the end of the reporting period (hence it is titled ‘as at...’). The balances of various individual asset accounts (e.g. cash, accounts receivables, equipment) and liability accounts (e.g. accounts payable, wages payable, mortgage payable) are listed on the statement of financial position, along with the balance of equity (for sole traders like Cleo’s Coffee, it is usually the closing balance of capital).

There are two formats that can be used to prepare the statement of financial position, which are the account format and the narrative format. The former shows assets on the left-hand side and liabilities and equity on the right hand side, whereas the latter lists all elements of statement of financial position in one column. Regardless of the format used, the statement of financial position must show the equality of accounting equation. That is, when account format is used, the statement of financial position must show that total assets on the left-hand side equal total liabilities plus equity on the right-hand side. When narrative format is used, the statement of financial position must show that net assets (i.e. total assets less total liabilities) equal total equity.

(c) Publicly listed companies are required to prepare statement of financial position at least once a year, which is at the end of their reporting period. This means that statement of financial position does not have to be prepared only once a year. As explained in part B above, a statement of financial position reports the assets, liabilities, and equity at a specific point in time. Hence, entities can prepare a statement of financial position as at any date. Although publicly listed companies must report their financial position to shareholders (i.e. external users) once a year, managers of the companies (i.e. internal users) might need to know their companies’ financial position at a specific point in time in order to make decision about the companies’ operations. Monthly reporting for internal purposes often includes a statement of financial performance, statement of financial position and statement of cash flow.

Problem 2.20**Preparation of financial statements * * LO3, 4, 5**

Dawson Industries began operations early in January 2023. On 31 December 2023, records showed the following asset, liability, equity, income and expense amounts:

Accounts receivable	\$ 25 600	Lila Dawson, Capital	\$?
Rent expense	13 500	Electricity expense	7 200
Cash at bank	10 250	Telephone expense	4 900
Supplies expense	5 250	Advertising expense	12 500
Accounts payable	9 500	Insurance expense	2 500
Service income	147 500	Wages expense	44 000
Supplies	11 000	Drawings	23 400
Equipment	48 000		

Required

- (a) Prepare a statement of financial performance for Dawson Industries for the year ended 31 December 2023.
 (b) Prepare a statement of financial position as at 31 December 2023.
 (c) Prepare a statement of changes in equity for 2023.
 (d) Explain the difference between the items 'supplies' and 'supplies expense'.
 (LO3, LO4 and LO5)

(a)

DAWSON INDUSTRIES		
Statement of financial performance for the year ended 31 December 2023		
INCOME		
Service income		\$147 500
EXPENSES		
Advertising expense	\$12 500	
Insurance expense	2 500	
Rent expense	13 500	
Supplies expense	5 250	
Telephone expense	4 900	
Electricity expense	7 200	
Wages expense	44 000	
		<u>89 850</u>
PROFIT		<u><u>\$57 650</u></u>

(b)

DAWSON INDUSTRIES	
Statement of financial position as at 31 December 2023	
ASSETS	
Cash at bank	\$10 250
Accounts receivable	25 600
Supplies	11 000
Equipment	48 000
TOTAL ASSETS	\$94 850
LIABILITIES	
Accounts payable	9 500
TOTAL LIABILITIES	\$9 500
NET ASSETS	\$85 350
EQUITY	
Lila Dawson, Capital	85 350
TOTAL EQUITY	\$85 350

(c)

DAWSON INDUSTRIES	
Statement of changes in equity	
for the year ended 31 December 2023	
Lila Dawson, Capital – 1 January 2023	—
Add: Capital contribution	\$51 100
Profit for the year	57 650
	108 750
Less: Drawings during the year	23 400
Lila Dawson, Capital – 31 December 2023	\$85 350

(d) The term ‘supplies’ refers to items purchased by an entity to be used as part of its operations (e.g. stationery). Supplies are usually purchased in bulk, and then are consumed or used during the period. At the time of purchase, supplies are recorded as assets to the entity because they have future economic benefits in the form of their use for the entity’s operation and they are controlled by the entity (i.e. the entity owns the supplies) as a result of past event (which is the purchase transaction). As an asset account, supplies are recorded on the statement of financial position.

‘Supplies expense’ refers to supplies that have been used or consumed by the entity in their operation during the period. Whilst unused supplies are assets to the entity, used supplies are recorded as expense because they are decreases in economic benefits (from the consumption by the entity) in the form of decreases in assets (i.e. supplies account). Furthermore, these decreases in economic benefits result in decreases in equity, and they are not distributions to owners (i.e. the entity consumes the economic benefits, not the owners). As an expense account, supplies expense is recorded on the statement of financial performance.

Problem 2.21**Correction of financial statements ★ ★ LO3, 4, 5**

A new business graduate with one subject of accounting prepared the financial statements below for Jack's Tutoring School at the end of the first year of operations.

JACK'S TUTORING SCHOOL			
Statement of financial performance			
for the year ended 30 June 2021			
Income			
Tutoring fees			\$ 230 000
Expenses			
Office rent expense	\$ 36 000		
Wages expense	86 000		
Office expenses	32 400		
Electricity expense	13 500		
J. Horner, drawings	22 400		
Depreciation expense			
— vehicle	6 600		
— equipment	2 100		
			<u>199 000</u>
Profit			<u>\$ 31 000</u>

JACK'S TUTORING SCHOOL			
Statement of financial position			
as at 30 June 2021			
Assets		Liabilities	
Cash at bank	\$ 25 200	Accounts payable	\$ 26 000
Equipment	34 600	Equity	
Vehicle	42 000	J. Horner, capital	75 800
	<u>\$ 101 800</u>		<u>\$ 101 800</u>

Additional analysis revealed the following:

1. Tutoring fees of \$15 500 (owed by students) were unrecorded at 30 June.
2. Additional equipment of \$5 500 purchased with a bank loan at the end of the month had not been recorded.
3. Office expenses included supplies on hand at 30 June costing \$4 600.
4. Wages of \$2500 were payable at 30 June.

Required

- (a) Prepare a corrected statement of financial performance for the year ended 30 June 2021.
- (b) Prepare a corrected statement of financial position in narrative form as at 30 June 2021.
- (c) Prepare a statement of changes in equity for the year ended 30 June 2021.
- (d) Discuss the accounting assumptions that Jack has breached.

(a)

JACK'S TUTORING SCHOOL		
Statement of financial performance		
for the year ended 30 June 2021		
INCOME		
Tutoring fees		\$245 500
EXPENSES		
Office rent expense	\$36 000	
Wages expense	88 500	
Office expenses	27 800	
Electricity expense	13 500	
Depreciation expense		
— vehicle	6 600	
— equipment	2 100	
	<u>8 700</u>	
		174 500
PROFIT		<u><u>\$71 000</u></u>

(b)

JACK'S TUTORING SCHOOL		
Statement of financial position		
as at 30 June 2021		
ASSETS		
Cash at bank		\$25 200
Accounts receivable		15 500
Supplies on hand		4 600
Equipment		40 100
Vehicle		42 000
TOTAL ASSETS		<u>127 400</u>
LIABILITIES		
Accounts payable		26 000
Wages payable		2 500
Bank loan		5 500
TOTAL LIABILITIES		<u>34 000</u>
NET ASSETS		<u>93 400</u>
EQUITY		
J. Horner, Capital		93 400
TOTAL EQUITY		<u><u>93 400</u></u>

Reconciliation of original capital of \$75 800 to \$93 400: \$75 800-profit recorded \$31 000 + revised profit \$71 000 – Drawings \$22 400.

(c)

JACK'S TUTORING SCHOOL Statement of changes in equity for the year ended 30 June 2021	
J. Horner, Capital – 1 July 2021*	44 800
Add: Profit for the year	71 000
	115 800
Less: Drawings during the year	22 400
J. Horner, Capital – 30 June 2021	93 400

*Beginning balance of capital is found by working backwards, namely, \$93 400 + \$22 400 – \$71 000. This assumes that Jack did not make a capital contribution during the year.

(d) Jack mainly has breached the *accrual basis assumption*, which states that financial statements of an entity are assumed to be prepared using accrual basis. Under the accrual basis, income (expenses) is (are) recognised in the period when increases (decreases) in economic benefits occur, rather than when cash is received or paid.

The accrual basis assumption was breached as Jack initially:

- Did not record \$15 500 tutoring fees owed by customers as income for the year ended 30 June 2021. The tutoring lesson was provided during that period, and therefore under the accrual basis the \$15 500 tutoring fees were earned in that period even though the customers have not yet paid; the amount owing should be recorded as an asset on the statement of financial position.
- Did not record the \$2500 wages owed by the tutoring school to its employees as expenses for the year ended 30 June 2021. The employees have provided their services to the tutoring school during the period, and therefore under the accrual basis the \$2500 wages payable was incurred in that period even though the employees have not yet been paid.
- Included \$4 600 unused supplies as expenses in the year ended 30 June 2021. Under the accrual basis, expenses are to be recognised when decreases in assets have occurred (i.e. when supplies are used), and therefore unused supplies should not be recognised as expenses. Instead, they should be recorded as assets on the statement of financial position.

Problem 2.22

Performance assessment from financial statements ★ ★ LO3, 4, 5

Tiffany established The Marketing Store, an Instagram management business on 1 January 2023 as a sole trader business. She contributed \$10 000 in cash to the business and did not withdraw funds for the year.

For the year ended 31 December 2023, the following events occurred in the business:

- 1. Received \$58 000 cash for marketing services provided.**
- 2. Paid cash expenses of \$15 000 for business supplies and website development.**
- 3. At the end of the year, the business purchased a new computer for \$1200 cash.**
- 4. The business leases premises as an office. Lease rental payments for the year amounted to \$14 000.**
- 5. The business borrowed \$25 000 to support its national expansion.**

Required

- (a) Prepare a statement of financial performance for The Marketing Store for the year ended 31 December 2023.**
- (b) Prepare a statement of cash flows for The Marketing Store for the year ended 31 December 2023.**
- (c) Discuss if a business can operate profitably and still have a net cash outflow for the year.**
- (d) Provide a counter argument to the statement that ‘a better indicator of business performance is cash flow’.**

(a)

THE MARKETING STORE Statement of financial performance for the year ended 31 December 2023	
INCOME	
Marketing services	\$58 000
EXPENSES	
Business supplies and website development	\$15 000
Rent expense	14 000
PROFIT	29 000

The computer has been treated as an asset acquisition.

