CHAPTER 2

Accounting and reporting on an accrual accounting basis

2.1 Introduction

The main purpose of this chapter is to extend cash flow accounting by adjusting for the effect of transactions that have not been completed by the end of an accounting period.

Objectives

By the end of this chapter, you should be able to:

- explain the historical cost convention and accrual concept;
- adjust cash receipts and payments in accordance with IAS 18 *Revenue*;
- account for the amount of non-current assets used during the accounting period;
- prepare a statement of income and a statement of financial position;
- reconcile cash flow accounting and accrual accounting data.

2.1.1 Objective of financial statements

The International Accounting Standards Committee (IASC) has stated that the objective of financial statements is to provide information about the financial position, performance and capability of an enterprise that is useful to a wide range of users in making economic decisions.[1]

Common information needs for decision making

The IASC recognises that all the information needs of all users cannot be met by financial statements, but it takes the view that some needs are common to all users: in particular, they have some interest in the financial position, performance and adaptability of the enterprise as a whole. This leaves open the question of which user is the primary target; the IASC states that, as investors are providers of risk capital, financial statements that meet their needs would also meet the needs of other users.[2]

Stewardship role of financial statements

In addition to assisting in making economic decisions, financial statements also show the results of the stewardship of management: that is, the accountability of management for the resources entrusted to it. The IASC view[3] is that users who assess the stewardship do so in order to make economic decisions, e.g. whether to hold or sell shares in a particular company or change the management.

Decision makers need to assess ability to generate cash

The IASC considers that economic decisions also require an evaluation of an enterprise's ability to generate cash, and of the timing and certainty of its generation.[4] It believes that users are better able to make the evaluation if they are provided with information that focuses on the financial position, performance and cash flow of an enterprise.

2.1.2 Financial information to evaluate the ability to generate cash differs from financial information on actual cash flows

The IASC approach differs from the cash flow model used in Chapter 1, in that, in addition to the cash flows and statement of financial position, it includes within its definition of performance a reference to profit. It states that this information is required to assess changes in the economic resources that the enterprise is likely to control in the future. This is useful in predicting the capacity of the enterprise to generate cash flows from its existing resource base.[5]

2.1.3 Statements making up the financial statements published for external users

The IASB stated in 2005[6] that the financial statements published by a company for external users should consist of the following:

- a statement of financial position;
- a statement of comprehensive income;
- a statement of changes in equity;
- a cash flow statement;[7]
- notes comprising a summary of significant accounting policies and other explanatory notes.

In 2007 the IASB stated[8] that a complete set of financial statements should comprise:

- a statement of financial position as at the end of the period;
- a statement of comprehensive income for the period;
- a statement of changes in equity for the period;
- a statement of cash flows for the period;
- notes comprising a summary of significant accounting policies and other explanatory information.

Entities may, however, use other titles in their financial statements. This means that for a period both the pre-2007 and post-2007 titles will be used.

In this chapter we consider two of the conventions under which the statement of comprehensive income and statement of financial position are prepared: the historical cost convention and the accrual accounting concept.

2.2 Historical cost convention

The historical cost convention results in an appropriate measure of the economic resource that has been withdrawn or replaced.

Under it, transactions are reported at the £ amount recorded at the date the transaction occurred. Financial statements produced under this convention provide a basis for determining the outcome of agency agreements with reasonable certainty and predictability because the data are relatively objective.[9]

By this we mean that various parties who deal with the enterprise, such as lenders, will know that the figures produced in any financial statements are objective and not manipulated by subjective judgements made by the directors. A typical example occurs when a lender attaches a covenant to a loan that the enterprise shall not exceed a specified level of gearing.

At an operational level, revenue and expense in the statement of comprehensive income are stated at the £ amount that appears on the invoices. This amount is objective and verifiable. Because of this, the historical cost convention has strengths for stewardship purposes, but inflation-adjusted figures may well be more appropriate for decision usefulness.

2.3 Accrual basis of accounting

The accrual basis dictates when transactions with third parties should be recognised and, in particular, determines the accounting periods in which they should be incorporated into the financial statements. Under this concept the cash receipts from customers and payments to creditors are replaced by revenue and expenses respectively.

