SOLUTIONS TO END-OF-CHAPTER MATERIAL

End-of-chapter numerical problems have been provided to illustrate the concepts explained in the chapter. The end-of-chapter exercises will facilitate better understanding of the conceptual framework of basic financial accounting. Theoretical and numerical exercises based on the chapter learning objectives are provided for practice and clarity.

Exercises

1 Calculate profit or loss LO2

Sarah's Science Service generated $14 000 in revenue in the month of January. Salaries were $3500 for the month and supplies used were $2000. Additionally, Sarah incurred $500 for advertising during the month.

Required

Calculate Sarah's profit or loss for the month of January.

Solution

14 000 – 3 500 – 2 000 – 500 = 8 000

Teaching tip: Profit is the most important aspect of a business. In simple terms, it is revenue minus expenses; but it becomes more complex when we have to determine what the revenues and expenses are. The first complexity is cash versus accrual accounting. From the outset, we recognise revenues when they are earned and expenses when they are incurred, even though the corresponding cash flow may occur before or after the fact. Sometimes it happens simultaneously, but it does not have to.

Helpful hint for students: The income statement reports the company's Revenues less Expenses. Revenues are earnings from doing business (not contributions from the owners or borrowings). Expenses are costs of doing business, not repayments to people you borrowed from or dividends (drawings) paid to owners.

2 Calculate equity LO3

A company reports assets of $100 000 and liabilities of $60 000.

Required

Calculate the company's equity.

Solution

$40 000

Teaching tip: It is the basic accounting equation:

A	= L	+ E
100 000	60 000	40 000

Helpful hint for students: The things you 'own' (assets) have come from money borrowed (liabilities) and the money you have put in, or contributed (the equity).

Or, to think of it another way: you are worth the difference between what you own less what you owe.

A	= L	+ E
100 000	60 000	40 000

3 Identify accounting principles LO2, 3

Each of the following statements is an application of the revenue recognition principle, the matching principle or the cost principle.

i A company records Equipment for the purchase price of $10 000 although the suggested retail price was $13 000.

ii A company receives $2000 for a service to be performed but records only $1000 as Service Revenue because it earned only half in the current period.

iii A company pays $6000 for insurance but uses only $4000 during the period. Therefore, it records only $4000 as Insurance Expense.

Required

Identify which principle relates to each statement.

Solution

i Cost principle. We record items at cost. This saves the subjective opinion of what they are 'worth'. It may also include conservatism in not anticipating profits.

ii Matching principle or time period concept. We record revenue when earned and match it to the period in which it was earned – I would not be too concerned about having a single correct answer, but it is useful to see how these concepts work together.

iii Matching principle/time period concept. As above, this applies for both revenues and expenses.

4 Calculate retained earnings LO4

At the beginning of the year, a company has retained earnings of $175 000. During the year, the company earns $110 000 of profits and distributes $30 000 in dividends.

Required

Calculate the company's retained earnings at year end.

Solution

$175 000 + 110 000 – 30 000 = 255 000

Teaching tip: Opening balance of retained earnings + Profits – Dividends = Closing retained earnings.

Retained earnings are earnings (profits) that have been retained (kept in the business). Dividends are profits that have been distributed (not retained).

Helpful hint for students:
The purpose of accounting is to identify, measure and communicate economic information about a particular entity to interested users. To accomplish this, accountants make the following four assumptions:
a. economic entity
b. time period
c. monetary unit
d. going concern.

Think about how each assumption affects accounting:
- Why the monetary unit assumption? If an economic activity cannot be expressed in dollars, then it is not recorded in the accounting system.
- Why the economic entity assumption? It allows a user to examine a company's accounting information without concern that the information includes the personal affairs of the owner(s).
- Why the time period assumption? Business owners and other interested parties usually do not want to wait long before they receive information on how a business is doing.
- Why the going concern assumption? Unless there is evidence to the contrary, most companies are assumed to be going concerns. Those that are not going concerns are often in the process of liquidation.

5 Calculate cash flows LO5

A company starts the year with $15 000 in cash. During the year, the company generates $80 000 from *operations*, uses $56 000 in *investing* activities and uses $38 000 in *financing* activities.

Required

Calculate the company's cash at year end using a basic cash flow format.

Solution

Beginning balance	$15 000
Cash flows from operating	80 000
Less: cash flows to investing	(56 000)
Less: cash flows to financing	(38 000)
Net change in cash – increase	1 000
Ending cash balance	$16 000

Teaching tip: Cash flows from operations and profits are different, and at this stage it may be difficult for students to understand why. The simplest example may be to explain that, while revenue earned by them today may be their wages from the job they work, they don't get the money until pay day – so revenue and cash inflow from operations are different.

Helpful hint for students: Cash flows are divided into three areas: **operations** (which usually produce cash – but cash flows from operations are not profit); **financing** (where we get our money from – but it may result in a cash outflow because of loan repayments or payments like dividends to owners); and **investing** (buying long-term assets).

6 Identify accounting assumptions and qualitative characteristics LO1, 6

Consider the following independent scenarios:

i Peter's Pizza has been in business for 25 years. All of its operations are profitable, and the accountants believe that the company will continue to operate into the foreseeable future.

ii A bank used the information presented in Fiona's financial statements to determine if it should extend a $300 000 loan to Fiona. The information in the financial statements made a difference in the bank's lending decision.

iii The manager of Martha's Antiques does not like to change accounting procedures because it hinders her ability to make year-to-year comparisons.

iv Sarah, owner of Abbotsford Animal Accommodation, informs her accountant that she does not want to review any accounting issue that is smaller than 1 per cent of profits.

v Matthew paid $10 000 for inventory which could now sell for only $6000, he recognises this decrease while not recognising the increase in land from $200 000 to $300 000.

vi Sue has two businesses, she keeps separate records for both businesses and does not combine them with her personal financial matters.

Required

Identify the accounting assumption or qualitative characteristic that relates to each scenario.

Solution

i. Going concern. (Assume a company will continue to operate into the foreseeable future.)
ii. Relevance. (The information is likely to influence or change a decision.)
iii. Consistency. (Allows current results to be compared with past results. A good analogy is world-record runners having to record their times with minimum wind assistance, since if the wind is blowing too strongly, they will not be consistent with past attempts and records.)
iv. Materiality. (Linked to relevance – if the amount is so small that it will not influence a decision, then it may be ignored.)
v. Prudence or conservatism means we recognise potential losses but not potential gains.

vi. Entity concept, where we not only separate the business from the owner/s but also one business from the other so we can determine the financial performance of each business and make decisions for each business.

Teaching tip: Accounting information must possess certain qualitative characteristics to be considered useful. Do not get consistency and comparability confused. Consistency applies to the same company; comparability applies to different companies.

With materiality, we must always be careful of a number of small amounts being ignored (and adding up to a larger amount that is relevant). One of the great 'urban myth' frauds is about the employee who took a fraction of every cent paid on interest on accounts. This was supposed to work because when there are millions of accounts paying interest each day, you only need .25 of a cent from 10 million accounts to give $25,000 a day – material for most of us.

Helpful hint for students: Consider how each characteristic impacts accounting.