(b)

THE MARKETING STORE Statement of cash flows for the year ended 31 December 2023	
CASH FLOWS FROM OPERATING ACTIVITIES	
Cash received from customers	\$58 000
Cash paid to suppliers and employees	(15 000)
Cash paid for rent	(14 000)
Net cash from operating activities	\$29 000
CASH FLOWS FROM INVESTING ACTIVITIES	
Purchase of computer	(1 200)
Net cash used in investing activities	(1 200)
CASH FLOWS FROM FINANCING ACTIVITIES	
Bank loan	25 000
Drawings by owner	—
Net cash from financing activities	25 000
Net increase (decrease) in cash held	52 800
Cash at beginning of year	10 000
Cash at end of year	\$62 800

(c) Yes, a business can operate profitably and still have net cash outflows for the year. In accrual accounting, cash flows are not the same as income and expenses. For example, cash outflows from investing (e.g. the purchase of equipment) and financing activities (e.g. a loan repayment) will affect cash outflows but are not income and expenses counted in calculating profit. Hence, a business can report a profit but have net cash outflows. The other reason for the difference is timing of cash flows relative to their revenue or expense recognition. Most cash flows from operating activities also result in income or expenses, but 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 this problem, there is no timing difference with the income and expenses being recognised in the same period as the receipt of the revenue and the payment of the expense.

(d) Business performance is generally assessed from three different perspectives: liquidity (i.e. ability to meet short-term obligations when they are due), solvency (i.e. ability to survive in a longer period of time), and profitability (i.e. operating success as measured by profit). Liquidity is associated with cash flows in the short-term, solvency is associated with both cash flow and profit in the long-term, and profitability is associated with profit in both short-term and long-term.

The three different performance assessments above indicate that both profit and cash flows are important indicators of an entity's performance. Cash flows are important as insufficient cash can cause liquidity problems and result in the entity being liquidated. On the other hand, profit is also important because the entity will fail if it does not generate sufficient profit to continue its operations. Subsequently, cash flows are not a better indicator of an entity's performance. Although the entity can have positive cash flows while trading at a loss in the short-term, it is not sustainable for the entity to keep operating at a loss in the long-term. Hence, cash flows and profits are both important indicators of an entity's performance and assist to provide information that is useful for decision-making.

Problem 2.23**Recording transactions and preparing financial statements ★ ★ LO3, 4, 5**

Financial balances for the car hire business of John's Limos on 31 March 2021 are provided below in a table in accounting equation form similar to the chapter illustrations.

Assets							=	Liabilities		+	Equity			
Cash at bank	+	Accounts receivable	+	Office equipment	+	Motor vehicles	+	Fuel supplies	=	Accounts payable	+	Loan payable	+	John Limos, capital
\$11 000	+	\$15 000	+	\$1 500	+	\$94 000	+	0	=	\$3 500	+	\$12 000	+	\$106 000

During April, the business of John's Limos entered into the following transactions:

- 1. Collected \$8000 of the accounts receivable.**
- 2. Paid \$2000 of the accounts payable.**
- 3. Purchased another vehicle for \$48 000. Paid \$5000 in cash and signed a loan agreement for the balance.**
- 4. Billed customers for services performed, \$10 500.**
- 5. Fuel supplies purchased on credit, \$3750.**
- 6. Paid expenses in cash, \$4250 (wages, \$2400; car cleaning \$1200; advertising, \$650).**
- 7. John Limos withdrew \$2000 for personal use.**
- 8. Paid parking fines of \$300.**

Required

- (a) List the 31 March 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 a statement of financial performance, a statement of changes in equity and a statement of cash flows for the month ended 30 April 2021, and a statement of financial position (account format) as at 30 April 2021.**

(a) and (b)

	Assets									=	Liabilities				+	Equity
	Cash at bank	+	Accounts receivable	+	Fuel supplies	+	Office equipment	+	Motor vehicles	=	Accounts payable	+	Loans payable	+	John Limos, capital	
	\$11 000	+	\$15 000	+	0	+	\$1 500	+	\$94 000	=	\$3 500	+	\$12 000	+	\$106 000	
(1)	+ 8 000		– 8 000													
	19 000	+	7 000	+	0	+	1 500	+	94 000	=	3 500	+	12 000	+	106 000	
(2)	– 2 000										– 2 000					
	17 000	+	7 000	+	0	+	1 500	+	94 000	=	1 500	+	12 000	+	106 000	
(3)	– 5 000								+48 000				+43 000			
	12 000	+	7 000	+	—	+	1 500	+	142 000	=	1 500	+	55 000	+	106 000	
(4)			+10 500												+10 500	
	12 000	+	17 500	+	—	+	1 500	+	142 000	=	1 500	+	55 000	+	116 500	
(5)				+	3 750						+ 3 750					
	12 000	+	17 500	+	3 750	+	1 500	+	142 000	=	5 250	+	55 000	+	116 500	
(6)	– 4 250														– 4 250	
	7 750	+	17 500	+	3 750	+	1 500	+	142 000	=	5 250	+	55 000	+	112 250	
(7)	– 2 000														– 2 000	
	5 750	+	17 500	+	3 750	+	1 500	+	14 2000	=	5 250	+	55 000	+	110 250	
(8)	-300														– 300	
	5 450	+	17 500	+	3 750	+	1 500	+	142 000	=	5 250	+	55 000	+	109 950	

(c)

JOHN'S LIMOS		
Statement of financial performance		
for the month ended 30 April 2021		
INCOME		
Services income		\$10 500
EXPENSES		
Wages expense	\$2 400	
Car cleaning expense	1 200	
Advertising expense	650	
Parking fines expense	300	
		<u>4 550</u>
PROFIT		<u><u>\$5 950</u></u>

JOHN'S LIMOS	
Statement of changes in equity	
for the month ended 30 April 2021	
John Limos, Capital – 1 April 2021	\$106 000
Add: Profit for the month	5 950
	<u>111 950</u>
Less: Drawings during the month	2 000
John Limos, Capital – 30 April 2021	<u><u>\$109 950</u></u>

JOHN'S LIMOS			
Statement of cash flows			
for the month ended 30 April 2021			
CASH FLOWS FROM OPERATING ACTIVITIES			
Cash received from customers	\$8 000		
Cash paid to suppliers and employees (1)	<u>(6 550)</u>		
Net cash from operating activities			\$1 450
CASH FLOWS FROM INVESTING ACTIVITIES			
Purchase of vehicle	<u>(5 000)</u>		
Net cash used in investing activities			(5 000)
CASH FLOWS FROM FINANCING ACTIVITIES			
Drawings by owner	<u>(2 000)</u>		
Net cash used in financing activities			<u>(2 000)</u>
Net decrease in cash held			(5 550)
Cash at beginning of month			<u>11 000</u>
Cash at end of month			<u><u>\$5 450</u></u>

(1) Paid Accounts Payable \$2000 + Cash Expenses \$4250 + Parking fines \$300
= \$6550

JOHN'S LIMOS			
Statement of financial position			
as at 30 April 2021			
ASSETS		LIABILITIES	
Cash at bank	\$5 450	Accounts payable	\$5 250
Accounts receivable	17 500	Loan payable	55 000
Fuel supplies	3 750	EQUITY	
Office equipment	1 500	John Limos, capital	109 950
Motor vehicles	<u>142 000</u>		
	<u>\$170 200</u>		<u>\$170 200</u>

Problem 2.24**Classifying items for financial statements ★ ★ LO3, 4, 5**

The following list of items relate to the business of Jay Street Wear.

1. Cash paid into the business by Jay to begin operations.
2. Racks purchased to display merchandise to customers.
3. Building leased for 2 years, with rent payable monthly in advance.
4. Streetwear items purchased from a manufacturer.
5. Amount owing to the manufacturer for merchandise purchased.
6. Insurance premium on the merchandise paid in advance.
7. Cash withdrawn by Jay for personal use.
8. Wages paid to casual employee.
9. Amount borrowed long-term from the bank.
10. Cash sales of merchandise to customers.
11. Spare change kept in the cash register at the checkout counter.

Required

- (a) Identify the elements of the financial statements (asset, liability, income, expense and equity) impacted by each of the transactions.
- (b) List the cash flow classification (operating, investing or financing) and direction (inflow or outflow) for each transaction.

(a) and (b)

1. For the business, this is the initial investment by the owner. In the statement of financial position of the business, asset (cash) increases and equity increases. In the statement of cash flows, this is recorded as cash inflows under financing activities.

2. This is an asset to the business, recorded as 'Store Equipment' on the statement of financial position. Assuming the racks were purchased for cash, this will be recorded as cash outflows under investing activities.

3. There is no building asset for the business here. The building does not belong to the business. In the statement of financial position, an increase in the asset for Prepaid Rent and a decrease in cash would be recorded if the rent is paid by the business each month in advance. In the statement of cash flows, paying the rent in advance is recorded as a cash outflow under operating activities when the payment is made. As time passes, in the statement of financial position there will be a reduction in the Prepaid Rent account for the rent that has expired. This expired rent will then be recorded as an expense (Rent Expense) in the statement of financial performance.

4. Street wear items are Inventory to the business. In the statement of financial position, inventory is recorded as an asset. Assuming the street wear items were purchased in cash, this will be recorded as a cash outflow under operating activities in the statement of cash flows.

5. This is recorded as liability (Accounts Payable) in the statement of financial position. Nothing is recorded in the statement of cash flows at this point. When the business pays the supplier for the amount owed, this will be recorded as a cash outflow under operating activities in the statement of cash flows.

6. This is recorded as an increase in asset (Prepaid Insurance) in the statement of financial position, as well as a decrease in cash account. In the statement of cash flows, paying insurance premium is recorded as cash outflows under operating activities. As the insurance expires with the passage of time, there will be a

reduction in the Prepaid Insurance account for the insurance that has expired. This expired insurance will then be recorded as an expense (Insurance Expense) in the statement of financial performance.

7. This will be recorded as a decrease in asset (cash) and a decrease in equity (Jay's capital) in the form of Drawings. In the statement of cash flows, owner's drawings are recorded as cash outflows under financing activities.

