

CHAPTER 2

Financial reports for decision making

CONTENTS

- 2.1 Classifying revenues, expenses and owner's equity
- 2.2 Preparation of financial statements
- 2.3 Preparation of financial statements
- 2.4 Preparation of financial statements – public sector
- 2.5 Determining missing elements in accounting equation
- 2.6 Analysis of cash flows

Problem 2.1 Classifying revenues, expenses and owner's equity

Data for Garf Electrical Services as of 30 June 2004 follow:

Service fees revenue	\$80 000	Commission revenue	\$30 000
Electricity expense	8 800	Salaries expense	33 000
Rent expense	11 000	Discount allowed	2 500
Insurance expense	25 000	Telephone expense	12 000
J. Smith, Drawings	5 000	J. Smith, Capital	92 700

Required:

- Classify the above items as owner's equity (O), drawings (D), revenue (R), or expense (E) and explain how each affects owner's equity.
- Prepare a statement of financial performance and a statement of owner's equity for the year ended 30 June 2004.

Solution

GARF ELECTRICAL SERVICES

A.

Service fees revenue	(R) - increases (O)
Electricity expense	(E) - decreases (O)
Rent expense	(E) - decreases (O)
Insurance expense	(E) - decreases (O)
J. Smith, Drawings	(D) - decreases (O)
Commission revenue	(R) - increases (O)
Salaries expense	(E) - decreases (O)
Discount allowed	(E) - decreases (O)
Telephone expense	(E) - decreases (O)
J. Smith, Capital	(O) - increases (O)

B.

GARF ELECTRICAL SERVICES	
Statement of Financial Performance	
for the year ended 30 June 2004	
<i>Revenues</i>	
Service fees revenue	\$80 000
Commission revenue	<u>30 000</u>
	\$110 000
<i>Expenses</i>	
Electricity expense	\$8 800
Rent expense	11 000
Insurance expense	25 000
Salaries expense	33 000
Telephone expense	12 000
Discount allowed	<u>2 500</u>
	<u>92 300</u>
Net Profit	<u>\$17 700</u>

GARF ELECTRICAL SERVICES	
Statement of Owner's Equity	
for the year ended 30 June 2004	
J. Smith, Capital (1 July, 2000)	\$80 000
Add: Contributions	0
Profit	<u>17 700</u>
	97 700
Less: Drawings	<u>5 000</u>
J. Smith, Capital (30 June, 2001)	<u>\$92 700</u>

Problem 2.2 Preparation of financial statements

Winthrop Industries began operations early in January 2003. On 31 December 2003, records showed the following asset, liability, owner's equity, revenue and expense amounts:

Accounts receivable	\$ 384 000	Stephen Winthrop, Capital	?
Rent expense	202 500	Electricity expense	\$108 000
Cash at bank	153 750	Telephone expense	73 500
Supplies expense	78 750	Advertising expense	187 500
Accounts payable	142 500	Insurance expense	37 500
Service revenue	2 212 500	Wages expense	660 000
Supplies	165 000	Drawings	351 000
Equipment	720 000		

Required:

- Prepare a statement of financial performance for Winthrop Industries for the year ended 31 December 2003.
- Prepare a statement of financial position (account format) as at 31 December 2003.
- Prepare a statement of owner's equity for 2003.

Solution

A.

WINTHROP INDUSTRIES		
Statement of Financial Performance		
for the year ended 31 December 2003		
<i>Revenues</i>		
Service revenue		\$2 212 500
<i>Expenses</i>		
Advertising expense	\$187 500	
Insurance expense	37 500	
Rent expense	202 500	
Supplies expense	78 750	
Telephone expense	73 500	
Electricity expense	108 000	
Wages expense	<u>660 000</u>	
		<u>1 347 750</u>
Net Profit		<u>\$ 864 750</u>

B.