- Going concern does not mean the company will continue forever (or even to the end of the next year, if major unexpected events – a global financial crisis or a natural disaster – happen that remove the basis of the business). It is the basis of preparing the financial statements. Take a pair of your shoes – what could they sell for compared to what they are worth to you (as a going concern)?
- Relevance: Information should have predictive or feedback value, and should be timely.
- Materiality: When an amount is small enough, normal accounting procedures are not always followed.
- Conservatism: An entity should choose accounting techniques that guard against overstating revenues or assets.
- Comparability: Entities must disclose the accounting methods that they use so that comparisons across companies can be made.

7 Accounting terms LO2, 3

Consider the following information:

Item	Appears on	Classified as
Salaries expense		
Equipment		
Cash		
Accounts payable		
Accounts receivable		

Buildings		
Contributed capital		
Retained earnings		
Interest revenue		
Advertising expense		
Sales		
Unearned revenue		

Required

Classify each of the items above according to:

a whether it appears on the income statement (Y/S) or balance sheet (B/S)

b whether it is classified as a revenue, expense, asset, liability or equity.

Solution

Item:	Appears on:	Classified as:
1 Salaries expense	Income statement	Expense
2 Equipment	Balance sheet	Asset
3 Cash	Balance sheet	Asset
4 Accounts payable	Balance sheet	Liability
5 Accounts receivable	Balance sheet	Asset
6 Buildings	Balance sheet	Asset
7 Contributed capital	Balance sheet	Equity
8 Retained earnings	Balance sheet	Equity
9 Interest revenue	Income statement	Revenue
10 Advertising expense	Income statement	Expense
11 Sales	Income statement	Revenue
12 Unearned revenue	*Balance sheet*	*Liability*

Teaching tip: Remind students that the account 'retained earnings' also appears on the statement of retained earnings. Contributed equity or Contributed capital (useful to know different companies report the same thing using different names) is a part of equity, since it represents resources that investors contribute to a business in exchange for an ownership interest. Revenues are increases, and expenses are decreases in resources, resulting from the sale of goods or the provision of services. An asset is a resource of a business; a liability is an obligation of a business; and equity is the difference between a company's assets and liabilities, which represents the remaining share of assets for the owners. The hard one is the last one, Unearned revenue (that is why it has been put in italics) – although it has the word 'revenue' it is in fact a liability because it is UNEARNED.

Helpful hint for students: Contributed capital (Contributed equity) is not a revenue account. Revenue accounts normally include the word revenue, income, or earned in the account name, but can also be a single word such as sales. Expenses normally include the word expense in the account name, and occasionally can represent several accounts such as cost of sales. Liabilities normally include the word payable. The hard one is the last one, Unearned revenue – although it has the word 'revenue' it is in fact a liability. We start with the simplest account titles but in the first few weeks of learning accounting you cannot expect to have the detailed knowledge to understand everything in the CSL Financial Statements.

8 Classify cash flows LO5

A company entered into the following cash transactions:

i Cash paid to suppliers

ii Cash received from issuing new shares

iii Cash paid to purchase a new office building

iv Cash paid in dividends to owners

v Cash received from customers

vi Repaying a bank loan

vii Cash received from the sale of land

viii Company income tax paid.

Required

Indicate the section of the cash flow statement in which each item would appear: operating activities (O), investing activities (I) or financing activities (F).

Solution

Item	Section of cash flow statement	Teaching tip: why?
Cash paid to suppliers	Operating	*Cash paid for operations*
Cash received from new shares	Financing	*Cash generated from owners*
Cash paid for new building	Investing	*Cash paid for assets (other than current assets)*
Cash paid for dividend	Financing	*Cash paid to owners who originally finance the business through buying shares*

Cash received from customers	Operating	*Cash generated from operations*
Repaying a bank loan	Financing	*Borrowing is financing, repayment is also (negative) financing*
Cash received from the sale of land	Investing	*Buying land is investing, sale of land is (negative) investing*
Company income tax paid	Operating	*Cash paid for operating – tax is an operating expense*

Teaching tip: The statement of cash flows is a financial statement that reports an entity's sources (inflows) and uses of cash (outflows) over a specific period of time. Profits that are distributed to owners are called dividends. Remember that dividends are not an expense of the company, and are therefore not included in cash flow from operations. They are simply a distribution of company assets to owners.

Helpful hint for students: The buying and selling of assets other than current assets, such as land, building, and equipment, are considered to be investing activities. Think of this as the company 'investing in itself'.

9 Accounting terms LO2, 3, 4, 5

Consider the following information:

i Revenues during the period

ii Supplies on hand at the end of the year

iii Cash received from borrowings during the year

iv Total liabilities at the end of the period

v Dividends paid during the year

vi Cash paid for a building

vii Cost of buildings owned at year end

viii Profits for the period (on two statements)

ix Closing balance of retained earnings (on two statements).

Required

Indicate whether you would find each of the above items on the income statement (Y/S), the balance sheet (B/S), the statement of retained earnings (SRE) or the cash flow statement (CFS).

Solution

i. Y/S

ii. B/S
iii. CF
iv. B/S
v. SRE
vi. CF
vii. B/S
viii. Y/S & SRE
ix. SRE & B/S

Teaching tip: Each financial statement reports specific types of accounts or activity. An income statement is a financial statement that shows a company's revenues and expenses over a specific period of time. A balance sheet reports a company's assets, liabilities and equity. The statement of retained earnings reports the change in a business's retained earnings over a specific period of time, so it reports dividends and net income (or loss). A statement of cash flows reports a company's cash inflows and outflows from its operating, investing and financing activities. Remind students that the account 'retained earnings' also appears on the statement of retained earnings. Contributed equity (capital or even ordinary shares) is part of equity, since it represents resources that investors contribute to a business in exchange for an ownership interest.

Helpful hint for students: The income statement is '**R**eally **E**asy', since it reports the company's **R**evenues and **E**xpenses. Expenses are costs of doing business. Assets are items of value and worth; liabilities are what a company owes; and equity is what is left over for the owners. The statement of cash flows reports the sources of cash and the payments of cash during a period. Remember that, since cash is in the name of the statement, all transactions must directly relate to the inflow or outflow of cash. Sales is a revenue account. An expense is a cost of doing business; therefore, cost of sales is reported on the income statement.

10 Financial statements LO2, 3, 4, 5

Listed below are questions posed by various users of a company's financial statements:

User	Questions	Financial statement
Shareholder	How did this year's sales figures compare with last year's sales figures?	
Banker	How much in borrowings does the company currently owe?	
Supplier	How much does the company owe its suppliers in total?	
Shareholder	Did the company pay any dividends during the year?	

Advertising Agent	How much advertising did the company incur in order to generate sales?
Banker	What was the company's total interest cost last year?

Required

Fill in the blanks with the financial statement(s) (i.e. income statement, balance sheet, statement of retained earnings and/or cash flow statement) the user would most likely use to find this information.

Solution

Shareholder: (CI) Income statement (income statement). The shareholder would look at the revenues on the income statement to determine how this year's sales figures compared with last year's sales figures.

Banker: (FP) Balance sheet (balance sheet). The banker would look at the liabilities on the balance sheet to find out how much debt the company had on its books.