8. This will be recorded as Wages Expense in the statement of financial performance. Wages Expense does not appear in the statement of financial position as a separate item but reduces equity by reducing profit. It also reduces the cash balance. Paying wages to employees is recorded as cash outflows under operating activities in the statement of cash flows.

9. Long-term borrowings are shown in the statement of financial position as an increase in liability (Long-term Loan Payable), and the cash received as an increase in asset (Cash). The cash received from this loan is also recorded as cash inflows under financing activities.

10. Sales of merchandise to customers are recorded as Sales Income or Revenue in the statement of financial performance. The transaction increases equity and increases Cash or Accounts Receivable. Assuming customers pay cash for the merchandise, this will be recorded as cash inflows under operating activities in the statement of cash flows.

11. Spare change kept in the cash register is shown in the statement of financial position as an asset (Cash).

Problem 2.25

Recording transactions and preparing financial statements ★ ★ LO2, 3, 5

Non-GST version

Financial balances for Ho Ming Wee, IT Consultancy, on 30 June 2021 are given below in a table in accounting equation form similar to the chapter illustrations.

Assets						=	Liabilities				+	Equity
Cash at bank	+	Accounts receivable	+	Office supplies	+	IT equipment	=	Accounts payable	+	Loan payable	+	Ho Ming Wee, capital
\$9 000	+	\$14 250	+	\$2 000	+	\$20 875	=	\$3 425	+	\$9 750	+	\$32 950

During the early part of July, the business entered into the following transactions.

1. Paid \$3260 on accounts payable.
2. Collected \$4600 of the monies owed by clients.
3. Purchased IT equipment for \$11 200. Paid \$1200 in cash and signed a loan agreement for the balance.
4. Billed customers for IT services performed, \$9820.
5. Purchased supplies on credit, \$2100.
6. Paid expenses in cash, \$9400 (advertising, \$2000; rent, \$6000; wages, \$1400).
7. Used \$600 of supplies during the period.
8. Collected \$9650 of accounts receivable.
9. Ho Ming Wee paid for a \$21 000 family holiday to Europe using the firm's bank account.

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 a statement of financial performance and a statement of changes in equity for the month and a statement of financial position in narrative format as at 31 July 2021.
- (d) Discuss if these financial statements are useful for the owner/manager of the business.

(a) and (b)

	Assets						=	Liabilities				+	Equity
	Cash at bank	+	Accounts receivable	+	Office supplies	+	Office equipment	=	Accounts payable	+	Loan payable	+	Ho Ming Wee, capital
	\$9 000	+	\$14 250	+	\$2 000	+	\$20 875	=	\$3 425	+	\$9 750	+	\$32 950
(1)	– 3 260								– 3 260				
	5 740	+	14 250	+	2 000	+	20 875	=	165	+	9 750	+	32 950
(2)	+4 600		– 4 600										
	10 340	+	9 650	+	2 000	+	20 875	=	165	+	9 750	+	32 950
(3)	– 1 200					+	11 200			+	10 000		
	9 140	+	9 650	+	2 000	+	32 075	=	165	+	19 750	+	32 950
(4)		+	9 820									+	9 820
	9 140	+	19 470	+	2 000	+	32 075	=	165	+	19 750	+	42 770
(5)				+	2 100				+ 2 100				
	9 140	+	19 470	+	4 100	+	32 075	=	2 265	+	19 750	+	42 770
(6)	– 9 400												– 9 400
	(260)	+	19 470	+	4 100	+	32 075	=	2 265	+	19 750	+	33 370
(7)													– 600
	(260)	+	19 470	+	3 500	+	32 075	=	2 265	+	19 750	+	32 770
(8)	+ 9 650		– 9 650										
	9 390	+	9 820	+	3 500	+	32 075	=	2 265	+	19 750	+	32 770
(9)	– 21 000												– 21 000
	(11 610)*	+	9 820	+	3 500	+	32 075	=	2 265	+	19 750	+	11 770

*Note: Cash at Bank account has a negative balance as there is not enough cash to pay for the family holidays. In this case, the business would use an overdraft facility (i.e. short-term borrowing) from bank to temporarily cover for the deficit. A bank overdraft is shown as a liability rather than a negative asset.

(c)

HO MING WEE — IT CONSULTANCY		
Statement of financial performance		
for the month ended 31 July 2021		
INCOME		
IT Service Fees		\$9 820
EXPENSES		
Wages expense	\$1 400	
Rent expense	6 000	
Advertising expense	2 000	
Supplies expense	600	
		<u>10 000</u>
LOSS		<u><u>\$180</u></u>

HO MING WEE — IT CONSULTANCY		
Statement of changes in equity		
for the month ended 31 July 2021		
Ho Ming Wee, capital – 1 July 2021		\$32 950
Less: Loss for the month		<u>180</u>
		32 770
Less: Drawings during the month		<u>21 000</u>
Ho Ming Wee, capital – 31 July 2021		<u><u>\$11 770</u></u>

HO MING WEE — IT CONSULTANCY	
Statement of financial position	
as at 31 July 2021	
ASSETS	
Accounts receivable	9 820
Office supplies	3 500
Office equipment	32 075
TOTAL ASSETS	\$45 395
LIABILITIES	
Bank overdraft	11 910
Accounts payable	2 265
Loan payable	19 450
TOTAL LIABILITIES	\$33 625
NET ASSETS	\$11 770
EQUITY	
Ho Ming Wee, capital	11 770
TOTAL EQUITY	\$11 770

(d) In the business Ho Ming Wee — IT Consultancy, Ho Ming Wee is assumed to be both the owner and manager of his business. Financial statements are useful as they provide information about an entity's financial performance and position. As a manager Ho Ming Wee would need more information in order to make decisions on day-to-day operations.

Financial statements are a summary of the business' financial performance and position. Hence, the information provided in the financial statements only pertains to the entity as a whole and is highly condensed. As a manager, Ho Ming Wee needs more detailed information (not just summary and total) such as break-down of income from different clients or depreciation on equipment, to help him in making decisions. Furthermore, if Ho Ming Wee's business has different divisions, the financial statements will not report details about each division. Ho Ming Wee would need more information about each division to make a comparison and evaluation for each division.

Another limitation of financial statements is that they only report historical financial information rather than forward looking information for business planning. As a manager, Ho Ming Wee also needs non-financial information, such as client's satisfaction rate, employee turnover, percentage of new clients and repeat business. Non-financial information is present and future-oriented, and will enable Ho Ming Wee to evaluate and plan.

In summary, although financial statements are useful in providing information about an entity's financial performance and positions, managers require more information than what is contained in the financial statements in order to make decisions about the entity's operations.

Problem 2.26**Identifying transactions from statement of financial position changes ★ ★ LO2, 5**

Emma Lu obtained registration to practise as a naturopath, and spent the month of July 2022 setting up her business — E. Lu, Naturopath.

Emma prepared a new statement of financial position after each transaction which occurred. During July, the following statement of financial positions were prepared.

(1)

E. LU, NATUROPATH			
Statement of financial position			
as at 1 July 2022			
Assets		Equity	
Cash at bank	\$ 85 000	E. Lu, capital	\$ 85 000

(2)

E. LU, NATUROPATH			
Statement of financial position			
as at 8 July 2022			
Assets		Liabilities and equity	
Cash at bank	\$ 50 000	Loan payable	\$ 160 000
Equipment	25 000	E. Lu, capital	85 000
Building	<u>170 000</u>		
	\$ <u>245 000</u>		\$ <u>245 000</u>

(3)

E. LU, NATUROPATH			
Statement of financial position			
as at 15 July 2022			
Assets		Liabilities and equity	
Cash at bank	\$ 50 000	Accounts payable	\$ 3 500
Office supplies	3 500	Loan payable	160 000
Equipment	25 000	E. Lu, capital	85 000
Building	<u>170 000</u>		
	\$ <u>248 500</u>		\$ <u>248 500</u>

(4)

E. LU, NATUROPATH			
Statement of financial position			
as at 22 July 2022			
Assets		Liabilities and equity	
Cash at bank	\$ 45 000	Accounts payable	\$ 3 500
Office supplies	3 500	Loan payable	155 000
Equipment	25 000	E. Lu, capital	85 000
Building	<u>170 000</u>		
	\$ <u>243 500</u>		\$ <u>243 500</u>

(5)

E. LU, NATUROPATH
Statement of Financial Position
as at 31 July 2022

Assets		Liabilities and equity	
Cash at bank	\$ 41 000	Accounts payable	\$ 3 500
Office supplies	3 500	Loan payable	155 000
Equipment	25 000	E. Lu, capital	81 000
Building	<u>170 000</u>		
	\$ 239 500		\$ 239 500

Required

- (a) Describe each of the five transactions that occurred during July 2022.
- (b) Emma is very focused on the environment. As a manager and owner of the business, discuss the actions that she could take to earn a reputation for having sustainable business practices.
- (c) Discuss whether you believe that disclosing sustainable business practices enhances the reputation of a business.

- (a)
- (i) On 1 July 2022, E. Lu invested \$85 000 in the business.
 - (ii) On 8 July, the business purchased equipment for \$25 000 and a building for \$170 000. This was financed with a cash payment of \$35 000 and a loan payable of \$160 000.
 - (iii) On 15 July, the business bought office supplies on credit for \$3500.
 - (iv) On 22 July, the business repaid \$5000 on the loan payable.
 - (v) On 31 July, the proprietor, E. Lu, withdrew \$4000 cash for her own use or paid expenses of \$4000.
- (b) The followings are examples of sustainable business practices:
- Recycling office supplies, such as papers or cardboards.
 - Installing solar panels on the roof of her building to generate electricity.
 - Installing water tank in her building to re-use rainwater.
 - Carefully selecting the suppliers of medicines or vitamins she used in her practice to include only suppliers with good environmental and ethical business conducts.
 - Installing more glass windows in the building where sunlight can go through and hence the building will use less electricity for lights during the day.
 - Having good insulation for the building so that inside temperature is more stable (use less heater/air conditioning).

Note: students may have other suggestions from their own experience, so it would be good to have a class discussion on this.

- (c) Given the attention and concern for the environment, stakeholders/society expect businesses to be good corporate citizens in preserving and looking after the environment for future generations. In other words, the stakeholders are not just interested in the financial success (i.e. profit) of an entity, but also in how the entity manages impacts of its business operations on the environment.

