PART 5

Accounting Regulation of Assets and Liabilities

CHAPTER 17

Regulation and the conceptual framework

CONTENTS

ADDITIONAL PROBLEMS

Problem 17.1 Conceptual framework

Inala Ltd uses the historical cost system. While reviewing the business activities of the company, you discover that the following transactions and events were recorded.

1. Ending inventory for the current year had a cost of $115 200 and a net realisable value of $102 000. The inventory was not reduced to its net realisable value because the company's accountant believed that 'the selling price will probably increase again during the next year'.
2. On 28 December of the current year, Inala Ltd signed a contract with a customer under which Inala Ltd agreed to manufacture equipment for the customer during January of the following year at a price of $39 000. Inala Ltd received a cheque for $7500 from the customer on 28 December and made the following entry:

Accounts Receivable	31 500	
Cash at Bank	7 500	
Sales		39 000

3. A new vehicle was purchased at a motor auction sale for cash of $32 000. If purchased from the company's normal supplier, the cash price of the machine would have been $38 000. The Vehicles account was debited for $38 000 and the following entry made:

Vehicles	38 000	
Cash at Bank		32 000
Gain from Bargain Purchase		6 000

4. Ignition security locks were installed in each of Inala Ltd's six delivery trucks at a cost of $180 each. The trucks had an average remaining useful life of 5 years. The transaction was recorded as:

Repairs Expense	1 080	
Cash at Bank		1 080

5. Leasehold improvements with an estimated useful life of 10 years were completed early in the current year at a cost of $120 000. Inala Ltd had a 6-year non-renewable lease on the property to which the improvements were made. To record amortisation for the current year, the accountant made the following entry:

Amortisation Expense	12 000	
Leasehold Improvements		12 000

Required:

For each item above, determine which accounting concept(s) (if any) is violated, and explain why. For each violation, indicate the correct treatment.

(*continued*)

Solution

INALA LTD

1. The qualitative characteristic of reliability and the requirements of AASB 1019 have been violated. The value of the inventory should be measured by its net realisable value if lower than cost. The financial report must provide a faithful representation of the transactions and events which have occurred; hence, if the price of the inventory has fallen, the best representation of the fair value of the inventory is net realisable value at balance date. (But what if the fair value is above cost?)
2. There has been non-performance of the contract by Inala Ltd. At this point, Inala Ltd has and should record a liability for \$7 500. There is no revenue and revenue recognition should be deferred until performance is carried out in the following year. The cash receipt should be recorded by a debit to Cash at Bank for \$7 500 and a credit to Unearned Revenue (a liability) for \$7 500. Note particularly statements made in SAC 4 paragraphs 61 and A68-A70 in relation to the signing of contracts and their non-performance. Is the accounting treatment different if the order placed with Inala Ltd was for specialised equipment?
   Under SAC 4's revenue recognition criteria, it could be argued that no violation has occurred in the recognition of the increase in the asset via accounts receivable, as the inflow may pass the probability test and can be reliably measured. The credit entry, however, would be to a liability rather than to revenue, as the contract is executory in nature. See SAC 4 paras. 61-64 for further discussion.
3. The principle of valuing assets at purchase price as per AASB 1015, and the definition of revenue, have been violated. Under the accounting standard, the machinery must be recorded (debit) at its actual cost of \$32 000 as measured by the amount of cash paid (credit) to acquire it.
4. No violation has occurred as the cost of the ignition security locks is probably immaterial. They should be charged to expense during the current year.
5. The definition of an expense and the expense recognition criteria have been violated. Since the leasehold improvements are attached to the leased property, the future benefits of the leasehold improvements are consumed over the life of the lease, and should be amortised over 6 years, which is shorter than the overall useful life of the improvements. Thus, the amortisation expense should be recorded at \$20 000 per annum.

Problem 17.2 Revenue recognition criteria

This problem concerns the correct application of the revenue recognition criteria and consists of two parts.

Required – Part I:

Critique each of the following statements.

A. The revenue recognition criteria provide that revenue should be recognised under accrual accounting at the time of sale.