Supplier: (FP) Balance sheet. The supplier would look at the liabilities on the balance sheet to determine how much the company owed its suppliers in total.

Shareholder: (CE/CF) Statement of retained earnings. The shareholder could find the amount paid for dividends shown as a reduction on the statement of retaining earnings. Also, the shareholder could find this amount on the statement of cash flows under 'Cash flows from financing'.

Advertising Agent: (CI) Income statement. The advertising agent could look under the expenses on the income statement to find out how much was used in advertising to generate sales.

Banker: (CI/CF) Income statement. The banker could look under expenses on the income statement to find out what the company's total interest cost was last year. Also, the banker could find this amount on the statement of cash flows under 'Cash flows from operations'.

Teaching tip: Each financial statement reports specific types of accounts or activity. An income statement is a financial statement that shows a company's revenues and expenses over a specific period of time. A balance sheet reports a company's assets, liabilities and equity. The statement of retained earnings reports the change in a business's retained earnings over a specific period of time, so it reports dividends and net income (or loss).

Helpful hint for students: The income statement is '**R**eally **E**asy', since it reports the company's **R**evenues and **E**xpenses. Assets are items of value and worth, liabilities are what a company owes, and the equity is what is left over for the owners.

11 Profit or loss and retained earnings LO2, 4

Hazelwood reports the following as of 30 June:

Revenues	$99 000
Beginning retained earnings	22 000
Expenses	88 000
Dividends	1 000

Required

Calculate profit or loss and ending retained earnings for the financial year ending 30 June.

Solution

Profits = Revenue – Expenses
Profits = $99 000 – $88 000
Profits = $11 000

Retained earnings = Beginning retained earnings + Profits (or minus loss) – Dividends
Retained earnings = $22 000 + $11 000 – $1 000
Retained earnings = $32 000

Helpful hint for students: Profits increase retained earnings; losses decrease retained earnings; dividends reduce retained earnings (dividends are earnings that are not retained).

12 Balance sheet equation LO3

Consider the following independent situations:

i Kelly contributes $80 000 to the business and the business has total assets of $200 000. How much are liabilities?

ii Tran starts the year with $50 000 in assets and $40 000 in liabilities. Profit for the year is $12 500 and no dividends are paid. How much is Tran's equity at the end of the year?

iii Evans doubles the amount of her assets from the beginning to the end of the year. At the end of the year, liabilities are $50 000 and equity is $30 000. What is the amount of Evan's assets at the beginning of the year?

iv During the year the liabilities of Hudson Company triple. At the beginning of the year, assets were $40 000 and equity was $20 000. What is the amount of liabilities at the end of the year?

Required

Use the accounting equation to answer each of the independent questions above.

Solution

i. ($200 000 Assets = $? Liabilities + $80 000 Equity)
Liabilities = $120 000 (simply to make the equation balance)

ii. Beginning of year: ($50 000 Assets = $40 000 Liabilities + ? Equity)
Equity = $10 000
Beginning equity $10 000 + $12 500 profits – $0 div. = $22 500 ending equity

iii. End of year: (? Assets = $50 000 Liabilities + $30 000 Equity)
Assets= $80 000
If Tania Ltd doubled its assets during the year, then it must have started the year with $40 000 ($80 000 ÷ 2 = $40 000)

iv. Beginning of year: ($40 000 Assets = ? Liabilities + $20 000 Equity)
Liabilities = $20 000

If liabilities tripled during the year, then Hudson has $60 000 in liabilities at the end of the year. ($20 000 × 3 = $60 000)

Teaching tip: The relationship between assets, liabilities and equity is represented by the accounting equation: Assets = Liabilities + Equity. Using your knowledge of the accounting equation, you can solve for the missing amounts by making it a simple mathematical problem.

Helpful hint for students: The accounting equation (Assets = Liabilities + Equity) is like any mathematical equation. It will always be equal (or balance). It can be rewritten in several forms, such as: Assets – Liabilities = Equity, or Assets – Equity = Liabilities

13 Statement of retained earnings LO4

Chan Company's retained earnings on 1 July is $245 800. The following information is available for the first two months of the financial year:

	July	August
Revenues	$80 000	$102 000
Expenses	85 000	80 000
Dividends	0	7 000

Required

Prepare the retained earnings section of the Statement of Changes in Equity for the *month* ending August 30.

Solution

First, calculate ending retained earnings at 31 July, which is equal to beginning retained earnings at 1 August.

1 July	Retained earnings	$245 800
	Add: Profits($80 000 – $85 000)	(5 000)
	Less: Dividends	0
31 July	Retained earnings	$240 800

Chan Company

Statement of retained earnings

For the month ending 31 August

1 Aug.	Retained earnings	$240 800
	Add: Profits*	22 000
	Less: Dividends	(7 000)
31 Aug.	Retained earnings	255 800

*Profits = Revenue – Expenses = $102 000 – $80 000 = $22 000

Teaching tip: The financial statements are interrelated. The income statement is prepared first. Use the profit or loss from the income statement when preparing the statement of change in equity (retained earnings).

Helpful hint for students: The income statement is '**R**eally **E**asy', since it reports the company's **R**evenues and **E**xpenses. Expenses are costs of doing business. A simple way to remember the statement of retained earnings is 'BIDE': **B**eginning retained earnings, plus net **I**ncome (profit or less loss), less **D**ividends, equals **E**nding retained earnings.

14 Links between financial statements LO2, 3, 4

Below are incomplete financial statements for Jasmine:

Balance sheet		Income statement	
Assets		Service revenue	$90 000
Cash	$ 8 000	Salaries expense	(c)
Inventory	22 000	Electricity expense	20 000

Total assets	$70 000	Profit	$ (d)
Liabilities			
Accounts payable	$ 7 000	**Statement of retained earnings**	
Equity		Retained earnings, beginning balance	$20 000
Contributed capital	(a)	Profit	(e)
Retained earnings	(b)	Dividends	10,000
Total liabilities & equity	$ 70 000	Retained earnings, ending balance	$60 000

Required
Calculate the missing amounts (not necessarily in alphabetic order).

Solution

Tip: work this problem in reverse. Begin with (e).

(e)

	Retained earnings, beginning balance	$20 000
+	Profits	**(e) 50 000**
–	Dividends	10 000
=	Retained earnings, ending balance	$60 000

(d) Profits or Loss = $50 000

(c)

	Sales	$90 000
–	Cost of sales	**(c) 20 000**
–	Administrative expenses	(20 000)
=	Profits	$50 000

(b) Retained earnings = $60 000 (from statement of retained earnings)

	Total liabilities and shareholders' equity	$70 000
–	Total liabilities	(7 000)
=	Total shareholders' equity	$63 000

(a)

	Ordinary shares	**(a)** $3 000
+	Retained earnings	60 000
=	Total equity	$63 000

Teaching tip: A balance sheet reports a company's assets, liabilities and equity. This relation between assets, liabilities and equity is represented by the accounting equation: Assets = Liabilities + Equity. Notice that the profit from the income statement is the missing amount of profit (or loss) on the statement of retained earnings. Also, the ending balance on the statement of retained earnings is the same amount as the retained earnings reported on the balance sheet.