There is growing demand for entities to disclose the impacts of their business on the environment and community, in addition to reporting the financial aspects of the business. This reporting, known as sustainability reporting, is not mandatory. However, growing numbers of entities (especially large listed companies) have voluntarily provided this information in order to be accountable and to increase their reputation to current and potential investors.

Many investors have become 'eco/green investors', which means they only want to invest in companies with sustainable business practices and good citizenship records. A number of sustainability indices, such as Dow Jones Sustainability Indexes, evaluate the sustainability performance of largest companies and have become reference point in sustainability for those green investors. Companies included in the sustainability indices must make continuous improvements to their long-term sustainability plans in order to remain in the indices.

By providing information about their environmental practices, the companies would be able to demonstrate what they have done to minimise damages on the environment and be perceived as responsible corporate citizens. This, in turn, will increase their reputation that is likely to attract more capital in the market and offer competitive advantage such as increase in sales.

Problem 2.27

Recording transactions and preparing financial statements ★ ★ LO3, 4, 5

Tran's Clothing Alterations began operations on 1 August 2023 and completed the following transactions during the first month.

1. Tran deposited \$18 000 of her personal funds in a current account at a bank opened in the name of the business.
2. Sewing equipment was purchased at a cost of \$9000, of which \$5000 was paid in cash. A loan payable was given for the remainder of \$4000.
3. Tran collected \$1500 from customers for alteration services performed.
4. Rent was paid for the month of August, \$1200.
5. Sewing supplies amounting to \$700 were purchased on credit.
6. Wages of \$500 were paid as well as an account for electricity, \$250.
7. Tran paid for the sewing supplies purchased in (5) above.
8. Supplies used during August amounted to \$300.

Required

- (a) Prepare a schedule. List the following assets, liabilities and equity as column headings: Cash at bank; Supplies; Equipment; Loan payable; Accounts payable; Tran, capital.
 - (b) Illustrate the effects of each of the transactions on the accounts listed. Indicate totals after each transaction and complete the schedule.
 - (c) Prepare an statement of financial performance, a statement of cash flows and a statement of changes in equity for the month ended 31 August 2023.
 - (d) Prepare a statement of financial position as at 31 August 2023.
- (a) and (b)

Assets					=	Liabilities			+	Equity		
Cash at bank		+	Supplies	+	Equipment	=	Loan payable		+	Accounts payable	+	Tran, capital
(1)	+18 000									+	18 000	
(2)	− 5 000			+	9 000		+4 000					
	13 000	+	0	+	9 000	=	4 000	+	0	+	18 000	
(3)	+1 500									+	1 500	
	14 500	+	0	+	9 000	=	4 000	+	0	+	19 500	

© John Wiley & Sons Australia, Ltd 2021

(c)

TRAN'S CLOTHING ALTERATIONS		
Statement of financial performance		
for the month ended 31 August 2023		
INCOME		
Services income		\$1 500
EXPENSES		
Rent expense	\$1 200	
Wages expense	\$500	
Electricity expense	\$250	
Supplies expense	\$300	
		<u>\$2 250</u>
LOSS		<u><u>\$750</u></u>

TRAN'S CLOTHING ALTERATIONS		
Statement of cash flows		
for the month ended 31 August 2023		
CASH FLOWS FROM OPERATING ACTIVITIES		
Cash received from customers	\$1 500	
Cash paid to suppliers and employees*	<u>\$(2 650)</u>	
Net cash used in operating activities		\$(1 150)
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase of equipment	<u>\$(5 000)</u>	
Net cash used in investing activities		\$(5 000)
CASH FLOWS FROM FINANCING ACTIVITIES		
Capital contribution from owner	<u>\$18 000</u>	
Net cash from financing activities		<u>\$18 000</u>
Net increase in cash held		\$11 850
Cash at beginning of month		<u>0</u>
Cash at end of month		<u><u>\$11 850</u></u>

* Cash paid to suppliers and employees = Rent \$1200 + Wages \$500 + Electricity \$250 + Accounts Payable \$700 = \$2650

TRAN'S CLOTHING ALTERATIONS Statement of changes in equity for the month ended 31 August 2023	
Tran, Capital – 1 August 2023	\$ —
Add: Capital contribution	\$18 000
Less: Loss for the month	\$(750)
Tran, Capital – 31 August 2023	<u>\$17 250</u>

(d)

TRAN'S CLOTHING ALTERATIONS Statement of financial position As at 31 August 2023			
ASSETS		LIABILITIES	
Cash at bank	\$ 11 850	Loan payable	\$ \$4 000
Supplies	\$ 400	EQUITY	
Equipment	\$ 9 000	Tran, Capital	\$ 17 250
	<u>\$ 21 250</u>		<u>\$ 21 250</u>

Problem 2.28

Correcting errors and preparing financial statements ★ ★ LO3, 5

Finesse Fitness was established on 1 April 2021 with an initial investment of \$50 000 by the owner, Toby Hewitt. During the first few months of business, the owner employed a student studying accounting who recorded the following list of assets.

Accounts payable	\$ 18 550
Motor vehicle	50 000
Cash at bank	15 500
Furniture	6 000
T. Hewitt, capital	75 000
Gym equipment	2 800
Loan payable	10 350

The accounting student also recorded the following list of liabilities and equity.

Accounts receivable	\$ 10 000
Land	21 600
Mortgage payable	20 000
Cash drawings by T. Hewitt	18 000

Required

- Assuming that the amounts above are correct, prepare a corrected statement of financial position in narrative form.
- Determine the amount of profit (loss) made by the business since its opening, assuming that the owner had invested an **additional \$10 000** into the business just before the amounts were calculated by the accountant.
- Prepare a statement of changes in equity for the period.

(a)

FINESSE FITNESS	
Statement of financial position	
as at 30 June 2021	
ASSETS	
Cash at bank	\$15 500
Accounts receivable	10 000
Motor vehicle	50 000
Furniture	6 000
Equipment	2 800
Land	21 600
TOTAL ASSETS	\$105 900
LIABILITIES	
Accounts payable	18 550
Mortgage payable	20 000
Loan payable	10 350
TOTAL LIABILITIES	\$48 900

NET ASSETS	\$57 000
EQUITY	
T. Hewitt, Capital*	57 000
TOTAL EQUITY	\$57 000

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

(b) Ending capital = Beginning capital + Profit – Drawings + Additional capital contribution

\$57 000 = \$100 000 + Profit – \$18 000 + \$10 000)

Solving for X: Loss = \$000

(c)

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

FINESSE FITNESS Statement of changes in equity for the 3 months ending 30 June 2021	
T. Hewitt, Capital – 1 April 2021	\$0
Add: Capital contribution	60 000
Add: Profit for the period	15 000
	75 000
Less: Drawings during the period	18 000
T. Hewitt, Capital – 30 June 2021	\$57 000

Problem 2.29

Analysing financial statement elements ★ ★ ★ LO1, 3, 5

Jason Vu offers tutoring services to first-year university students. He has set up a sole proprietorship business named JV Tutoring. Jason has collected the following information relating to his business activities at the end of the financial year:

Office supplies	\$1500	Accounts payable	\$1080
Office supplies expense	840	Cash at bank	8445
Telephone expense	255	Computer equipment	8250
Motor vehicle expense	330	Advertising expense	510
Accounts receivable	1500	Tutoring income	9750
Bank loan	7500		

The following information was disclosed from examining Jason's bank statement:

Tutoring receipts	\$ 8250	Payments to suppliers	\$2355
Initial contribution by Jason	3300	Repayment of loan	1500
Bank loan received	9000	Computer equipment purchase	8250

Required

(a) Without preparing formal financial statements, calculate the following:

- (i) profit/loss for the year**
- (ii) total assets at the end of the year**
- (iii) total liabilities at the end of the year**
- (iv) Jason Vu's capital balance at the end of the year**
- (v) net cash inflow/outflow for the year.**

(b) Recalculate the figures you provided in requirement (a), assuming that Jason had withdrawn \$5000 in cash during the year.

(c) Jason cannot deal with the demand for tutoring services. Simon, Jason's friend, is prepared to make a capital contribution and join the business as an owner. Visit www.business.gov.au/planning/business-structures-and-types to read more about choosing a business structure. Advise Jason on the relevant business structure to use and what he needs to do.

(a)

(i) Profit = Income – Expenses

- Total Income = Tutoring Income \$9750.
- Total Expenses = Office supplies expense \$840 + Telephone expense \$255 + Motor vehicle expense \$330 + Advertising expense \$510 = \$1935

Profit = \$9750 – \$1935 = \$7815.

(ii) Total Assets = Office supplies \$1500 + Accounts receivable \$1500 + Cash at bank \$8445 + Computer equipment \$8250 = \$19 695

Total Assets = \$19 695.

(iii) Total liabilities = Bank loan \$7500 + Accounts payable \$1080 = \$8580

Total Liabilities = \$8580.

(iv) Closing Capital = Opening capital \$3300 + Additional contributions \$0 + Profit \$7815 – Drawings \$0 = \$11 115

Closing Capital = \$11 115.

(v) Net Cash Inflow/(Outflow) = Cash flow from operations + Cash flow from investing activities + Cash flow from financing activities + Initial contribution

- Cash flow from operations = Tutoring receipts \$8250 – Payment to suppliers \$2355 = \$5895
- Cash flow from investing activities = Purchase of equipment (\$8250)
- Cash flow from financing activities = Bank loan received \$9000 – Bank loan repayment \$1500 = \$7500
- Net Cash Inflow/(Outflow) = Cash flow from operations \$5895 + Cash flow from investing activities (\$8250) + Cash flow from financing operations \$7500 + Initial contribution \$3300 = \$8445

Net Cash Inflow/(Outflow) = \$8445.