WINTHROP INDUSTRIES			
Statement of Financial Position			
as at 31 December 2003			
<i>Assets</i>		<i>Liabilities</i>	
Cash at Bank	\$153 750	Accounts payable	\$142 500
Accounts receivable	384 000		
Supplies	165 000	<i>Owner's Equity</i>	
Equipment	<u>720 000</u>	S. Winthrop, Capital	<u>1 280 250</u>
	<u>\$1 422 750</u>		<u>\$1 422 750</u>

C.

WINTHROP INDUSTRIES	
Statement of Owner's Equity	
as at 31 December 2003	
Stephen Winthrop, Capital	\$766 500
Add: Net profit	<u>864 750</u>
	1 631 250
Less: Drawings	<u>351 000</u>
Stephen Winthrop, Capital - 31 December	<u>\$1 280 250</u>



Problem 2.3 Preparation of financial statements

On 1 August 2003, Judith Rainer opened the Rain and Hail Sailing School by contributing \$200 000 to the business. The list below contains the assets, liabilities, revenues and expenses of the Sailing School for the month of August:

Cash at bank	\$ 15 800
Debtors	9 000
Sailing equipment	244 000
Loan from bank	60 000
Creditors	2 000
Tuition fees earned	19 000
Advertising expense	1 500
Rent expense	2 500
Repairs expense	1 000
Insurance expense	800

Drawings in cash by Rainer for the month amounted to \$6400.

Required:

- Prepare a statement of financial performance and a statement of owner's equity for Rain and Hail Sailing School for the month of August.
- If it was discovered later that the business had incurred an extra \$1500 for repairs which had not been paid for, discuss how this information would affect the financial statements prepared in requirement A.

Solution

RAIN AND HAIL SAILING SCHOOL Statement of Financial Performance for the month ended 31 August 2003		
<i>Revenues</i>		
Tuition fees earned		\$19 000
<i>Expenses</i>		
Advertising expense	\$1 500	
Rent expense	2 500	
Repairs expense	1 000	
Insurance expense	<u>800</u>	
		<u>5 800</u>
Net Profit		<u>\$13 200</u>

RAIN AND HAIL SAILING SCHOOL Statement of Owner's Equity for the month ended 31 August 2003		
Judith Rainer, Capital - 1 August 2003		\$200 000
Add: Net profit for the month		<u>13 200</u>
		213 200
Less: Drawings during the year		<u>6 400</u>
Judith Rainer, Capital - 31 August 2003		<u>\$206 800</u>

B.

The discovery of an additional \$1 500 in repairs which have been incurred and not paid for would:

- increase repairs expense by \$1 500 to \$2 500 and decrease reported net profit by \$1 500 to \$11 700 in the profit and loss statement; and
- the reduced reported net profit of \$11 700 would decrease closing capital by \$1 500 to \$205 300 in the statement of owner's equity.

Problem 2.4 Preparation of financial statements – public sector

Greenbank Shire Council's records on 30 June 2004 disclosed the following amounts:

	(\$000s)		(\$000s)
Employee costs	800	Grants	1 321
Materials and contracts expense	1 100	Receivables	359
Depreciation expense	495	Land	1 012
Interest expense	215	Investments	1 123
Rates revenue – general	1 196	Other assets	11 125
– water	97	Bank overdraft	98
Interest revenue	156	Creditors	780
Donations	25	Loans	4 510

Required:

- Prepare an operating statement for the year ended 30 June 2004.
- Prepare a statement of financial position (narrative form) as at 30 June 2004.

Solution

A.

GREENBANK SHIRE COUNCIL Operating Statement for the year ended 30 June 2004			
	(000s)	(000s)	
<i>Revenues</i>			
Rates – general	\$1 196		
– water	97		
Interest revenue	156		
Grants	1 321		
Donations	<u>25</u>		
			\$2 795
<i>Expenses</i>			
Employee costs	800		
Materials and contracts	1 100		
Depreciation	495		
Interest expense	<u>215</u>		
			<u>2 610</u>
Net Profit/surplus			<u>\$ 185</u>

B.