Helpful hint for students: Work this problem in reverse. Using your knowledge of the accounting equation and the interrelationship among the financial statements, you can work out the missing amounts by making it a simple mathematical problem.

15 Qualitative characteristics LO6

The following qualitative characteristics of accounting were discussed in the chapter:

i consistency

ii relevance

iii understandability

iv comparability

v prudence (conservatism)

vi materiality

vii faithful representation.

Required

Match the descriptions with the appropriate characteristic.

a The ability of accounting information to be comprehensible to those who have a reasonable knowledge of business and are willing to study the information with reasonable diligence.

b The capacity to affect business decisions.

c The dependability of accounting information.

d The ability to compare and contrast the financial activities of the same company over a period of time.

e The threshold over which an item begins to affect decision-making.

f The way in which accountants deal with uncertainty.

g The ability to determine similarities and differences.

Solution

a. Understandability: The ability of accounting information to be comprehensible to those who have a reasonable knowledge of business and are willing to study the information with reasonable diligence.

b. Relevance: The capacity to affect business decisions.

c. Faithful representation: The extent to which accounting information can be depended upon to reflect the economic events and position.

d. Comparability: The ability to compare and contrast the financial activities of the same company over a period of time.

e. Materiality: The threshold over which a financial item begins to affect decision-making.

f. Prudence (conservatism): The way in which accountants deal with uncertainty.

g. Consistency: The ability to use accounting information to be weighed against or contrasted to the financial activities of different businesses.

16 Assumptions and principles LO1, 2, 3

The Harbour Group had the following situations during the year:

i Inventory with a cost of $186 400 is reported at its market value of $235 600.

ii Harbour added four additional weeks to its fiscal year so that it could make its income look stronger. Past financial years were 52 or 53 weeks (in a leap year), this financial 'year' is 56 weeks and it is not even a leap year.

iii Harbour's CEO purchased a yacht for personal use and charged it to the company.

iv Revenues of $25 000 earned in the prior year were recorded in the current year.

v Harbour will be paid in the next financial year for work carried out in this financial year; the decision was made to include the revenue in the next financial year.

vi In an attempt to show exactly how much profits are earned Harbour reports $9 876 543.21 of profits for the financial year.

Required

In each situation, identify the assumption or principle that has been violated and discuss how Harbour should have handled the situation.

Solution

i. Cost principle: Assets should be reported at historical cost $186 400.

ii. Time period assumption: An entity cannot randomly change its time period. This also violates 'consistency'. An entity should use the same accounting methods year to year and disclose when they change methods.

iii. Economic entity assumption: Personal affairs of owners should be kept separate from business affairs.

iv. Revenue recognition principle: Revenue should be recorded in the period during which it is earned (also time period).

v. Revenue recognition (with accrual accounting) – as in (iv) above.

vi. Materiality: Would the decision by users be affected if $9 877 000 was reported (or even $9.9m)?

Teaching tip: Principles, assumptions and qualitative characteristics are necessary to communicate the financial activities and position of a business and to help ensure that accounting information is indeed useful. Revenue is earned when the sale of the good or the provision of the service is substantially complete and collection is reasonably assured; it is not dependent on the receipt of cash.

Helpful hint for students: Economic entity assumption: We do not have to worry that the financial information of the owner is mixed with the financial information of the business. Remember that the receipt of cash is not required to record revenue; we focus on when it is earned (i.e., the company has a right to it).

Problems

17 Prepare financial statements LO 2, 3, 4

The following items are available from the financial records of Innovators Incorporated at the financial year ending June 30, 2018:

Accounts payable	$27 000
Accounts receivable	21 000
Advertising expense	6 000
Buildings	76 000
Contributed capital	30 000
Cash	6 320
Notes payable	70 000

Salaries expense	9 500
Service revenue	16 820
Equipment	25 000

Required

Prepare Innovators Incorporated's income statement and statement of retained earnings for the year and its balance sheet at the end of the year.

Solution

Innovators Incorporated
Income statement
For the year end June 30, 2018

Service revenue		$16 820
Salary Expense	9 500	
Advertising Expense	6 000	
Total expenses		15 500
Profit (Income)		$1 320

Innovators Incorporated
Statement of retained earnings
For the year ended June 30, 2018

Retained earnings, opening balance	$0
Add: Net income	1 320
Less: Dividends	0
Retained earnings, ending balance.	$1 320

Innovators Incorporated
Balance sheet
As at year end June 30, 2018

Assets

Cash	$ 6 320
Accounts receivable	21 000
Buildings	76 000
Equipment	25 000

Total assets		$128 320
Liabilities and shareholders' equity		
Accounts payable	$27 000	
Notes payable	70 000	
Total liabilities		$ 97 000
Contributed capital	$30 000	
Retained earnings	1 320	
Total shareholders' equity		31 320
Total liabilities and shareholders' equity		$128 320

Teaching tip: The financial statements are interrelated. The income statement is prepared first. Use the net income or net loss from the income statement when preparing the statement of retained earnings. The new ending balance on the statement of retained earnings is the balance reported for retained earnings on the balance sheet. In this problem the cost of the boat and the supplies is prorated over three months. One-third of the cost of the boat and supplies is 'used' and reported on the income statement as expenses for the month. The remaining 'unused' amount (two-thirds) for the boat and supplies are reported on the balance sheet as assets.

Helpful hint for students: The income statement is '**R**eally **E**asy', since it reports the company's **R**evenues and **E**xpenses. Expenses are costs of doing business. Assets are items of value and worth; liabilities are what a company owes; and the equity is what is left over for the owners. A simple way to remember the statement of retained earnings is **BIDE**: **B**eginning retained earnings plus net **I**ncome (or less net loss) less **D**ividends equals **E**nding retained earnings. The amount of cash reported on the balance sheet must be computed. Consider all the sources of cash and all payments of cash for the month.

18 Identify and correct income statement errors LO2

Sivabalan Group was started on 1 July. At the end of the financial year the company used an accounting intern to prepare the following financial statement:

Sivabalan Group income sheet at 30 June	
Income from services	$170 000
Accounts receivable	40 000
Total revenue	$210 000
Less: Expenses	

Salaries	$ 57 000
Advertising	(14 000)
Dividends	10 000
Electricity	22 000
Total expenses	$ 75 000
Total income	$135 000

Required

List all of the deficiencies that you can identify in this income statement and prepare an income statement with correct information and proper format.

Solution

Deficiencies:

- 'Income sheet' should read 'Income statement'.
- 'at 30 June' should read 'For the year ended 30 June.'
- 'Income from services' should read 'service revenue'.
- Accounts receivable should not be reported on the income statement; it should be reported in the balance sheet.
- Dividends are not an expense and should be reported on the statement of retained earnings, not the income statement.
- Advertising expense should not be a negative expense, it should be an addition to the total expenses that will be deducted from revenue to calculate net income.

Sivabalan Group

Income statement

For the year ended 30 June

Service revenue		$170 000
Less expenses		
Salaries	57 000	
Advertising	14 000	
Electricity	22 000	
Total expenses		93 000
Profits		77 000

19 Identify and correct balance sheet errors LO3

Hildebrand House Haunting (HHH) commenced business on 1 July. It was a good year as Hildebrand believes she has over $100 000 of assets. At the end of the financial year the following financial statement was quickly prepared by a student intern:

HHH Balance Statement for the Year Ending 30 June	
Resources:	
Cash	$ 30
Things we sell	40
Land	53
Retained earnings	17
Grand total	$146
Debts:	
Money we owe	$ 43
Contributed capital	63
Grand total	$106

Required

List all of the deficiencies that you can identify in this financial statement and prepare a proper balance sheet.