(b)

(i) No change.

$$\text{Profit} = \$9750 - \$1935 = \$7815.$$

(ii) Change.

$$\text{Total Assets} = \text{Office supplies } \$1500 + \text{Accounts receivable } \$1500 + \text{Cash at bank } \$3445 \text{ (i.e. } \$8445 - \$5000) + \text{Computer equipment } \$8250 = \$14\,695$$

$$\text{Total Assets} = \$14\,695.$$

(iii) No change.

$$\text{Total liabilities} = \text{Bank loan } \$7500 + \text{Accounts payable } \$1080 = \$8580$$

$$\text{Total Liabilities} = \$8580$$

(iv) Change.

$$\text{Closing capital} = \text{Opening capital } \$3300 + \text{Additional contributions } \$0 + \text{Profit } \$7815 - \text{Drawings } \$5000 = \$6115$$

$$\text{Closing Capital} = \$6115.$$

(v) Change.

$$\text{Net Cash Inflow/(Outflow)} = \text{Cash flow from operations} + \text{Cash flow from investing activities} + \text{Cash flow from financing activities} + \text{Initial contribution}$$

- Cash flow from operations = Tutoring receipts \$8250 – Payments to suppliers \$2355 = \$5895.
- Cash flow from investing activities = Purchase of equipment (\$8250)
- Cash flow from financing activities = Bank loan received \$9000 – Bank loan repayment \$1500 – Drawings \$5000 = \$2500
- Net Cash Inflow/(Outflow) = Cash flow from operations \$5895 + Cash flow from investing activities (\$8250) + Cash flow from financing activities \$2500 + Initial contribution \$3300 = \$3445

$$\text{Net Cash Inflow/(Outflow)} = \$3445.$$

(c) By establishing a partnership, Jason has the advantage of having more resources through Simon's capital contributions. This additional capital can then be used to expand the tutoring business without the need to source a bank loan. Changing the business structure to a partnership also means that Jason can share the workload of managing the business with Simon, which will be helpful considering Jason is currently overloaded by the demand for tutoring services.

A disadvantage is that Jason will need to share the business' profits with Simon in proportion to what is stipulated in the partnership agreement. A partnership, like sole proprietorship, has unlimited liability. As a partnership is not a separate legal entity, the individual partners (i.e. Jason and Simon) are personally liable for the partnership's debts. In addition, Jason as a partner will be liable for any action or decision that Simon makes on behalf of the partnership. This is called mutual agency.

If Jason decides to set up the tutoring business as a company, he will have all the advantages of a partnership as discussed above (i.e. additional capital and workload sharing), plus the benefit of limited liability. A company is a separate legal entity, which means that the owners (shareholders) are not personally liable for the debts of the company. Jason could also transfer/sell all or part of his shares in the company to Simon or someone else, had he wished not to continue with the tutoring business.

On the other hand, a company is more expensive to set up than a partnership. Financial and tax reporting requirements for companies are also far greater than the reporting requirements for partnership. Therefore, Jason needs to consider the costs and benefits of different business structures and make a decision accordingly.

Problem 2.30

Preparation of financial statements ★ ★ ★ LO3, 4, 5

Yamindi was raised on a farm in the Northern Territory and loves animals. When he finished secondary school, Yamindi had nearly \$5000 in a savings account. He used his savings to start a business venture, a pet warehouse store.

During the month of November 2021, Yamindi located a small building that he could rent for \$100 per month. After transferring \$3000 from his savings account to a business bank account in the name of Animals4Life, he paid cash out of the account for rent and the purchase of supplies. Although he would not keep a full set of accounting records, he decided to deposit all receipts from sales into the bank account and to make all payments by direct debit out of the account. In this way he would have a relatively complete record of his business activities. Yamindi also kept a daily workbook in which he recorded all sales to customers.

On 1 December, Yamindi opened his warehouse to the public. During the first couple of months, he was unusually busy. Needing to make a decision on continuing the operation of the business or to enrol for the first semester at university, Yamindi reviewed his bank account and daily sales book to determine how well he had done. The review disclosed the following:

1. Total cash deposited in the account (including the initial \$3000 deposit) was \$8920.
2. The daily workbook showed that on 31 January 2022 customers owed him \$1000 for goods supplied, which he expected to collect during February.
3. Direct debits had been made out of the account for:
 - Rent payments, \$400 for the months of November to February.
 - The purchase of grooming equipment, \$4500. The equipment cost \$5000 and Yamindi still owed the supplier \$500 on the purchase.
 - Grooming supplies, \$560. Yamindi estimated that the cost of grooming supplies on hand at 31 January was \$160.
 - The payment of electricity bills for the months of November and December, \$600. He had just received his bill for the month of January for the amount of \$350, but had not yet paid it.
 - Advertising paid, \$1216.
 - Withdrawals made by Yamindi to pay for personal expenses, \$1300.

Required

- (a) Prepare an statement of financial performance for Yamindi's Animals4Life for the 3-month period from 1 November 2021 to 31 January 2022.
- (b) Prepare a statement of financial position as at 31 January 2022 and a statement of changes in equity for the 3-month period.
- (c) What other information would you need to determine how well Yamindi had done during the 3-month period?

(a)

YAMINDI'S ANIMALS4LIFE	
Statement of financial performance	
for the three months ended 31 January 2022	
INCOME	
Sales revenue [$\$8920 - \$3000 + 1000$]	\$6 920
EXPENSES	
Electricity expense [$\$600 + \350]	\$950

Rent expense [3 months × \$100]	300	
Advertising expense	1 216	
Supplies expense [\$560 – \$160]	<u>400</u>	
		2 866
PROFIT		<u>\$4 054</u>

(b)

YAMINDI'S ANIMALS4LIFE Statement of changes in equity for the three months ended 31 January 2022	
Yamindi, capital – 1 November 2021	\$3 000
Add: Profit for the three months	<u>4 054</u>
	7 054
Less: Drawings during the month	<u>1 300</u>
Yamindi, capital – 31 January 2022	<u>\$5 754</u>

YAMINDI'S PET WAREHOUSE Statement of financial position as at 31 January 2022			
ASSETS		LIABILITIES	
Cash at bank	\$ 344	Accounts payable	\$ 500
Accounts receivable	1 000	Electricity payable	<u>350</u>
Prepaid rent	100	Total liabilities	850
Grooming supplies	160	EQUITY	
Grooming equipment	<u>5 000</u>	Yamindi, capital	<u>5 754</u>
	<u>\$6 604</u>		<u>\$6 604</u>

(c) Several additional items would be useful to determine how well Yamindi had done in the 3-month period:

1. The useful life of the grooming equipment so that an expense could be determined for depreciation.
2. The amount of interest that Yamindi could have earned on the \$3000 if he had invested it in an alternative manner.
3. The amount Yamindi could have earned during the 3-month period if a job were available.
4. The current value of the assets of the business as a whole on 31 January 2022.

Case studies

Decision analysis

Schutz Building Services financial statements

Schutz Building Services is a fast-growing business in the property services industry. Johan Schutz started the business 3 years ago and has worked hard to establish the firm. Johan has no accounting knowledge and simply keeps his invoices and receipts in a shoebox that he takes to his accountant once a year to be sorted out and turned into financial statements for tax purposes. Johan does not use the financial statements for decision making. So long as he has cash in the bank, Johan is satisfied with how his business is operating. Unfortunately, Johan's accountant has now retired.

Johan is negotiating a significant contract to source supplies and the contractor wants to see his financial statements to ensure that Johan can meet his payments each month. Johan has asked you to prepare financial statements. Based on his last tax return and the contents of his shoebox for this year, you have established the following items.

Cash in the shoebox (with the receipts and invoices)	\$ 500
Cash in the bank account	3 800
Property services provided	550 000
Amounts owed by customers	80 000
Wages paid to employees	150 000
Wages owed to the employees	3 500
Equipment	68 000
Material supplies used	310 000
Material supplies on hand	18 000
Amounts owed to suppliers	30 000
Motor vehicle	32 000
Motor vehicle expenses	5 600
Electricity and telephone expense	4 000
Cash used by Johan for personal expenditure	5 700

Required

- Using the information, provide a statement of financial performance and a statement of financial position in narrative form for Schutz Building Services for the current period.**
- How would the financial statements you produce help the supplier of building materials decide whether or not to trade with Johan? What parts of the financial statements would be positive indicators that Schutz Building Services would pay for supplies on time and what items may cause some concern for the supplier?**

(a)

SCHUTZ BUILDING SERVICES Statement of financial performance For the year ended 30 June		
INCOME		
Service revenue		\$550 000
EXPENSES		
Wages expense	\$153 500	
Supplies expense	310 000	
Motor vehicle expense	5 600	
Electricity and telephone expense	4 000	
		473 100
PROFIT		
		\$76 900

SCHUTZ BUILDING SERVICES Statement of financial position as at 30 June		
ASSETS		
Cash on hand		\$500
Cash at bank		3 800
Accounts receivable		80 000
Supplies		18 000
Motor vehicle		32 000
Equipment		68 000
TOTAL ASSETS		
		\$202 300
LIABILITIES		
Accounts payable		30 000
Wages payable		3 500
TOTAL LIABILITIES		
		\$33 500
NET ASSETS		
		\$168 800
EQUITY		
J. Schutz, Capital		\$168 800
EQUITY		
		\$168 800

(b) The total equity of \$168 800 compared to total liabilities of \$33 500 is a good indication of the net position of the business, i.e. Net assets = Total assets – Total liabilities = \$168 800. Current assets of \$102 300 well exceed the liabilities of \$33 500. The only real concern could be with the level of accounts receivable that may suggest that Johan is not very diligent about collecting amounts from his customers.

The supplier would need more information on the entity's ability to pay for materials in addition to the total net assets.

A statement of cash flows would provide details on cash flows from operations, cash flows from investing activities and cash flows from financing activities. This would assist the supplier in assessing the firm's ability to pay for materials.

Critical thinking

Read the following article on integrated reporting and answer the questions below.

Integrated reporting

A more holistic approach to corporate reporting

- Reports have become more compliance-focused, longer and harder to use due to increasing business complexity, and demands from regulators and investors for more information.
- Thirty years ago, around 20 per cent of a company's value was intangible, while now it's around 80%. As financial statements are mainly based on tangible value, they are no longer able to give investors the full picture.
- As companies increasingly consult with stakeholders, and consider the social and environmental impacts of business, they are producing more reports. Yet there is often no connectivity between the reports, or between financial and non-financial information.

Bringing it all together

Integrated reporting is a more holistic approach to corporate reporting.

It gives report preparers a way to explain to investors how an organisation creates value over time. The goal is to provide investors with the information they need to make more effective capital allocation decisions that facilitate better long-term investment returns.

