**Decision Making Context – Week 1 Solutions**

*Discussion Question*

*Regulators are concerned with external auditors providing advisory services to a client at the same time as providing auditing services to that client. Explain why this is a concern.*

Suggested topics for discussion:

* If an external auditor is required to express an independent opinion on whether the financial reports present a true and fair view of the entity’s performance and financial position, can the auditor successfully be involved in providing management services to the client and maintain independence?
* Note that as a result of certain significant corporate crashes in the early 2000s, the Australian government introduced requirements (via CLERP no 9) for auditors to declare their independence and to ensure a rotation of auditors every 5 years, with a further two-year delay before a former auditor can become an officer of the former client.

*Discuss the significance of the following assumptions in the preparation of an entity’s financial statements:*

*(a) entity assumption*

*(b) accrual basis assumption*

*(c) going concern assumption*

*(d) period assumption*

1. 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 theaccounting 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 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.

Exercise Questions

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| **Exercise 2.9** |  | **Preparation of a balance sheet** | | |  | |
|  |  |  |  |  |  |  |

*Month-end balance sheet amounts for the legal practice of Adam Booth, a local lawyer, for 3 consecutive months of 2016 are shown below. The information is complete except for the balance in the Capital account.*

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

***Required***

1. *Determine the balance in Adam Booth’s Capital account at the end of each month.*
2. *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.*
3. *Prepare a balance sheet for the business at the end of December 2016. (The heading should read: Adam Booth, Lawyer)*

A.

Based on the accounting equation: Assets – Liabilities = Equity

|  |  |  |
| --- | --- | --- |
| 31 October Capital Balance | = | $(9100 + 16 100 + 700 + 29 800 + 226 000) – $(10 100 + 5100 + 134 700) |
|  | = | **$131 800** |

|  |  |  |
| --- | --- | --- |
| 30 November Capital Balance | = | $(3900 + 15 000 + 1800 + 29 700 + 224 000) – $(3100 + 4100 + 134 300) |
|  | = | **$132 900** |

|  |  |  |
| --- | --- | --- |
| 31 December Capital Balance | = | $(3000 + 8050 + 1600 + 39 300 + 222 000) – $(3000 + 4800 + 133 900) |
|  | = | $**132 250** |

B.

|  |  |  |
| --- | --- | --- |
| Profit for November | = | $132 900 – $131 800 |
|  | = | **$1100** |

|  |  |  |
| --- | --- | --- |
| Loss for December | = | $132 250 – $132 900 |
|  | = | **–$650** |

C.

|  |  |
| --- | --- |
| **ADAM BOOTH, LAWYER**  **Balance Sheet**  **as at 31 December 2016** | |
| 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 2.12** |  | **Preparation of income statement and balance sheet** |  |

*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 2016, Toby and Talea determined the following financial information for their business:*

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

*A real estate agent valued the buildings at $500 000 on 30 June 2016.*

***Required***

1. *Prepare an income statement for Beaut Beach Caravan Park for the year ended 30 June 2016.*
2. *Prepare a balance sheet for the business as at 30 June 2016.*
3. *Explain why you have used a particular valuation for the buildings in the balance sheet.*

A.

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| --- | --- | --- |
| **BEAUT BEACH CARAVAN PARK**  **Income Statement**  **for the year ended 30 June 2016** | | |
| INCOME |  |  |
| Income — camping |  | $185 000 |
| Income — cabins |  | 272 000 |
|  |  | 457 000 |
| EXPENSES |  |  |
| Salaries and wages expense | $220 000 |  |
| Other expenses | 45 000 |  |
| Supplies used | 71 000 |  |
|  |  | 336 000 |
| PROFIT |  | $121 000 |
|  |  |  |

B.

|  |  |
| --- | --- |
| **BEAUT BEACH CARAVAN PARK**  **Balance Sheet**  **as at 30 June 2016** | |
| 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 2016, the valuation placed on the buildings in the balance sheet 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 balance sheet.

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

|  |  |  |  |  |  |  |
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| **Problem 2.2** |  | **Preparing financial statements** | | |  |  |
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Asset, liability, equity, income and expense amounts for Sadoka’s Interior Decorating at 30 June 2016 are presented below:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Cash at bank  Accounts receivable  Supplies  Equipment  Accounts payable  Sadoka Nato, Capital  Decorating services income | $ 22 800  117 600  26 400  125 600  33 700  ?  386 000 |  | Advertising expense  Insurance expense  Rent expense  Supplies expense  Telephone expense  Electricity expense  Wages expense | $ 36 000  8 000  33 000  12 600  12 200  17 000  111 000 |

***Required***

*A. Prepare an income statement for the business for the year ended 30 June 2016.*

*B. Prepare a balance sheet in narrative format as at 30 June 2016.*

A.

|  |  |  |
| --- | --- | --- |
| SADOKA’S INTERIOR DECORATING  **Income Statement**  **for the year ended 30 June 2016** | | |
|  |  |  |
| INCOME |  |  |
| Decorating services income |  | $386 000 |
|  |  |  |
| EXPENSES |  |  |
| Advertising expense | $36 000 |  |
| Insurance expense | 8 000 |  |
| Rent expense | 33 000 |  |
| Supplies expense | 12 600 |  |
| Telephone expense | 12 200 |  |
| Electricity expense | 17 000 |  |
| Wages expense | 111 000 |  |
|  |  | 229 800 |
| PROFIT |  | $156 200 |
|  |  |  |

B.

|  |  |
| --- | --- |
| **SADOKA’S INTERIOR DECORATING**  **Balance Sheet**  **as at 30 June 2016** | |
| ASSETS  Cash at bank  Accounts receivable  Supplies  Equipment  TOTAL ASSETS |  |
| $22 800 |
| 117 600 |
| 26 400 |
| 125 600 |
| $292 400 |
| LIABILITIES |  |
| Accounts payable | 33 700 |
| TOTAL LIABILITIES | $33 700 |
| NET ASSETS | **$258 700** |
| EQUITY |  |
| Sadoka Nato, Capital | 258 700 |
|  |
| TOTAL EQUITY | **$258 700** |
|  |  |

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Problem 2.3** |  | **Determining missing elements in accounting equation** | | |
|  |  |  |  |  |

*Calculate the two missing amounts for each independent case below.*

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| **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 |