Solution

Deficiencies:

- It should be noted that the amounts are in thousands of dollars.
- It is a Balance sheet not a Balance statement.
- Items should be classified as assets, liabilities and shareholders' equity, not resources and debts.
- 'Things we sell' should read 'Inventory'.
- Retained earnings should be classified as part of shareholders' equity.
- 'Grand total' should read 'Total assets' and 'Total liabilities and shareholders' equity'.
- 'Money we owe' should read 'Accounts payable'.

HHH

Balance sheet

For the year ended 31 December

Assets	
Cash	30 000
Inventory	40 000
Land	53 000
Total assets	123 000
Liabilities and shareholders' equity	
Accounts payable	43 000
Contributed capital	63 000
Retained earnings	17 000
Total liabilities and shareholders' equity	123 000

20 Errors in accounting LO1, 2, 3

The Nguyen Company was incorporated on 1 July. At 30 June the following year Ms Ly Nguyen, the CEO and sole owner, prepared the company's balance sheet as follows:

Nguyen Company Balance Sheet 30 June
Assets

Cash	$25 000
Accounts receivable	40 000
Inventory	35 000
Building	20 000
Liabilities and Equity	
Accounts payable	$40 000
Building loan	15 000
Retained earnings	37 000

Ly is not an accountant by trade and she believes there may be some mistakes. She has provided you with the following additional information:

i The building is Ly's personal beach house. However, she plans on using it for company retreats and for hosting some large clients. She decided to list the asset and the corresponding liability for this reason.

ii The inventory was originally purchased at $12 000, but due to a recent increase in demand she believes she could sell it for at least $35 000. She thought that $35 000 would best portray the economic reality of her inventory.

iii Ly included $5000 in accounts receivable and retained earnings for a service that she will provide next year. Since she is honest and will provide the service, she decided to record the amount in this year's balance sheet.

Required

Comment on what accounting assumptions or principles have been violated; briefly describe how each item should be accounted for and prepare a correct balance sheet.

Solution

The economic entity assumption, which states that the personal affairs of the owners are assumed to be separate from the business affairs of the entity, has been violated. The corporation should rent the beach house from Ly and record the expense. The beach house is not an asset of the business, so neither the asset nor the related liability should be reported on the corporation's balance sheet.

The cost principle, which states that assets should be recorded at historical cost, has been violated. Market value is subjective; therefore, the inventory should be correctly recorded at $12 000.

The revenue recognition principle has been violated. A receivable and the increase in shareholder's equity cannot be recorded until the service has been provided and the revenue is earned.

Nguyen Company

Balance sheet

For the year ended 31 December

Assets	
Cash	$25 000
Accounts receivable	35 000
Inventory	12 000
Total assets	72 000
Liabilities and shareholders' equity	
Accounts payable	$40 000
Retained earnings	32 000
Total liabilities and shareholders' equity	72 000

21 Preparing financial statements LO2, 3, 4

On 1 July you begin a whale watching business for the winter whale migration season by contributing $60 000 of capital and borrowing $80 000 from your parents. With the money you pay $48 000 in July to rent a boat with all the equipment needed. You also purchase advertising on the hotel TV channel for $25 000 and during the month fuel for $155 000. You also pay your parents $800 for monthly interest.

You decide to charge $90 per passenger. At the end of the month of July, you have taken 2400 guests aboard the boat. Included in those 2400 guests were tour groups from China who always pay seven days after whale watching. The tour group at the end of July owes you $1080.

Required

Prepare an income statement and a statement of retained earnings for the month ending 31 July and a balance sheet at 31 July. How might the financial statements influence your plans next year?

Solution

The balance for cash must be calculated.

The loss result is very similar to cash flow from operations, as there was only one accrual (A/cs Rec of $1 080). The financial statements show a substantial loss.

Whale Watching
Income statement
For the month ending 31 July

Service revenue ($90 x 2 400)		$216 000
Expenses:		
Boat	$48 000	
Fuel	155 000	
Interest	800	
Advertising	25 000	
Total expenses		228 800
LOSS		$12 800

Whale Watching
Statement of retained earnings
For the month ending 31 July

Retained earnings, 1 July.	$0
Add: Net income (loss)	(12 800)
Less: Dividends	0
Retained earnings, 31 July.	($12 800)

Whale Watching
Balance sheet
31 July

Assets		
Cash	$126 420	
Accounts receivable	1 080	
Total assets		$127 500
Liabilities and shareholders' equity		
Borrowings	80 000	
Total liabilities		$ 80 000
Contributed equity (capital)	$60 000	
Retained earnings* (from above)	(12 500)	
Total shareholders' equity		47 500
Total liabilities and shareholders' equity		$127 500

Cash is the balancing item – but just to check (in thousands)
60 + 80 + 216 – 1.08 – 48 – 25 – 155 – 0.5 = 126.42 Or $90 x 2 388 instead of 216 – 1.08

Teaching tip: The financial statements are interrelated. The income statement is prepared first. Use the net income or net loss from the income statement when preparing the statement of retained earnings. The new ending balance on the statement of retained earnings is the balance reported for retained earnings on the balance sheet. In this problem, the cost of the boat and the supplies is prorated over three months. One-third of the cost of the boat and supplies is 'used' and reported on the income statement as expenses for the month. The remaining 'unused' amount (two-thirds) for the boat and supplies are reported on the balance sheet as assets.

Helpful hint for students: The income statement is '**R**eally **E**asy', since it reports the company's **R**evenues and **E**xpenses. Expenses are costs of doing business. Assets are items of value and worth; liabilities are what a company owes; and the equity is what is left over for the owners. A simple way to remember the statement of retained earnings is BIDE: **B**eginning retained earnings, plus net **I**ncome (profit or less loss), less **D**ividends, equals **E**nding retained earnings. The amount of cash reported on the balance sheet must be computed. Consider all the sources of cash and all payments of cash for the month.

Cases

22 Read, locate and compare financial statements LO1, 2, 5

Access the latest financial statements for CSL (Google 'CSL Annual Report').

Required

a For CSL Limited's (ASX: CSL) last financial year, identify the amounts reported for revenues, total comprehensive income, total assets and cash flows from operating activities. Also, identify the date on which the financial statements are prepared.

b Locate Cochlear Limited's (ASX: COH) financial statements for the same year. Identify the same information as in the previous requirement.

c Compare both companies. Identify which company is: (i) the largest, (note how you define *largest*) (ii) the most profitable (be careful how you define *most profitable*) and (iii) the best able to generate cash from its operations.

Solution

This depends on which annual report is accessed.