And an integrated report shows the links between an organisation's strategy, governance and business model.

Source: Chartered Accountants Australia and New Zealand 2019.

Required

- Discuss what you would expect to find in an integrated report.**
- The International Integrated Reporting Council (IIRC) was established in 2010. It launched the International Integrated Reporting Framework in 2013. Describe the concept of value creation in the IIRC Framework.**
- Discuss why integrated reporting has emerged given that companies prepare narrative reports such as the directors' report, management commentary, management's discussion and analysis, and operating and financial review in addition to financial statements.**

Note: A useful resource for students is the FAQs on the IIRC website and the responses below are drawn sourced from this site. See <https://integratedreporting.org/faqs/>

(a) and (b) The International Integrated Reporting Council (IIRC) has an International Integrated Reporting <IR> Framework (the "<IR> Framework"), a principles-based framework for the preparation of an integrated report. This was developed in 2013 and is being refreshed in 2020. According to the IIRC, an integrated report is a concise communication about how an organization's strategy, governance, performance and prospects, in the context of its external environment, lead to the creation of value in the short, medium and long term.

An integrated report provides insight about the resources and relationships used or affected by the organization. These are referred to as 'the capitals'. Capitals are stocks of value on which an organization's business model depends as inputs, and which are increased, decreased or transformed through its business activities and outputs. The capitals are categorized in the <IR> Framework as financial, manufactured, intellectual, human, social and relationship, and natural.

The key content elements expected in an integrated report are:

- Organizational overview and external environment
- Governance

- Business model
- Risks and opportunities
- Strategy and resource allocation
- Performance
- Outlook
- Basis of preparation and presentation

An organization can structure its integrated report however it chooses. A structure often used is around the capitals if it thinks this is the best way to explain its value creation story.

The IIRC recognises that the concept of 'value' is subjective. Accordingly there is no one-size-fits-all definition of 'value creation' in the International <IR> Framework. Organizations – public or private, large or small, for-profit or not-for-profit – are encouraged to develop and express their own interpretation of value. This means considering the needs and interests of key stakeholders, recognizing that the value created for the organization generally relies on the value created for others. This also means understanding how value is created and, in particular, how the business model transforms resources and relationships (or capitals) into products, services, by-products and waste.

To evaluate how successfully an organization delivers value, it should consider the effects of its outputs and activities on each class of capital.

(c) An aim of integrated reporting is to promote a more cohesive and efficient approach to corporate reporting, that draws on various reporting strands and communicates the full range of factors that materially affect an organization's ability to create value over time.

The IIRC notes that a combined report merges a range of existing disclosures, including, for example, the organization's financial report, sustainability report, governance filings and website content. Although the combined report offers a one-stop shop for organizational information, it can also suffer several drawbacks. Whereas each component report had a well-defined purpose, and was prepared with a specific audience and set of information needs in mind, the consolidated report is inevitably larger in volume and broader in scope. In this case, it seems the whole is not greater than the sum of its parts.

By contrast, the content of an integrated report is viewed through a fine lens: value creation over time. The integrated report should be more than merely a summary of information found elsewhere; rather, it makes explicit the connectivity of information in the context of value creation. A feature of an integrated report is its conciseness.

Narrative reports such as the directors' report, management commentary, management's discussion and analysis, and operating and financial review in addition to financial statements, are prepared to supplement the financial statements and provide contextual information and this is done through the lens of management. In contrast, an integrated report goes further than providing context to the financial statements, requiring a broader multi-capitals perspective, over a longer time horizon, to better communicate how value is created.

Given the plethora of reporting requirements and frameworks, an initiative, Corporate Reporting Dialogue, is underway to respond to market calls for greater coherence, consistency and comparability between corporate reporting frameworks, standards and related requirements.

The Corporate Reporting Dialogue's participants are CDP, the Climate Disclosure Standards Board, the Financial Accounting Standards Board (observer status), GRI, the International Accounting Standards Board, the International Integrated Reporting Council, the International Organization for Standardization and the Sustainability Accounting Standards Board.

Communication and leadership

Read the following article and answer the questions below.

Alternative ways to structure your accounting practice

As the case for an alternative business model for accounting firms becomes more compelling, traditional partnership arrangements in public practices are being challenged. Accounting firms are expected to increasingly embrace 'corporatised' structures as they diversify their activities and bring in younger practitioners.

Hayes Knight chairman Greg Hayes CPA acknowledges that historically partnerships have been the most common type of structure used to create what he calls 'tie-ups'. They enable partners to have equal say over decisions and an equal share of profits. However, firm structures continue to evolve. 'We are now seeing a clear shift from the old collegiate partnership style of practice ownership to corporatised structures in various forms,' Hayes says. 'It really comes down to understanding what the practice is about and then putting in a structure that can accommodate where you are now and where you'd like to take it in the future. You don't want to be in a situation where you need to change structures, [which] can bring tax and other consequences.'

Hayes, who advises other accountants, says there are various reasons for the structural shift. 'Part of it is because there is a level of firms bulking up. Firms are getting slightly larger and introducing new partners. The corporatised model is certainly an easier way to manage practices as they grow and it does sit better with Gen Ys [also known as Millennials] looking at opportunities to get into a practice.'

Hayes says a drawback of a partnership is that every time there is a movement in the partnership — for example, the addition of new partners or a partner leaving — the partnership has to be reconstructed and becomes a new or different identity for tax or legal purposes. 'In contrast, a corporate structure has continuity,' he maintains. 'If I sell my shares in a corporate structure, nothing changes at the corporate level. Shares just move from person A to person B. The other issue with a partnership is that partners have joint and several liability. That means their liability is unlimited and there's no proportionate liability. So at the risk management level, a corporate structure would generally be preferable to a partnership. Assuming you haven't done anything dishonest, if anything goes wrong within a corporate structure, the damage is typically contained in the corporate entity. If something goes wrong in a partnership, damages reach through to individual partners, including all their personal assets.'

Hayes says the way a firm is structured also makes a difference when it wants to bring in new people, retain them or plan for succession. In other words, a corporate structure allows different levels of ownership. Newcomers, for example, can be offered a stake in the firm, but it doesn't have to be equal to that of the founding partners.

Source: Efrat 2018.

Required

- (a) Discuss the different forms of ownership a professional service firm can take.
 - (b) Discuss why a professional service firm would consider listing on a stock market.
 - (c) Report on the financial and share price performance of Slater & Gordon, a law firm that listed on the Australian Securities Exchange and Kelly + Partners, an accounting firm that listed on the Australian Securities Exchange.
 - (d) Identify who 'leads' the large accounting firms – PricewaterhouseCoopers (PWC), Ernst & Young (EY), Deloitte, and KPMG.
- (a) Different forms of ownership a Professional Service Firm (PSF) can take include:
- **Partnership:** this is the traditional structure of a PSF. In a partnership, partners are the owners, managers and key professionals providing services to clients. Each partner is personally liable for the partnership's debts and actions taken by other partners (i.e. unlimited liability). Partnership is the most common business structure for PSFs as it is viewed as the most optimal form for managing professionals by balancing the conflicting needs of owners, professionals and clients.

- **Limited liability partnership:** this structure was introduced in response to large legal settlements paid by partnerships, which then became partners' personal liabilities. Limited liability partnerships are similar to traditional partnerships, except that partners in a limited liability partnership has limited personal liability over the partnership's debts.
- **Private corporation:** a private corporation is a company owned by relatively small shareholders, which do not trade the company's shares to public through the market. Rather, the company's shares are traded or exchanged privately.
- **Publicly listed company (PLC):** in the late 1990s, a trend has emerged in which PSFs (mainly accounting firms) moved from traditional partnership structure to PLC. The trend began when thousands of smaller accounting firms were acquired by companies such as American Express and H&R Block. The move towards public ownership for PSFs may be caused by various factors such as growth in size, increasing complexity of partnership, increasing risk of litigation, and growing need for capital.

(b) A main reason for a professional service firm listing on a stock exchange is to access capital for growth. Slater and Gordon was Australia's first publicly listed law firm, listing in 2007, after ownership laws changed to allow people other than lawyers to own a law firm. As noted in its prospectus, the equity raised through listing was to support Slater & Gordon's ongoing acquisition program and an acceleration of the organic growth of the business through national brand building initiatives. The listing also provided an opportunity for key shareholders who had provided pre-listing funding to support an acquisition strategy to sell down part of their holding in Slater & Gordon.

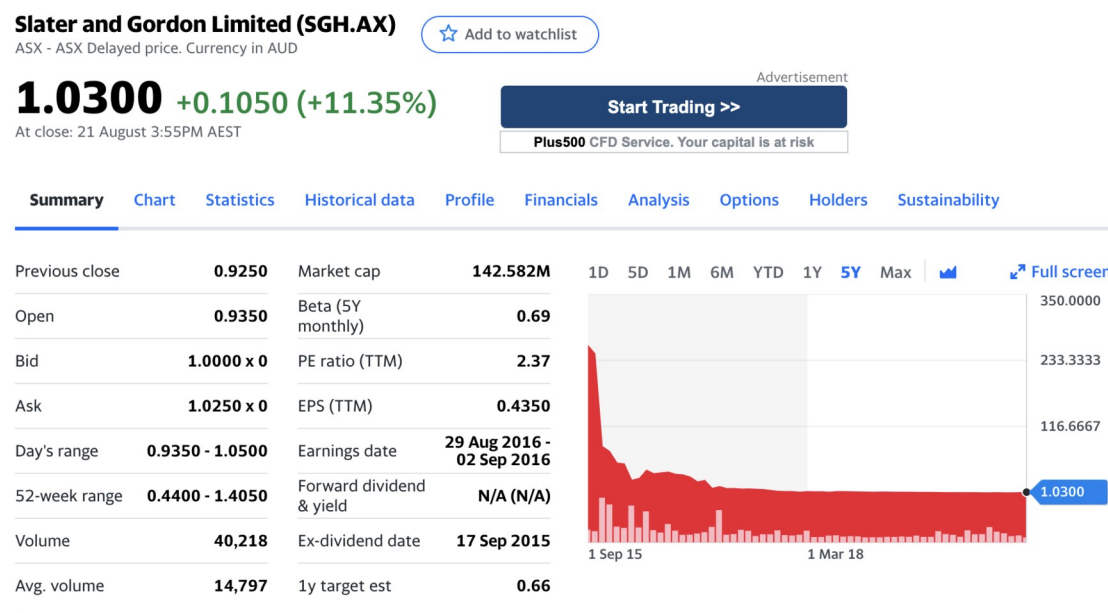
Kelly+Partners listed in 2017. Since 2006 it had grown from two initial start-up accounting business into a network of sixteen owner-driven operating businesses.