GREENBANK SHIRE COUNCIL Statement of Financial Position as at 30 June 2004		(000s)
<i>Assets</i>		
Receivables		\$359
Land		1 012
Investments		1 123
Other assets		<u>11 125</u>
TOTAL ASSETS		<u>\$13 619</u>
<i>Liabilities</i>		
Bank overdraft		98
Creditors and provisions		780
Loans		<u>4 510</u>
TOTAL LIABILITIES		<u>\$5 388</u>
NET ASSETS		<u>\$8 231</u>
<i>Owner's equity</i>		
Accumulated surplus		<u>8 231</u>
OWNER'S EQUITY		<u>\$8 231</u>

Problem 2.5 Determining missing elements in accounting equation

Calculate the two missing elements for each independent case in the table below.

Case	Total assets	Total liabilities	Owner's equity	Total revenue	Total expenses	Net profit (loss)
1	\$120 000	\$ 40 000	\$?	\$136 000	\$?	\$13 200
2	?	25 000	30 000	89 000	?	4 250
3	70 000	?	50 000	83 000	65 000	?
4	?	106 000	172 000	?	260 000	31 000
5	120 000	?	70 000	?	62 000	(14 000)

Solution

Calculate the two missing amounts for each independent case below.

Case	Total assets	Total liabilities	Owner's equity	Total revenue	Total expenses	Net profit (loss)
1	\$120 000	\$ 40 000	\$ 80 000	\$136 000	\$122 800	\$13 200
2	<u>55 000</u>	25 000	30 000	89 000	<u>84 750</u>	4 250
3	70 000	<u>20 000</u>	50 000	83 000	65 000	<u>18 000</u>
4	<u>278 000</u>	106 000	172 000	<u>291 000 48</u>	260 000	31 000
5	120 000	<u>50 000</u>	70 000	<u>000</u>	62 000	(14 000)

Problem 2.6 Analysis of cash flows

José Carez owns a series of small laundries which operate under the business name of Cleanaway Laundry Services. During the month ended 30 April 2004, the laundries received cash of \$515 000 from services to customers. In addition, the following transactions occurred during the month:

1. The business sold an old counter from one of its laundries for \$400 cash.
2. An employee of the business repaid a \$2000 loan to the business.
3. Payments were made during the month for:
 - electricity, \$8000
 - purchase of solvents and cleaners, \$345 000
 - wages, \$23 000
 - rent of business premises, \$6000
 - a new advertising sign to replace one blown over in a storm, \$1200.
4. Carez intends to expand the business into a new suburb. Hence, the business has borrowed \$150 000 from a bank.
5. At the end of the month, the business entered into a lease agreement for rental of new premises at \$1200 per month, beginning in May.

Required:

- A. Prepare a statement of cash flows for Cleanaway Laundry Services for the month of April 2004. List the cash flows in a way that you feel highlights important information for decision making by users. Justify your presentation.
- B. From the viewpoint of a decision maker, do you believe that the cash flows for April are a good indication of cash flows in future months? Explain why or why not.

Solution

A.

CLEANAWAY LAUNDRY SERVICES		
Statement of Cash Flows		
for the month ended 30 April 2004		
CASH FLOWS FROM OPERATING ACTIVITIES		
Receipts from customers	\$515 000	
Payments to suppliers and employees (1)	(374 000)	
Net cash from operating activities		\$141 000
CASH FLOWS FROM INVESTING ACTIVITIES		
Sale of Counter	400	
Net cash used in investing activities		400
CASH FLOWS FROM FINANCING ACTIVITIES		
Bank Loan	150 000	
Net cash from financing activities		150 000
Net increase (decrease) in cash held		\$191 400

1. Payments to suppliers and employees = electricity \$800 + purchase of solvents & cleaners \$345 000 + wages \$23 000 + rent \$6 000 + payment for advertising sign \$1 200 – loan repaid by employee (\$2 000) = \$374 000

Note: Lease agreement entered into in April but no cash payment until May.

B.

The cash flows for April is not a good indication of cash flows in future months as it does not include the lease payments due from May onwards. The bank loan received in April is a one off positive cash flow event. Subsequent cash flows statements will show future loan repayments as a negative cash flow.