Teaching tip: The aim of this exercise is to encourage students to look an annual report (even only if in the back of the textbook) hopefully find the latest version on the Internet, find the financial statements in the middle of those annual reports, and then look at the financial statements and see that there are four and each of them contains different information. Further, students should start to notice that they show different aspects of financial performance and position: revenue and expense in the income statement, assets, etc., in the balance sheet and cash flow from operations, etc., in the cash flow statement. Depending on the year, the financial statements may be called something slightly different – but this is not a problem, since students should get used to different names and even different formats.

If you require students to go on to Part B, the differences in the statements as well as the size of the numbers can be discussed.

Part C raises more issues – size could be revenue, profits, total assets or even number of employees. It could be market capitalisation (i.e., the amount of money to buy all the shares in the company at current share prices – market capitalisation is also reported in the financial press; the Weekend edition of *The Australian* lists the top 150 companies by market capitalisation). Some of this information is available in the business section of most large newspapers. Answers will depend on which year's financial statements are used.

23 Ethics in accounting LO1, 2, 6

As the chief accountant at an education college which is listed on the Australian Securities Exchange you discover that profits in each of the previous five years have been understated due to an error in accounting. After much thought, you decide to approach the CEO. Her response is: 'What the public doesn't know won't hurt them. We'll just adjust this year's profits to make up for the mistakes. We are having a bad year and this comes as a great relief, it will certainly get us out of a hole'.

Required

Identify the ethical dilemma of this situation; outline the ways that you could respond and explain the possible consequences of your responses.

Solution

Your CEO wants you to ignore the fact that previous financial statements are misstated (and therefore mislead investors) and wants you to make the current financial statements misleading (wrong/fraudulent). She is arguing that, over the total six-year period, total profit will be reported correctly, so the incorrect reporting each year is not important.

Possible responses:

Option 1: 'I understand that profits are large enough in previous years to absorb the current loss, so we report a profit this year as per the previous five, but the information we will be reporting is not correct. It is therefore not reliable. We should report unbiased or representatively faithful information to our investors. We should disclose the errors in the previous years and report current year results truthfully.'

Consequence: Although it will be hard to stand up to your boss, this is the right action to take in this situation. By recognising the error in restating prior financial statements, you avoid committing another error by misstating current profits. There may be negative consequences to this action in that you may be criticised for not being 'a team player'. But to incorrectly report a profit this year when a loss has been made is FRAUD.

Option 2: 'I understand. You are the CEO; you have the experience and, ultimately, the authority and responsibility. I will do what I am told.'

Consequence: The current year's financial performance (profits) will be overstated and prior years' income will remain understated. If someone outside the company discovers that the company knew of and ignored the error, there could be more severe consequences than just restating the financial statements. Additionally, if you do as your boss says this time, she may expect you to act in unethical (illegal/criminal) ways in the future, reminding you of your past compliance/cooperation/collaboration/complicity/collusion. She could go as far as suggesting it was your idea, as the accountant, and that she merely took your advice as she doesn't really understand these detailed accounting issues.

24 Written communication skills LO2, 3, 4, 5

Your wonderful brother has just won lotto. He is trying to find companies in which to invest his winnings; however, he is having trouble reading the financial statements because he has no idea what they are saying. Knowing you are in an accounting class, your brother is willing to pay you $10 a word to write to him about financial statements (maximum 400 words).

Required

Prepare a written response to your brother explaining what information is contained in each financial statement and how it is relevant to investors.

Solution

My Dearest Loving Brother,

Congratulations on winning the lotto! I am honoured that you thought of me when seeking advice.

First, in order for you to decide where to invest your money, it is a great idea to examine the financial statements of each potential company. To do this, you must understand what information is presented on each of the four financial statements:

- The income statement (sometimes known as the profit and loss statement or, more correctly, the statement of comprehensive income) presents all revenues earned and all expenses incurred by the corporation. The purpose of the income statement is to present the net income of the company. This tells you how profitable the company was during the specified period of time. A good idea would be to look at the income statements for the past few years and make sure the company has had consistent positive net income – and, even better, to look and see if they are growing.

- The statement of retained earnings shows the change in a company's retained earnings over a specific period of time. Net income increases retained earnings, while dividends and net losses decrease retained earnings. Retained earnings serve as a link between the income statement and balance sheet; net income increases retained earnings, and the calculated ending retained earnings are shown on the balance sheet as a part of shareholders' equity.

- The balance sheet shows assets, liabilities and shareholders' equity at a specific point in time. It shows a company's resources, or assets, and the claims, or liabilities, against those resources. The basic structure of the statement is: assets equal liabilities plus shareholders' equity. The balance sheet tells you about the financial structure of the company. It tells you how the company finances its operations, whether from lenders (liabilities) or investors (equity).

- The statement of cash flows reports a company's cash inflows and outflows. There are three sections on the statement: operating, investing and financing. This statement reveals where a company gets its cash, and then where that cash goes.

I hope this helps. If you have any extra money after you finish investing, I know of a certain Accounting student who could use some extra cash!

All my love forever, Jon T

ENRICHMENT MODULES

Please note: solutions follow at the end of this document.

Exercises

Module.Ex.01.01 Complete financial statements LO2, 3, 4

The following are incomplete financial statements for Lee Limited.

Balance sheet

Assets	
Cash	$ 6 000
Inventory	20 000
Buildings	(a)
Total assets	64 000
Liabilities and shareholders' equity	
Liabilities	
Accounts payable	$ 7 000
Shareholders' equity	
Contributed equity	(b)
Retained earnings	(c)
Total liabilities and shareholders' equity	64 000

Income statement

Revenues	$120 000
Cost of goods sold	70 000
Administrative expenses	30 000
Net income	$ (d)

Statement of retained earnings

Beginning retained earnings	20 000
Net income	(e)
Dividends	(f)
Ending retained earnings	40 000

Required
Calculate the missing amounts.

Module.Ex.01.02 Net income and retained earnings LO2, 4

Based on the following information, calculate profit or loss and ending retained earnings for the year ending 30 June.

Nova Corporation reports the following as of 30 June:

Revenue	$10 000
Beginning retained earnings	20 000
Expenses	8 000
Dividends	1 000

Required
Calculate profit or loss, and ending retained earnings, for the year ending 30 June.

Module.Ex.01.03 Identify balance sheet accounts LO3

The following accounts are taken from a statement of financial position:

1. Cash
2. Retained earnings
3. Equipment
4. Supplies
5. Accounts payable.

Required
Indicate whether each account is an asset (A), liability (L) or part of equity (E).

Module.Ex.01.04 Identify income statement accounts LO3

The following accounts are taken from a company's financial statements:

1. Cost of goods sold
2. Sales
3. Dividends
4. Interest revenue

5. Interest expense
6. Depreciation.

Required
Indicate whether each account is a revenue (R), expense (E) or neither (N).

Module.Ex.01.05 Statement of retained earnings LO4

Michaela Machinations has been in business for over 100 years. Retained earnings on 1 January are $245 800. The following information is available for the first two months of the year.

	January	**February**
Revenues	$80 000	$102 000
Expenses	85 000	80 000
Dividends	7 000	

Required
Prepare a statement of retained earnings for the month ending 28 February.

Module.Ex.01.06 Classify cash flows LO5

A company entered into the following cash transactions:

1. Cash paid to suppliers
2. Cash received from issuing new ordinary shares
3. Cash paid to purchase new office furniture
4. Cash paid to owners
5. Cash received from customers.