Its prospectus notes that the capital raised through listing will increase its financial capacity and flexibility to fund its growth strategy.

(c) A summary of the financial and share price performance of Slater & Gordon:

Extract from Yahoo finance (23 August 2020) <https://au.finance.yahoo.com/quote/SGH.AX/>

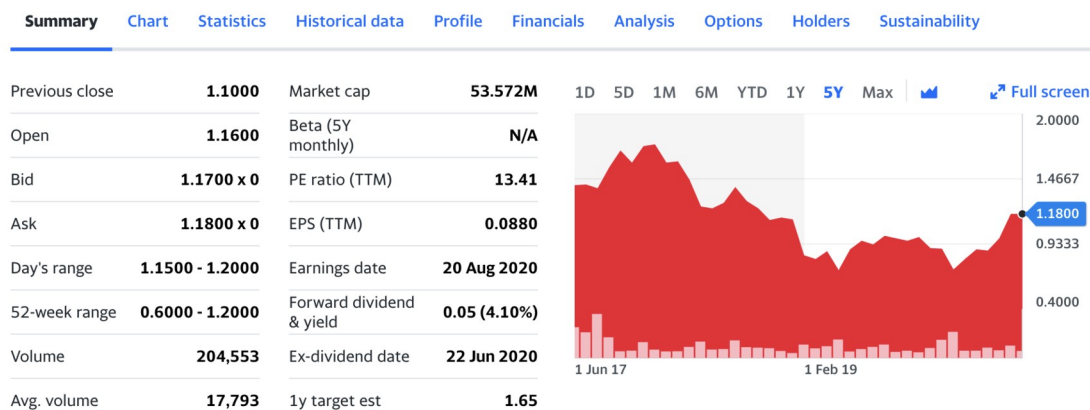
Slater and Gordon's offer price was \$1.00. As at 21 August 2020, the share's 52 week trading range is \$0.44 to \$1.405, with a closing price on 21 August 2020 being \$0.925. For the years 2017, 2018 and 2019, the company's revenues (000s) were \$601459, \$162166 and \$156092, respectively. Its net income for the equivalent periods being \$546549 loss, \$113726 and \$31260.



A summary of the financial and share price performance of Kelly + Partners:

Extract from Yahoo finance (23 August 2020) <https://au.finance.yahoo.com/quote/KPG.AX?p=KPG.AX>

Kelly+Partners offer price was \$1.00. As at 21 August 2020, the share's 52 week trading range is \$0.60 to \$1.20, with a closing price on 21 August 2020 being \$1.10. For the years 2017, 2018 and 2019, the company's revenues (000s) were \$30,198 \$39,469 and \$39,975, respectively. Its net income for the equivalent periods being \$2,790 loss, \$4,383 and \$2,436.



(d) Each of the large professional accounting firms is set up as a network of independent member firms.

KPMG is structured as a global network of independent firms. KPMG International, a Swiss cooperative, is the coordinating entity and is legally separate from each member firm. Each KPMG member firm is separate and legally distinct and generally locally owned and managed. KPMG International does not provide services to clients – the member firms provide services. KPMG International operates with a global board and a global management team. Each member firm (approximately 160) has its own governance and management team structure.

Deloitte is structured similarly to KPMG. Deloitte is made up of member firms that are members of Deloitte Touche Tohmatsu Limited (Deloitte Global), a UK private company limited by guarantee. The member firms are separate and discrete legal entities, primarily organised on an individual country or regional basis, and each operates within the legal and regulatory framework of its particular jurisdiction(s). Individual member firms have access to the skills and knowledge of other member firms, the ability to consult within the Deloitte network, and the benefit of the network's market recognition and reputation. Deloitte Global does not provide services to clients. Deloitte member firm partners are generally the sole owners of their respective member firms. The member firms are primarily organized on an individual country or regional basis, and each operates within the legal and regulatory framework of its particular jurisdiction(s). They are separate and independent firms that have come together to practice under a common brand and shared methodologies, client service standards, and other professional protocols and guidelines.

PwC is the brand under which the member firms of PricewaterhouseCoopers International Limited (PwCIL) operate and provide professional services. Together, these firms form the PwC network. The PwC network is not a global partnership, a single firm, or a multinational corporation. Rather, it consists of firms which are separate legal entities. Firms in the PwC network are members in, or have other connections to, PricewaterhouseCoopers International Limited (PwCIL), an English private company limited by guarantee. PwCIL does not practise accountancy or provide services to clients. Rather its purpose is to act as a coordinating entity for member firms in the PwC network. Member firms of PwCIL can use the PwC name and draw on the resources and methodologies of the PwC network. In addition, member firms may draw upon the resources of other member firms and/or secure the provision of professional services by other member firms and/or other entities. In return, member firms are bound to abide by certain common policies and to maintain the standards of the PwC network as put forward by PwCIL.

EY also operates as a network of member firms which are structured as separate legal entities in a partnership. EY has an Executive and Regions. The Executive includes its global leadership, governance bodies and three geographic areas and oversees EY's global strategy, brand, business planning, investments and priorities. The regions, some 28, are grouped under three geographic Areas: Americas; Europe, Middle East, India and Africa (EMEIA); and Asia-Pacific.

Ethics and governance

Read the following article and answer the questions.

We need to know more about charities to be sure they are helping their cause, not themselves

The case of Eman Sharobeem, the NSW Australian of the Year finalist who stole almost \$800 000 from charitable organisations she ran, highlights major problems with transparency throughout the nonprofit sector. Sharobeem managed two organisations that received funds to help immigrant women. She stole the money over more than 10 years, using it to buy items such as jewellery and a Mercedes. That she was got away with it for so long is indicative of the nonprofit sector's general lack of accountability. The overwhelming majority of organisations make no public financial disclosures. Generally the only ones that do are those required to by law. Only nonprofit groups registered as charities have to lodge information with the sector's regulator, the Australian Charities and Not-for-Profit Commission (ACNC). The degree of information depends on their annual revenue. Only charities earning more than A\$1 million a year must submit audited financial statements.

The commission is now considering increasing this threshold to A\$5 million.

My research suggests this will make publicly available financial disclosures extremely rare. This means donors, volunteers, employees and taxpayers will have even less assurance that charity dollars are being spent efficiently on their intended cause.

The Australian nonprofit sector

Australia's nonprofit sector numbers about 600 000 organisations. Despite the sector's scale and social importance, we don't know much about it. Most information is limited to the 56 000 registered charities that have to submit a basic Annual Information Statement to the charities regulator to be tax-exempt. These charities receive more than A\$140 billion in annual revenue as well as 328 million unpaid hours from almost 3 million volunteers.

Voluntary disclosure is rare

My research on financial disclosures looked at 342 nonprofit organisations. They covered four areas: social services, culture and recreation, education and research, and environment. Just 55 (16%) made their annual reports and financial statements public. Of those, 52 had annual revenues of at least \$A1 million. Just three charities earning less than A\$1 million made their financial statements voluntarily public. This suggests most nonprofit organisations are unlikely to make financial disclosures if not required to do so.

Differences between sub-sectors

Among those making financial disclosures, there is no consistency in approach taken. This was particularly glaring among social services organisations, which made up 34 of the 52 organisations in my study earning more than A\$1 million a year.

This graph shows the best and worst disclosure scores within the four sub-sectors.

The score indicates the extent of voluntary financial disclosures above and beyond what is required by law. These include the amount of grants received, total donation revenue, program expenses, administration expenses, management expenses and the value of volunteer contributions.

Charities' inconsistent disclosures

Best and worst performers in charity sub-sectors by extent of voluntary disclosures made.



Each organisation received a score of one for each voluntary disclosure within its published financial statement.

The lack of consistency illustrates the failure of the charity regulator's reporting requirements to create a level playing field. For example, a 'basic religious charity' of any size does not have to answer financial questions or submit financial reports.

Elaborate narratives, limited financial disclosures

Most crucially, there is no obligation under the existing reporting standard for any organisation to specifically disclose what it spends on its core social mission. So while most of the 52 organisations provided elaborate narratives about their social mission, few disclosed the actual amount of money spent on their mission. As a result, it's hard for donors to assess how many cents in the dollar go to the cause they want to support.

Public's right to greater transparency

These limited, inconsistent and vague disclosures are an impediment to the nonprofit sector. It is difficult to assess if an organisation is deploying its resources consistent with its mission.

Charitable nonprofit organisations are eligible for many tax benefits and government subsidies. These benefits should oblige them to put their financial records in the public domain.

What needs to be done

Rather than making financial disclosure even rarer, the Australian Charities and Not-for-Profit Commission should make three key regulatory changes.

First, there needs to be a reporting system where all nonprofit organisations have to make minimal financial disclosures of funds received and spent. This should be irrespective of their size or status.

Second, there needs to be a standardised approach to disclosures, so anyone can know what an organisation spends, and how much goes to its core social mission rather than other costs such as fundraising. This would enable the performance of organisations with similar missions to be compared.

Third, the nonprofit regulator needs to create a platform to make all financial disclosures easily accessible to the public.

These reforms are crucial for people to have confidence in the nonprofit sector and the organisations to which they donate.

Source: Ghoorah 2018. Originally published on *The Conversation*.

Required

- Identify the stakeholders of charities.
- Discuss the financial information you would like to know about the charities that you donate to?
- Summarise the outcomes of the Independent Commission Against Corruption's (ICAC) investigation of Eman Sharobeem.
- Suggest what the Australian Charities and Not-for-Profit Commission (ACNC) could do to enhance financial disclosures of charities.
- Charities must meet the ACNC's Governance Standards to be registered and remain registered with the ACNC. Summarise these governance standards.

(f) Each year the ACNC publishes the Australian Charities Report, a comprehensive record of the charity sector, produced from the latest data from charity Annual Information Statements. Read the most recent report and prepare a fact sheet summarising financial and governance information related to the charity sector.