Revenue and expenses are derived by adjusting the realised operating cash flows to take account of business trading activity that has occurred during the accounting period, but has not been converted into cash receipts or payments by the end of the period.

2.3.1 Accrual accounting is a better indicator than cash flow accounting of ability to generate cash

The accounting profession generally supports the view expressed by the Financial Accounting Standards Board (FASB) in the USA that accrual accounting provides a better indication of an enterprise's present and continuing ability to generate favourable cash flows than information limited to the financial aspects of cash receipts and payments.[10]

The IASC supported the FASB view in 1989 when it stated that financial statements prepared on an accrual basis inform users not only of past transactions involving the payment and receipt of cash, but also of obligations to pay cash in the future and of resources that represent cash to be received in the future, and that they provide the type of information about past transactions and other events that is most useful in making economic decisions.[11]

Having briefly considered why accrual accounting is more useful than cash flow accounting, we will briefly revise the preparation of financial statements under the accrual accounting convention.

2.4 Mechanics of accrual accounting – adjusting cash receipts and payments

We use the cash flows set out in Figure 1.7. The derivation of the revenue and expenses for this example is set out in Figures 2.1 and 2.2. We assume that the enterprise has incomplete

Figure 2.1 Derivation of revenue

	£
Cash received	172,500
Invoices not paid (= Sales invoiced – Cash received)	22,500
Revenue = Total invoiced	195,000

Figure 2.2 Derivation of expense

	Materials	*Services*
	£	£
Cash paid	129,000	21,600
Invoices not paid	37,000	900
Expense = Total invoiced	166,000	22,500

records, so that the revenue is arrived at by keeping a record of unpaid invoices and adding these to the cash receipts. Clearly, if the invoices are not adequately controlled, there will be no assurance that the £22,500 figure is correct. This is a relatively straightforward process at a mechanistic level. The uncertainty is not how to adjust the cash flow figures, but when to adjust them. This decision requires managers to make subjective judgements. We now look briefly at the nature of such judgements.

2.5 Subjective judgements required in accrual accounting – adjusting cash receipts in accordance with IAS 18

In Figure 2.1 we assumed that revenue was derived simply by adding unpaid invoices to the cash receipts. In practice, however, this is influenced by the commercial facts underlying the transactions. For example, if the company is a milk producer, the point at which it should report the milk production as revenue will be influenced by the existence of a supply contract. If there is a contract with a buyer, the revenue might be recognised immediately on production.

So that financial statements are comparable, the IASC[12] has set out revenue recognition criteria in IAS 18 *Revenue* in an attempt to identify when performance was sufficient to warrant inclusion in the revenue for the period. It stated that:

> In a transaction involving the sale of goods, performance should be regarded as being achieved when the following conditions have been fulfilled:
>
> **(a)** the seller of the goods has transferred to the buyer the significant risks and rewards of ownership, in that all significant acts have been completed and the seller retains no continuing managerial involvement in, or effective control of, the goods transferred to a degree usually associated with ownership; and
>
> **(b)** no significant uncertainty exists regarding:
>
> (i) the amount to be received for the goods;
>
> (ii) the costs incurred or to be incurred in producing or purchasing the goods.

The criteria are simple in their intention, but difficult in their application. For instance, at what exact point in the sales cycle is there no significant uncertainty? The enterprise has to decide on the critical event that can support an assumption that revenue may be recognised.

To assist with these decisions, the standard provided an appendix with a number of examples. Figure 2.3 gives examples of critical events.

The amount of detail in the accounting policy for turnover will depend on the range of activities within a business and events occurring during the financial year. For example, the relevant section of the 2008 Annual Report of the Chloride Group,[13] which tests and assembles electronic products, simply reads:

> **Revenue**
> Revenue represents the amounts, excluding VAT and similar sales-related taxes, receivable by the Company for goods and services supplied to outside customers in the ordinary course of business. Revenue is recognised when persuasive evidence of an arrangement with a customer exists, products have been delivered or services have been rendered and collectability is reasonably assured.

