# Lecture 3 Answers

1. (a) An asset is a resource that is controlled by an entity, as a result of a past transaction that is expected to bring economic benefits (generate profits). Assets can be split into two categories: Non-current assets – are to be owned for longer than 12 months. Buildings , furniture, machinery and motor vehicles. These are tangible assets.

Brands, patents and goodwill. These are intangible assets.

Current assets – owned at the reporting date but are to be used by the business to make profits in the next 12 months. Inventory=stock; Trade receivables= Debtors; Cash.

(b) An expense is a period cost. It is costs that are incurred in the year and that the business has benefited from in the year. They have no future economic benefit. For example electricity cost, advertising, accountancy fees and training costs.

(c) Accruals concept - expenses are matched to the revenues that they help generate. Expenses, costs, income and revenue are accounted for when they are earned or incurred, not when cash flows in or out of the company. For example, the cost of a non-current asset is spread over the years that are expected to benefit from its use.

1. The golden handshake must be recognised as an expense.

Generally training costs and golden handshakes cannot be recognised as an asset.

The problem is that to be regarded as an asset the entity must control the asset and there must be expected economic benefits. It is very difficult for an organisation to control an employee and how do you quantify the future benefits.

Please note football clubs do regard players’ contract fees as an asset and the cost is written off over the duration of a contract. An exception.

1. This is an example of the accruals concept.

It would not show a true and fair view of the contract, if costs and revenues were not recognised in the income statement until the end of the project.

Investors would not get a complete picture of the organisation.

An accounting standard (IAS 11) for long term contract is in operation and sets out how a business should account for revenue as a project proceeds.

This is important if all businesses follow the accounting standard which they are required to do by company law, it provides a consistency of approach and so a company engaged in long term contracts can be compared with others and investors can make rational investment decision.

The company has to make a realistic assessment of the stage of completion of the contract at each reporting date. Having done this, it can then recognise an appropriate amount of sales revenue and costs within the income statement. Normally revenue would not be recognised in advance for fear of a company misrepresenting its profits, but for long term contracts it is an appropriate treatment.

4.

Month 1 £ £

Revenue (200@£380) 76,000

Opening inventory 0

Purchases (500@£300) 150,000

Closing inventory (300@£300) (90,000)

Cost of sales (200@£300) (60,000)

Gross profit (200 @£80) 16,000 GP % = 16,000/76,000 =21%

Month 2 £ £

Revenue (800@ £380) 304,000 Opening inventory (300@£300) 90,000 Purchases (1,000@ £300) 300,000 Closing inventory (500@£300) (150,000) Cost of sales (800@£300) (240,000) Gross profit (800@ £80) 64,000 GP % = 64,000/304,000 =21%

Month 3 £ £

Revenue (1,700 @ £380) 646,000 Opening inventory (500@£300) 150,000 Purchases (1,200@£300) 360,000 Closing inventory (0) Cost of sales (1,700@£300) (510,000) Gross profit (1,700@ £80) 136,000 GP %= 136,000/646,000 = 21%

Cash position

Month 1 Month 2 Month 3 £ £ £

Cash inflow (200@380) 76,000 (800@380) 304,000 (1,700@380) 646,000

Cash outflow (500@300) (150,000) (1000@300) (300,000) (1,200@300) (360,000) Cash position (74,000) 4,000 286,000

Total Profits 16,000 + 64,000 + 136,000 = 216,000

Total cash (74,000) + 4,000 + 286,000 =216,000