(a) The stakeholders of charities include:

- Employees and volunteers
- Members of the organisation
- Investors/**grant makers**/lenders/donors
- Customers/service users and families
- The local community
- Local voluntary organisations
- Other charities
- The local authority
- Government
- Beneficiaries
- Regulator (including Tax Office)

(b) Donors to charities may be interested in the following financial information:

Funds received and spent

- Cash balance (excessive is not necessarily good as the charity may not be dispersing the funds in a timely manner)
- Operating costs and percentage spent on non-program expenses
- Remuneration of management and board members

(c) The ICAI found that Ms Sharobeem had corruptly misappropriated nearly \$800,000 of public funds from the Immigrant Women's Health Services and the Non-English Speaking Housing organisation. The misappropriation occurred through

Ms Sharobeem using fake names to claim extra salaries for her and her sons, claiming expenses she was not entitled to, doctoring receipts, reporting fake enrolments in her courses to earn more money from funding bodies than entitled and charging personal costs such as garden renovations and pest control to charity.

(d) The article suggests that the ACNC should do the following to enhance the financial transparency of the not-for profit sector. First, it should require minimum financial disclosures by all not-for profit organisations. Presently, the requirement for disclosure is size-tested with only larger organisations required to report. Second, the ACNC should standardise the disclosures required. A standardisation would enable greater comparability (across organisations and within organisations over time). The third suggestion is that the financial information should be readily accessible to stakeholders.

(e) The governance standards of ACNC are a set of core, minimum standards that deal with how charities are run (including their processes, activities and relationships. A charity needs to be able to demonstrate the steps that it has taken to comply with the standards (considering factors such as its size, purpose and activities). There are five governance standards:

- Standard 1: Purposes and not-for-profit nature. Charities must be not-for-profit and work towards their charitable purpose. They must be able to demonstrate this and provide information about their purposes to the public.
- Standard 2: Accountability to members. Charities that have members must take reasonable steps to be accountable to their members and provide them with adequate opportunity to raise concerns about how

the charity is governed.

- Standard 3: Compliance with Australian laws. Charities must not commit a serious offence (such as fraud) under any Australian law or breach a law.
- Standard 4: Suitability of Responsible Persons. Charities must take reasonable steps to:
 - be satisfied that its Responsible Persons (such as board or committee members or trustees) are not disqualified from managing a corporation under the Corporations Act 2001 (Cth) or disqualified from being a Responsible Person of a registered charity by the ACNC Commissioner, and
 - remove any Responsible Person who does not meet these requirements.
- Standard 5: Duties of Responsible Persons. Charities must take reasonable steps to make sure that Responsible Persons are subject to, understand and carry out the [duties](#) set out in this Standard.

See <https://www.acnc.gov.au/for-charities/manage-your-charity/governance-hub/governance-standards>

(f) At the time this solution was prepared, 2018 was the most recent ACNC report.

<https://www.acnc.gov.au/tools/reports/australian-charities-report-2018>

There is an annual information set that can be downloaded into an excel file for students to explore. Instructors could set information for students to extract and summarise.

The key findings from the analysis of more than 48,000 charities were:

- In the 2018 reporting year charity revenue grew by over 6%, significantly more than the Australian economy in the same period (1.9%).
- Australia's charities, overall, operated at a surplus, supported by substantial assets.
- Revenue was up by \$9.3 billion, from \$146.1 billion in 2017 to \$155.4 billion in 2018.
- Donations rose to \$10.5 billion, an increase of \$600 million from the previous year.
- The largest charities (0.4% of all charities) reported revenue of over \$100 million.
- Assets increased by \$18.7 billion to \$323 billion.
- Almost half of charity revenue came from Government (47%), and over a third (34%) was generated by providing goods and services (some of which are subsidised by government funding).
- Most charities were small (66%) generating less than \$250,000 in revenue, followed by large (18%) with revenue of over \$1 million, and medium (16%) with revenue of \$250,000 or more but under \$1 million.
- Charities employed more than 1.3 million people.
- Volunteer numbers across Australia's charity sector increased to 3.7 million, up 12% on the previous year's figure of 3.3 million.
- Half of all charities operated without any paid staff.
- Charities spent \$81.1 billion on employee expenses, up 8% on the previous year's figure of \$74.8 billion.
- The most common activities for charities included religious activities, primary and secondary education, grant-making, social services and aged care services.

Financial analysis

Apple Inc.

Refer to the latest financial report of Apple on its website, <http://investor.apple.com>. Answer the following questions using the consolidated statement of financial position and notes to the consolidated financial statements.

Required

- (a) State the accounting equation for Apple in dollar figures at the end of the reporting period for the end and beginning of the last reporting year. Comment on what this reveals about Apple's financing policy.**
- (b) Explain why the change in total assets equals the change in total liabilities plus the change in total equity.**
- (c) State Apple's profit (loss) for the last reporting year.**
- (d) Determine Apple's net increase (decrease) in cash flows for the last reporting period in aggregate and by operating, investing and financing categories.**
- (e) Explain how Apple could apply the principle of materiality of an item of financial information when preparing financial reports.**
- (f) Apple is identified as a company that ranks highly on the Global Reputation Index. Research and report on the factors that contribute to Apple's high ranking in this index.**
- (g) Corporate reporting is evolving and is more than reporting on profits. Reporting on the entity's performance related to people and the planet is increasingly important and included within the annual report or as a stand-alone report. List examples of such reporting by Apple.**

The solution below is based on the Apple Inc. Annual Report for the year ending 28 September 2019, available on Apple's website: <http://investors.apple.com>.

(a) Accounting equation for Apple as at 28 September 2019 (in \$millions):

Assets = Liabilities + Equity

$$\text{▪ } \$338\,516 = \$248\,028 + \$90\,488$$

Accounting equation for Apple as at 29 September 2018 (in \$millions):

Assets = Liabilities + Equity

$$\$365\,725 + \$258\,578 + \$107\,147$$

The accounting equation reflects an entity's financing policy. That is, an entity's assets can be funded by either creditors (i.e. liabilities) or owners (i.e. equity). Looking at the accounting equation for Apple as at the end of September 2019, it can be seen that a larger proportion of Apple's assets is funded by liabilities than by the owners (shareholders).

At the end of September 2019, the debt to assets ratio, calculated as total liabilities divided by total assets, is 73 percent. This shows that 73 percent of Apple's assets were funded by creditors through borrowings and the remaining 27 percent is funded by shareholders through equity.

At the end of September 2018, the debt to assets ratio was 71%. Hence, the ratio has remained at a similar level.

(b) The \$27 209 million decrease in Apple's total assets as at end September 2018 and 2019 less the \$10 550 million decrease in Apple's total liabilities as at end September 2018 and 2019 equals the \$16 659 million change in total equity. 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.

(c) Apple's profit (referred to as 'net income' in the Consolidated Statement of Operations on p.30 of the annual report) for the period ending 28 September 2019 amounted to \$55 256 million.

(d) Information about Apple's cash flows can be found in the Consolidated Statement of Cash Flows on p.33 of the annual report.

Apple's net decrease in cash flows for the year ending 28 September 2019 was \$24 311 million. This can be disaggregated into:

- \$69 391 million cash generated by operating activities. The largest cash flows under operating activities were contributed by customers through sales income.
- \$45 896 net cash inflow associated with investing activities, with largest cash inflows and outflows from maturities and sales of marketable securities.
- \$90 976 cash used in financing activities, mainly from share repurchases.

(e) The concept of materiality relates to the significance of financial information in the financial report. Information is material if the omission or misstatement of that particular information will influence users in making economic decisions. The application of materiality differs between entities, as what is considered material for one entity might be considered immaterial for another entity. Thus, assessing which information is material requires considerable professional judgment.

In applying the principle of materiality of financial information in its financial statements, Apple needs to consider which information is relevant to users in the context of economic decision-making. Although the assessment of what is material entirely depends on each entity and there is no accounting standard that provides quantitative guidelines to determine materiality, Apple could use some common rules in assessing materiality such as:

- nature of the information (for example, information about Apple's plan to discontinue one of its major products is material by nature in understanding the company's scope of operations);
- percentage of profit before tax (e.g. an omission or error greater than five percent of profit is more likely to be considered as material);
- percentage of total assets;
- percentage of total revenue;
- percentage of equity.

(f) According to the 2020 Global Corporate Reputation Index, Apple is included in the top 100 companies with the strongest corporate reputations in the index. Information on The Global Corporate Reputation Index is available at: <https://www.reputationinstitute.com/thought-leadership/global-reprtrak-100>

The Global Reputation Index measures the reputation of over 5,000 companies in six countries based on consumer interviews regarding company qualities. The two sets of attributes identified in the index that drives corporate reputation are performance (i.e. perceived success of a company's products or services) and citizenship (i.e. a company's works in being a good corporate citizen such as adoption of environmentally friendly policies or sponsorship of charity organisations and community events). The reputation standing reflects stakeholders perceptions of what a company stands for and if its actions are congruent with its values.

Some factors that might contribute to Apple's high ranking in this index include:

- The company's financial success in generating profit.
- People come first mandate.
- A safe and respectful workplace.
- Educational programs that offers workers to take free classes on a range of subjects, such as finance, computer, and English.
- A supply chain working to protect the planet.
- Worker protection against discrimination on the basis of race, color, age, gender, sexual orientation, ethnicity, disability, religion, political affiliation, union membership, national origin, and marital status, and prohibits pregnancy tests or medical tests for discriminatory use.
- Zero-tolerance policy on underage labour.
- Prevention of excessive work hours.
- Requirements for Apple's suppliers to provide a safe work environment, to eliminate physical hazards wherever possible, and to establish administrative controls that reduce risk.
- Requirements for Apple's facilities to hold up-to-date permits for air emissions, wastewater discharge, hazardous waste disposal, X-ray equipment, and boundary noise.
- Strict policies on ethical conducts when dealing with workers, suppliers and customers, with violations of these conducts resulting in immediate termination with suppliers.

Source: Apple Supplier Responsibility Progress Report.

(g) Examples of reporting on people and the planet by Apple are :



https://www.apple.com/au/supplier-responsibility/pdf/Apple_SR_2020_Progress_Report.pdf