The revenue recognition policy for Wolseley plc in its 2008 Annual Report[14] is more specific with reference to sales returns as follows:

> **Revenue**
> Revenue is the amount receivable for the provision of goods and services falling within the Group's ordinary activities, excluding intra-group sales, estimated and actual sales returns, trade and early settlement discounts, value added tax and similar sales taxes.
>
> Revenue from the provision of goods is recognised when the risks and rewards of ownership of goods have been transferred to the customer. The risks and rewards of ownership of goods are deemed to have been transferred when the goods are shipped to, or are picked up by, the customer.
>
> Revenue from services, other than those that arise from construction service contracts (see below), are recognised when the service provided to the customer has been completed.
>
> Revenue from the provision of goods and all services is only recognised when the amounts to be recognised are fixed or determinable and collectibility is reasonably assured.

Figure 2.3 Extracts from IAS 18 *Revenue* illustrating critical events

Transaction	Critical event
Services	
Servicing fees included in the price of the product[15]	When the selling price of a product includes an identifiable amount for subsequent servicing for, say, a warranty period, it will normally be appropriate to defer the relevant portion of the selling price and to recognise it as revenue over the appropriate period.
Sales of goods	
Shipment made giving the buyer right of return[16]	Recognition of revenue in such circumstances will depend on the substance of the agreement. In the case of normal retail sales (e.g. chain store offering money back if not satisfied) it may be appropriate to recognise the sale but to make a suitable provision for returns based on previous experience. In other cases the substance of the agreement may amount to a sale on consignment, in which case the revenue should not be recognised until the goods are sold to a third party.

2.5.1 Inflating revenue

Total revenue can have an impact on the value of a company's shares and a number of companies attempted to raise their market capitalisation by artificially inflating total revenue. In the US the FASB reacted by issuing guidance[17] on the treatment of sales incentives such as slotting fees (these are payments to a retailer to obtain space on shelves or in catalogues) and cooperative advertising programmes. The result of the guidance was that the fees must be deducted from the revenue rather than expensed – the effect is that that revenue is reduced, gross profit is reduced, expenses are reduced but net profit remains unchanged.

The issue of the FASB guidance clarified the position for many companies of what had been a grey area and a number of companies restated their turnover.

For example, the Novartis Group disclosed in its 2002 Annual Report that it had changed its treatment of discounts allowed to customers:

> Sales are recognised when the significant risks and rewards of ownership of the assets have been transferred to a third party and are reported net of sales taxes and rebates. . . . Sales have been restated for all periods presented to treat certain sales incentives and discounts to retailers as sales deductions instead of marketing and distribution expenses.

Note that this does not affect the bottom line but does have an impact on the sales and gross profit figures.

2.6 Subjective judgements required in accrual accounting – adjusting cash payments in accordance with the matching principle

We have seen that the enterprise needs to decide when to recognise the revenue. It then needs to decide when to include an item as an expense in the statement of comprehensive income. This decision is based on an application of the matching principle.

The matching principle means that financial statements must include costs related to the achievement of the reported revenue. These include the internal transfers required to ensure that reductions in the assets held by a business are recorded at the same time as the revenues.

The expense might be more or less than the cash paid. For example, in the Norman example, £37,000 was invoiced but not paid on materials, and £900 on services; £3,125 was prepaid on rent for the six months after June. The cash flow information therefore needs to be adjusted as in Figure 2.4.

Figure 2.4 Statement of comprehensive income for the six months ended 30 June 20X1

	Operating cash flow £	*ADJUST cash flow* £	*Business activity* £
Revenue from business activity	172,500	22,500	195,000
Less: Matching expenses			
Transactions for materials	129,000	37,000	166,000
Transactions for services	21,600	900	22,500
Transaction with landlord	6,250	(3,125)	3,125
OPERATING CASH FLOW from business activity	15,650		
Transactions NOT converted to cash or relating to a subsequent period		(12,275)	
PROFIT from business activity			3,375

2.7 Mechanics of accrual accounting – the statement of financial position

The statement of financial position or statement of financial position, as set out in Figure 1.12, needs to be amended following the change from cash flow to accrual accounting. It needs to include the £ amounts that have arisen from trading but have not been converted to cash, and the £ amounts of cash that have been received or paid but relate to a subsequent period. The adjusted statement of financial position is set out in Figure 2.5.