Required
Indicate the section of the statement of cash flows in which each item would appear: operating activities (O), investing activities (I) or financing activities (F).

Module.Ex.01.07 Qualitative characteristics LO6

The following terms relate to qualitative characteristics of accounting information:

1. Relevance
2. Reliability
3. Comparability

4. Consistency
5. Materiality
6. Prudence
7. Understandability.

Required
Briefly describe each characteristic.

Problems

Module.Prob.01.08 Errors in accounting LO1, 2, 3

The Mock Company was formed on 1 January. At 31 December, William Mock, CEO and sole shareholder, prepared the company's Statement of Financial Position as follows:

Mock Corporation
Balance sheet
31 December

Assets	
Cash	$25 000
Accounts receivable	40 000
Inventory	35 000
Buildings	20 000
Liabilities and shareholders' equity	
Accounts payable	$40 000
Building loan	15 000
Retained earnings*	37 000

Mock (not an accountant by trade) believes there may be some mistakes in his statement of financial position. He has provided you with the following additional information:

- The building is Mock's personal beach house. However, he plans on using it for company retreats and for hosting some large clients. He decided to list the asset and the corresponding liability for this reason.

- The inventory was originally purchased at $12 000, but due to a recent increase in demand, he believes he could sell it for at least $35 000. He thought that $35 000 would best portray the economic reality of his inventory.
- Mock included $5 000 in accounts receivable and shareholders' equity for a service that he will provide next year. Since he is an honest man, and will provide the service, he decided to record the amount in this year's statement of financial position.

Required

Comment on what accounting assumptions or principles are violated; briefly describe how each item should be accounted for; and prepare a correct balance sheet.

Module.Prob.01.09 Identify and correct income statement errors LO2

Muncie Group commenced business on 1 July. At the end of the year, the company had a first-year Accounting student prepare the following income statement:

Muncie Group
Income statement
30 June

Income from services	$170 000
Account receivable	40 000
Total income	210 000
Less: expenses	
Salaries	57 000
Advertising	(14 000)
Dividends	10 000
Depreciation	22 000
Total expenses	75 000
Net income	135 000

Required

List all of the deficiencies that you can identify in this income statement, and prepare a proper income statement.

Module.Prob.01.10 Identify and correct statement of financial position errors LO3

Bizilia's commenced business on 1 January. At the end of the year, an employee with a Mathematics degree prepared the following balance sheet:

Bizilias's
Balance sheet
For the year ending 31 December

Resources	
Cash	30 000
Stuff we can sell	40 000
Equipment	61 000
Retained earnings	17 000
Grand total	146 000
Debts	
Money we owe to vendors	43 000
Accumulated depreciation	8 000
Contributed equity	63 000
Grand total	114 000

Required
List all of the deficiencies that you can identify in this statement of financial position, and prepare a proper statement of financial position.

Module.Prob.01.11 Balance sheet equation LO3

Consider the following independent situations:

1. Versa starts the year with $20 000 in assets and $14 000 in liabilities. Profits for the year are $9 500, and no dividends are paid. How much is the shareholders' equity at the end of the year?
2. Intex doubles its assets from the beginning to the end of the year. Liabilities at the end of the year are $75 000, and shareholders' equity is $40 000. What is the amount of Intex's assets at the beginning of the year?
3. During the year, the liabilities of Herbert Limited triple in amount. Assets at the beginning of the year were $52 000, and shareholders' equity is $22 000. What is the amount of liabilities at the end of the year?

Required

Use the accounting equation to answer each situation.

Module.Prob.01.12 Financial statements LO2, 3, 4, 5

The following are various questions posed by different users of accounting information.

User	Questions	Financial statement
Shareholder	Are sales rising as fast as inventory balances?	________________
Banker	Did the company pay dividends to shareholders last year?	________________
Manager	How much capital (equity) have shareholders contributed to the company?	________________
Shareholder	What is the ratio between liabilities and equity?	________________
Regulator	Did the company earn abnormally high profits due to price gouging	________________
Employee	How much did employees earn in wages last year?	________________

Required

Fill in the blank with the financial statement(s) the user would most likely use to find this information.

Module.Prob.01.13 Preparing financial statements LO2, 3, 4

During the month of April, you conduct art seminars for children. On 1 April, you borrow $500 from your parents, buy $400 of supplies, and pay $50 for advertising on the radio and $25 to rent a room in a local recreation centre. You charge $20 per child per seminar. At the end of the month, you have held seminars for 80 children, of which you have received payment for 76. You have $30 of supplies remaining, and you pay your parents $5 for the use of their money during the month.

Required

Prepare an income statement and a statement of retained earnings for the month ending 30 April, and balance sheet at 30 April.

Cases

Module.Case.01.14 Read, locate and compare financial statements LO2, 3, 5

Access CSL's latest financial statements.

Required

a. Identify revenues, profits before tax, total assets, cash flows from operating activities and the date on which the financial statements are prepared.

b. Compare CSL's financial statements to Cochlear's, and identify which company is:

- the larger
- the more profitable
- best able to generate cash from its operations.

Module.Case.01.15 Ethics in accounting LO1, 2, 6

As the chief financial officer (CFO) at Blaire's Costume Jewellery Company, you discover that profits for the previous five years have been overstated due to an error in accounting. After much thought, you decide to approach the company president. His response is, 'What the public doesn't know won't hurt them. We'll just adjust this year's profits to make up for the mistakes. We had a pretty good year, and I think our income for this year can absorb the errors.'

Required

Identify the ethical dilemma of this situation; identify the ways that you could respond; and explain the possible consequences of your response.

SOLUTIONS TO ENRICHMENT MODULES

Exercises

Module.Ex.01.01

a. Total assets = Cash + Inventory + Building
$64 000 = $6 000 + $20 000 + Building
Building = $38 000

b. Total liabilities and shareholders' equity – Total liabilities = Total shareholders' equity
$64 000 – $7 000 = $57 000
Total shareholders' equity = Contributed capital + Retained earnings
$57 000 = Contributed equity + $40 000
Contributed equity = $17 000

c. Retained earnings = $40 000 (from the statement of retained earnings)

d. Revenues – Cost of goods sold – Administrative expenses = Profits
$120 000 – $70 000 – $30 000 = Net income
Profits = $20 000

e. Profits = $20 000 (from the income statement)

f. **Beginning retained earnings + Profits – Dividends = Ending retained earnings**
$20 000 + $20 000 – Dividends = $40 000
Dividends = $0

Module.Ex.01.02

Profits = Revenue – Expenses
Profits = $10 000 – $8 000
Profits = $2 000

Retained earnings = Beginning retained earnings + Profits (or minus loss) – Dividends
Retained earnings = $20 000 + $2 000 – $1 000
Retained earnings = $21 000

Module.Ex.01.03

1. A
2. E
3. A

4. A
5. L

Module.Ex.01.04

1. E
2. R
3. N
4. R
5. E
6. E

Module.Ex.01.05

First, calculate ending retained earnings at 31 January, which are equal to beginning retained earnings at 1 February.