B. Revenue is generated with the passage of time.

C. Revenue must be earned before it is recognised.

Required – Part II:

Indicate the amount of revenue that should be recognised in 2003 in each of the following cases and explain why.

A. A cheque for $49 000 is received from a customer during 2003 in payment for equipment that is to be manufactured and shipped to the customer during 2004.

B. Net credit sales for 2003 amounted to $210 000, three-quarters of which were collected in 2003. Past experience indicates that about 90% of all credit sales are eventually collected.

Solution

Part I

A. The statement that revenue should be recognised under accrual accounting at the time of sale is incorrect. The appropriate criteria to consider for revenue recognition are contained in AASB 1004, which is an expansion of SAC 4's criteria. AASB 1004's and SAC 4's criteria are outlined in the text. According to SAC 4, revenue should be recognised when it is probable that the inflow or saving in outflow of economic benefits has occurred, and such inflow or savings in outflow can be measured reliably. Following this, most revenue is recognised under accrual accounting when the goods are sold or services are rendered even though cash may not be collected until a later period. The operating cycle is virtually complete and the inflow is probable. In some cases revenue is recognised as the production process takes place, eg. the percentage-of-completion method. In other cases revenue is recognised only as cash is collected, such as an instalment sale if there is a high degree of uncertainty as to whether the full sales price will be collected. For further comments here, see SAC 4 para. 130–131. AASB 1004 provides different recognition criteria for different types of revenue. With respect to the sale of goods, the standard presumes that the goods will be sold before revenue can be recognised, as control of the goods must pass to the buyer. However, AASB 1004 excludes any revenue recognition arising from valuing goods at market value. Consider the case of self-generating and regenerating assets (SGARAs), as discussed in AASB 1037.

B. The statement that revenue is generated with the passage of time is correct only in some situations such as interest revenue and rent revenue. In most other cases, revenue is generated (as distinguished from recognised) in a continual process as the activities that give rise to revenue take place. The acquisition of goods and services, the production process, selling and collection all contribute to the operating cycle. Revenue recognition depends on the criteria established in AASB 1004 and SAC 4.

C. Revenue does not have to be earned before it is recognised, even though the majority of revenue will be earned before recognition criteria are satisfied. AASB 1004 points out that revenue can consist of contributions received. These can include gifts received, rates and taxes received and government grants, all of which are not earned. AASB 1004 also regards liabilities forgiven as revenue, and these too are not "earned" as such.

Part II

A. No revenue should be recognised in 2003 because the inflow of economic benefits has not yet occurred. Revenue should be recognised in 2004 when the production is completed and the equipment is shipped to the customer. The cash collected should be credited to Unearned Revenue, a liability. In 2004 the unearned revenue should be transferred to revenue.

B. The entire $210 000 should be recognised as revenue in 2003 since it is probable that the inflow of benefits has occurred and can be measured reliably. A deduction of $21 000 (10% × $210 000) should be taken for estimated bad debts expense. The result is to recognise net revenue of $189 000 in 2003.

Problem 17.3 Exit value accounting

Financial statements for Dawesville Traders Ltd follow:

DAWESVILLE TRADERS LTD
Statement of Financial Performance
for the year ended 30 June 2003

SALES REVENUE		$139 600
EXPENSES		
Cost of goods sold	$69 600	
Depreciation expense	8 300	
Other expenses	22 200	100 100
NET PROFIT		$ 39 500

DAWESVILLE TRADERS LTD
Statement of Financial Position
as at 30 June 2003

ASSETS		LIABILITIES	
Cash at bank	$ 19 000	Accounts payable	$ 21 100
Accounts receivable (net)	31 000	Loan payable	14 600
Inventory	22 500		35 700
Plant and equipment	58 600	SHAREHOLDERS' EQUITY	
Accumulated depreciation	(8 300)	Share capital	74 500
Land	26 900	Retained profits	39 500
	$149 700		$149 700

Dawesville Traders Ltd began operations in July 2002, at which time the share capital was issued and plant and equipment and land were purchased. Sales were made and expenses (except for depreciation) were incurred evenly throughout 2002–03.