Figure 2.5 Statement of financial position adjusted to an accrual basis

	£
Capital	50,000
Net operating cash flow: **realised**	15,650
Net operating cash flow: **to be realised next period**	(12,275)
	53,375
Lease	80,000
Net cash balance (refer to Figure 1.11)	(14,350)
Net amount of activities not converted to cash or relating to subsequent periods	(12,275)
	53,375

2.8 Reformatting the statement of financial position

The item 'net amount of activities not converted to cash or relating to subsequent periods' is the net debtor/creditor balance. If we wished, the statement of financial position could be reframed into the customary statement of financial position format, where items are classified as assets or liabilities. The IASC defines assets and liabilities in its *Framework*:[18]

- An asset is a resource:
  - controlled by the enterprise;
  - as a result of past events;
  - from which future economic benefits are expected to flow.
- A liability is a present obligation:
  - arising from past events;
  - the settlement of which is expected to result in an outflow of resources.

The reframed statement set out in Figure 2.6 is in accordance with these definitions. Note that the same amount of £3,375 results from calculating the difference in the opening and closing net assets in the statements of financial position as from calculating the residual amount in the statement of comprehensive income. When the amount derived from both approaches is the same, the statement of financial position and statement of comprehensive income are said to **articulate**. The statement of comprehensive income provides the detailed explanation for the difference in the net assets and the amount is the same because the same concepts have been applied to both statements.

Figure 2.6 Reframed statement as at 30 June

		Reframed
	£	£
CAPITAL	50,000	50,000
Net operating cash flow: **realised**	15,650	
Net operating cash flow: **to be realised**	(12,275)	
NET INCOME		3,375
	53,375	53,375
NON-CURRENT ASSETS	80,000	80,000
NET CURRENT ASSETS		
Net amount of activities not converted to cash	(12,275)	
CURRENT ASSETS		
Trade receivables		22,500
Other receivables: Prepaid rent		3,125
CURRENT LIABILITIES		
Trade payables		(37,000)
Other payables: service suppliers		(900)
Net cash balance	(14,350)	(14,350)
	53,375	53,375

2.9 Accounting for the sacrifice of non-current assets

The statement of comprehensive income and statement of financial position have both been prepared using verifiable data that have arisen from transactions with third parties outside the business. However, in order to determine the full sacrifice of economic resources that a business has made to achieve its revenue, it is necessary also to take account of the use made of the non-current assets during the period in which the revenue arose.

In the Norman example, the non-current asset is the lease. The extent of the sacrifice is a matter of judgement by the management. This is influenced by the prudence principle, which regulates the matching principle. The prudence principle determines the extent to which transactions that have already been included in the accounting system should be recognised in the statement of comprehensive income.

2.9.1 Treatment of non-current assets in accrual accounting

Applying the matching principle, it is necessary to estimate how much of the initial outlay should be assumed to have been revenue expenditure, i.e. used in achieving the revenue of the accounting period. The provisions of IAS 16 on **depreciation** assist by defining depreciation and stating the duty of allocation, as follows:

> Depreciation is the systematic allocation of the depreciable amount of an asset over its useful life.[19]
>
> Depreciable amount is the cost of an asset, or other amount substituted for cost in the financial statements, less its residual value.[20]

> The depreciation method used should reflect the pattern in which the asset's economic benefits are consumed by the enterprise.[21]

This sounds a rather complex requirement. It is therefore surprising, when one looks at the financial statements of a multinational company such as in the 2005 Annual Report of BP plc, to find that depreciation on tangible assets other than mineral production is simply provided on a straight-line basis of an equal amount each year, calculated so as to write off the cost by equal instalments. In the UK, this treatment is recognised in FRS 15 which states that where the pattern of consumption of an asset's economic benefits is uncertain, a straight-line method of depreciation is usually adopted.[22] The reason is that, in accrual accounting, the depreciation charged to the statement of comprehensive income is a measure of the amount of the economic benefits that have been consumed, rather than a measure of the fall in realisable value. In estimating the amount of service potential expired, a business is following the **going concern assumption**.

2.9.2 Going concern assumption

The going concern assumption is that the business enterprise will continue in operational existence for the foreseeable future. This assumption introduces a constraint on the prudence concept by allowing the account balances to be reported on a depreciated cost basis rather than on a net realisable value basis.

It is more relevant to use the loss of service potential than the change in realisable value because there is no intention to cease trading and to sell the fixed assets at the end of the accounting period.