1 Jan.	Retained earnings	$245 800
	Add: Profits($80 000 – $85 000)	(5 000)
	Less: Dividends	0
31 Jan.	Retained earnings	$240 800

Michaela Machinations
Statement of retained earnings
For the month ending 28 February

1 Feb.	Retained earnings	$240 800
	Add: Profits*	22 000
	Less: Dividends	(7 000)
28 Feb.	Retained earnings	255 800

*Profits = Revenue – Expenses = $102 000 – $80 000 = $22 000

Module.Ex.01.06

1. O
2. F
3. I
4. F
5. O

Module.Ex.01.07

1. **Relevance**: The capacity of accounting information to make a difference in decisions.
2. **Reliability**: The extent to which accounting information can be depended upon.
3. **Comparability**: The ability to use accounting information to be weighed against or contrasted to the financial activities of different businesses.
4. **Consistency**: The ability to compare or contrast the financial activities of the same entity over time.
5. **Materiality**: The threshold at which a financial item begins to affect decision-making.
6. **Prudence**: The manner in which accountants deal with uncertainty regarding economic situations.
7. **Understandability**: The ability to comprehend the financial activities by a person who has a reasonable understanding of business and is willing to study the information with reasonable diligence.

Problems

Module.Prob.01.08

- The economic entity assumption, which states that the personal affairs of the owners are assumed to be separate from the business affairs of the entity, has been violated. The corporation should rent the beach house from Mock and record the expense. The beach house is not an asset of the business, so neither the asset nor the related liability should be reported on the corporation's balance sheet.
- The cost principle, which states that assets should be recorded at historical cost, has been violated. Market value is subjective; therefore, the inventory should be

correctly recorded at $12 000.

- The revenue recognition principle has been violated. A receivable and the increase in shareholder's equity cannot be recorded until the service has been provided and the revenue is earned.

Mock Corporation
Balance sheet
For the year ended 31 December

Assets	
Cash	$25 000
Accounts receivable	35 000
Inventory	12 000
Total assets	72 000
Liabilities and shareholders' equity	
Accounts payable	$40 000
Retained earnings	32 000
Total liabilities and shareholders' equity	72 000

Module.Prob.01.09

Deficiencies:

- '30 June' should read 'For the year ended 30 June'.
- 'Income from services' should read 'Service revenue'.
- Accounts receivable should not be reported on the income statement; it should be reported on the balance sheet.
- 'Total income' should read 'Total revenue'.
- Dividends are not an expense and should be reported on the statement of retained earnings, not the income statement.
- Advertising expense should not be a negative expense, it should be an addition to the total expenses that will be deducted from revenue to reach net income.

Muncie Group
Income statement
For the year ended 30 June

Service revenue		$170 000
Less expenses		
Salaries	57 000	
Advertising	14 000	
Depreciation	22 000	
Total expenses		93 000
Profits		77 000

Module.Prob.01.10

Deficiencies:

- '31 December' should read 'For the year ended 31 December'.
- Items should be classified as assets, liabilities and shareholders' equity, not as resources and debts.
- 'Stuff we can sell' should read 'Inventory'.
- Retained earnings should be classified as part of shareholders' equity.
- 'Grand total' should read 'Total assets' and 'Total liabilities and shareholders' equity'.
- 'Money we owe to vendors' should read 'Accounts payable'.
- Accumulated depreciation should be under 'Assets', as it is a reduction to the equipment account.

Bizilias's
Balance sheet
For the year ended 31 December

Assets	
Cash	30 000
Inventory	40 000
Equipment	61 000
Less: Accumulated depreciation	(8 000)
Total assets	123 000

Liabilities and shareholders' equity	
Accounts payable	43 000
Contributed equity	63 000
Retained earnings	17 000
Total liabilities and shareholders' equity	123 000

Module.Prob.01.11

1. If Versa starts the year with $20 000 in assets and $14 000 in liabilities, then the equation A = L + E tells us that Versa started the year with $6 000 in equity ($20 000 = $14 000 + Equity). With profits of $9 500 and dividends of $0, equity increased $9 500 during the year. Therefore, owners' equity at the end of the year is $15 500 ($6 000 + $9 500).

2. If Intex ends the year with $75 000 in liabilities and $40 000 in equity, then the equation A = L + E tells us that Intex ended the year with $115 000 in assets (Assets = $75 000 + $40 000). If Intex doubled its assets during the year, then it must have started the year with $57 500 ($115 000 ÷2 = $57 500).

3. If Herbert starts the year with $52 000 in assets and $22 000 in equity, then the equation A = L + E tells us that Herbert started the year with $30 000 in liabilities ($52 000 = Liabilities + $22 000). If liabilities tripled during the year, then Herbert has $90 000 in liabilities at the end of the year ($30 000 × 3 = $90 000).

Module.Prob.01.12

User	Questions	Financial statement
Shareholder	Are sales rising as fast as inventory balances?	IS and FP
Banker	Did the company pay dividends to shareholders last year?	RE
Manager	How much equity have shareholders contributed to the company?	FP
Shareholder	What is the ratio between liabilities and	FP

	equity?	
Regulator	Did the company earn abnormally high profits due to price gouging	IS
Employee	How much did employees earn in wages last year?	IS

Module.Prob.01.13

Income statement
For the month ending 30 April

Service revenue ($20 x 80)		$1 600
Expenses		
Supplies	$370	
Interest	5	
Advertising	50	
Rent	25	
Total expenses		450
Profit		$1 150

Statement of retained earnings
For the month ending 30 April

1 Apr.	Retained earnings	$ 0
	Add: Profits*	1 150
	Less: Dividends	(0)
30 Apr.	Retained earnings	$1 150

Balance sheet
For the year ended 30 April

Assets	
Cash (see note 1)	$1 540
Accounts receivable ($20 x 4 payment not received)	80
Supplies	30
Total assets	$1 650

Liabilities and shareholders' equity	
Note payable	500
Retained earnings	1 150
Total liabilities and shareholders' equity	$1 650

Note 1: $1 540 = $500 – $400 – $50 – $25 + $1 520 – $5

Cases

Module.Case.01.14

The aim of this exercise is to encourage students to look at financial statements and start to notice that they show different aspects of financial performance and position.

Answers will depend on which year's financial statements are used.

Module.Case.01.15

Ethical dilemma

Your boss wants you to ignore the fact that previous and current financial statements are misstated, and therefore mislead investors. He is arguing that over the total six-year period, total profit will be reported correctly, so the incorrect reporting each year is not important.

Possible responses

Option 1: 'I understand that profits are large enough this year to absorb the previous losses and still be profitable, but the information we will be reporting is not correct. It is therefore not reliable. We should report unbiased information to our investors. We should disclose the errors in the previous years and report current-year results truthfully.'

Consequence: Although it will be hard to stand up to your boss, this is the right action to take in this situation. By recognising the error in restating prior financial statements, you avoid committing another error by misstating current profits. There may be negative consequences to this action, in that you may be criticised for not being 'a team player'.

Option 2: 'I understand, Mr. Boss. I will do what I am told.'

Consequence: The current year's profits will be understated and prior years' income will remain overstated. If someone outside the company discovers that the company knew of and ignored the error, there could be more severe consequences than just restating the financial statements. Additionally, if you do as your boss says this time, he may expect you to act in unethical ways in the future.