Assume the Consumer Price Index was:

204 on 1 July 2002
218 on 30 June 2003.

The exit value at 30 June 2003 of various assets were: inventory $40 000; plant and equipment $37 000; land $35 000.

Required:

A. Prepare an exit value statement of financial performance for the year ended 30 June 2003.

B. Prepare an exit value statement of financial position as at 30 June 2003. (Round to the nearest dollar.)

(*continued*)

Solution

A.

DAWESVILLE TRADERS LTD
Statement of Financial Performance (exit value)
for the year ended 30 June 2003

Sales revenue		$139 600
Cost of goods sold		69 600
Gross profit		70 000
Expenses - other		22 200
		47 800
Price variation adjustments:		
Inventory ($40 000 – $22 500)	$17 500	
Plant and equip.($58 600 – 8 300 + 8 300 – 37 000)	(21 600)	
Land ($35 000 – $26 900)	8 100	4 000
		51 800
Less: Capital maintenance adjustment		
($74 500 × [218 – 204] ÷ 204)		5 113
Net profit		$46 687

B.

DAWESVILLE TRADERS LTD
Statement of Financial Position (exit value)
as at 30 June 2003

Assets	
Cash at bank	$19 000
Accounts receivable	31 000
Inventory	40 000
Plant and equipment	37 000
Land	35 000
	$162 000
Liabilities	
Accounts payable	$21 100
Loan payable	14 600
	35 700
Shareholders' equity	
Share capital	74 500
Capital maintenance reserve ($74 500 × [218 – 204] ÷ 204)	5 113
Retained profits (balancing item)	46 687
	$162 000

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Problem 17.4 General price level financial statements

A statement of financial performance for 2002 and a statement of financial position as at 31 December 2002 for Springwood Suppliers Ltd are presented below:

SPRINGWOOD SUPPLIERS LTD
Statement of Financial Performance
for the year ended 31 December 2002

SALES REVENUE		$744 000
Cost of goods sold		427 800
GROSS PROFIT		316 200
EXPENSES		
Depreciation	$ 18 480	
Other expenses	213 600	232 080
NET PROFIT		$ 84 120

SPRINGWOOD SUPPLIERS LTD
Statement of Financial Position
as at 31 December 2002

Cash at bank		$ 67 200
Accounts receivable		95 760
Inventory		106 800
Plant and equipment		206 400
Accumulated depreciation		(42 000)
Land		58 800
Investment in debentures of Sunnycorp Ltd		18 000
		$ 510 960
Accounts payable		$ 117 600
Loan payable, due in 2005		109 200
		226 800
Share capital	$ 138 000	
Retained profits	146 160	284 160
		$ 510 960

Additional information

1. Inventory was acquired evenly throughout 2002.
2. The company was formed in 1996, at which time the capital was issued and the plant and equipment purchased.
3. The investment in debentures of Sunnycorp Ltd was made in 1998.
4. Sales were made and expenses (except for depreciation) were incurred evenly throughout the year.
5. A purchasing-power gain on monetary items of $5580 was calculated for the year.
6. The land was acquired in two purchases. The first parcel was purchased with the plant and equipment in 1996 for $36 000; the second portion was purchased in 1998 for $22 800.
7. The assumed Consumer Price Index on various dates was:

In 1996 when the company was formed	150
In 1998 when the debentures and land were purchased	180
On 31 December 2002	220
Average for the year 2002	210

Required:

A. Prepare a general price level statement of financial performance for the year ended 31 December 2002.
B. Prepare a general price level statement of financial position as at 31 December 2002.

Solution

A.

SPRINGWOOD SUPPLIERS LTD
General Price Level Statement of Financial Performance
for the year ended 31 December 2002

Sales revenue ($744 000 × 220/210		$779 429
Cost of goods sold ($427 800 × 220/210)		448 171
Gross profit		331 258
Expenses:		
Depreciation ($18 480 × 220/150)	$27 104	
Other ($213 600 × 220/210)	223 771	250 875
Profit before purchasing power gain		80 383
Purchasing power gain		5 580
Net profit		$85 963

B.

SPRINGWOOD SUPPLIERS LTD
General Price Level Statement of Financial Position
as at 31 December 2002

Assets	
Cash at bank	$67 200
Accounts receivable	95 760
Inventory ($106 800 × 220/210)	111 886
Plant and equipment ($206 400 × 220/150)	302 720
Accumulated deprecation ($42 000 × 220/150)	(61 600)
Land*	80 667
Investment in debentures (monetary)	18 000
	$614 633
Liabilities and shareholders' equity	
Accounts payable	$117 600
Loan payable	109 200
Share capital	138 000
Capital maintenance reserve (= $138 000 × (220 − 150)/150)	64 600
Retained profits (balancing amount)	185 233
	$614 633

* $36 000 × 220/150 = $52 800
$22 800 × 220/180 = $27 867
Total = $80 667

Problem 17.5 Current cost financial statements

A statement of financial performance for the year ended 30 June 2003 and a statement of financial position as at 30 June 2003 for Mansfield Merchandisers Ltd are presented below:

MANSFIELD MERCHANDISERS LTD
Statement of Financial Performance
for the year ended 30 June 2003

SALES REVENUE (90 000 units × $10)		$900 000
Less: Cost of goods sold (FIFO)		500 000
[40 000 units × $5]		
[50 000 units × $6]		
GROSS PROFIT		400 000
EXPENSES		
Wages and salaries expense	$90 000	
Rent expense	40 000	
Depreciation of vehicles	24 000	
Other expenses	36 000	190 000
NET PROFIT		$210 000

MANSFIELD MERCHANDISERS LTD
Statement of Financial Position
as at 30 June 2003

ASSETS		LIABILITIES AND SHAREHOLDERS' EQUITY	
Cash at bank	$ 40 000	Accounts payable	$132 000
Accounts receivable	150 000	Loan payable	170 000
Inventory	530 000	Accrued expenses	4 000
Motor vehicles	120 000	Share capital	300 000
Accumulated depreciation	(24 000)	Retained profits	210 000
	$816 000		$816 000

The business was formed on 1 July 2002 at which time the shares were issued and the motor vehicles purchased. Purchases of inventory during the year were:

2 July 2000	40 000 units for $5 each
30 October 2000	80 000 units for $6 each
31 March 2001	50 000 units for $7 each

Sales of inventory occurred as follows:

30 000 units when the cost price was $5
30 000 units when the cost price was $6
30 000 units when the cost price was $7

The current cost of inventory on 30 June 2003 was $8. The current cost of motor vehicles at 30 June 2003 was $150 000. Vehicles are depreciated over 5 years straight line with no residual value.

A purchasing power gain on monetary items was calculated as $11 000.

Required:
Prepare a current cost statement of financial performance and statement of financial position for the year ended 30 June 2003.

(*continued*)

MANSFIELD MERCHANDISERS LTD
Current Cost Statement of Financial Peformance
for the year ended 30 June 2003

Sales revenue			$900 000
Cost of goods sold	30 000 x $5 = $150 000		
	30 000 x $6 = $180 000		
	30 000 x $7 = $210 000		540 000
Gross profit			360 000
Expenses:			
Wages and salaries expense		$90 000	
Rent expense		40 000	
Depreciation of vehicles*		27 000	
Other expenses		36 000	193 000
			167 000
Plus: purchasing power gain on monetary items			11 000
			$178 000

* (120 000 + 150 000)/2 ÷ 5

MANSFIELD MERCHANDISERS LTD
Current Cost Statement of Financial Position
as at 30 June 2003

Assets		Liabilities and shareholder's equity	
Cash at bank	$40 000	Accounts payable	$132 000
Accounts receivable	150 000	Loan payable	170 000
Inventory (80 000 x $8)	640 000	Accrued expenses	4 000
Motor vehicles	150 000	Share capital	300 000
Accumulated depreciation	(30 000)	Current cost reserve	
		(balancing item)	166 000
		Retained profits	178 000
	$950 000		$950 000