In our Norman example, the procedure would be to assume that, in the case of the lease, the economic resource that has been consumed can be measured by the amortisation that has occurred due to the effluxion of time. The time covered by the accounts is half a year: this means that one-tenth of the lease has expired during the half-year. As a result, £8,000 is treated as revenue expenditure in the half-year to 30 June.

This additional revenue expenditure reduces the income in the income account and the asset figure in the statement of financial position. The effects are incorporated into the two statements in Figures 2.7 and 2.8. The asset amounts and the income figure in the statement of financial position are also affected by the exhaustion of part of the non-current assets, as set out in Figure 2.8.

It is current accounting practice to apply the same concepts to determining the entries in both the statement of comprehensive income and the statement of financial position. The amortisation charged in the statement of comprehensive income at £8,000 is the same as the amount deducted from the non-current assets in the statement of financial position. As a result, the two statements articulate: the statement of comprehensive income explains the reason for the reduction of £4,625 in the net assets.

How decision-useful to the management is the income figure that has been derived after deducting a depreciation charge?

The loss of £4,625 indicates that the distribution of any amount would further deplete the financial capital of £50,000 which was invested in the company by Mr Norman on setting up the business. This is referred to as **capital maintenance**; the particular capital maintenance concept that has been applied is the **financial capital maintenance concept**.

2.9.3 Financial capital maintenance concept

The financial capital maintenance concept recognises a profit only after the original monetary investment has been maintained. This means that, as long as the cost of the assets

Figure 2.7 Statement of comprehensive income for the six months ending 30 June

	Operating cash flow CURRENT period £	*Adjust cash flow* £	*Business activity CURRENT period* £
Revenue from business activity	172,500	22,500	195,000
Less			
Expenditure to support this activity:			
Transactions with suppliers	129,000	37,000	166,000
Transactions with service providers	21,600	900	22,500
Transaction with landlord	6,250	(3,125)	3,125
OPERATING CASH FLOW from activity	15,650		
TRANSACTIONS NOT CONVERTED TO CASH		(12,275)	
INCOME from business activity			3,375
Allocation of non-current asset cost to this period			8,000
INCOME			(4,625)

Figure 2.8 Statement of financial position as at 30 June

	Transaction cash flows £	*Notional flows* £	*Reported* £
CAPITAL	50,000		50,000
Net operating cash flow: **realised**	15,650		
Net operating cash flow: **to be realised**	(12,275)		
Net income before depreciation		3,375	
AMORTISATION		(8,000)	
Net income after amortisation			(4,625)
	53,375		45,375
NON-CURRENT ASSETS	80,000	80,000	
Less amortisation		(8,000)	
Net book value			72,000
NET CURRENT ASSETS			
Net amount not converted to cash	(12,275)		
CURRENT ASSETS			
Trade receivables			22,500
Other receivables – prepaid rent			3,125
CURRENT LIABILITIES			
Trade payables			(37,000)
Other payables: service suppliers			(900)
Net cash balance	(14,350)		(14,350)
	53,375		45,375

representing the initial monetary investment is recovered against the profit, by way of a depreciation charge, the initial monetary investment is maintained.

The concept has been described in the IASC *Framework for the Presentation and Preparation of Financial Statements*:

> a profit is earned only if the financial or money amount of the net assets at the end of the period exceeds the financial or money amount of the net assets at the beginning of the period, after excluding any distributions to, and contributions from, owners during the period. Financial capital maintenance can be measured in either nominal monetary units [as we are doing in this chapter] or in units of constant purchasing power [as we will be doing in Chapter 4].[23]

2.9.4 Summary of views on accrual accounting

Standard setters:
The profit (loss) is considered to be a guide when assessing the amount, timing and uncertainty of prospective cash flows as represented by future income amounts. The IASC, FASB in the USA and ASB in the UK clearly state that the accrual accounting concept is more useful in predicting future cash flows than cash flow accounting.

Academic researchers:
Academic research provides conflicting views. In 1986, research carried out in the USA indicated that the FASB view was inconsistent with its findings and that cash flow information was a better predictor of future operating cash flows;[24] research carried out in the UK, however, indicated that accrual accounting using the historical cost convention was 'a more relevant basis for decision making than cash flow measures'.[25]

2.10 Reconciliation of cash flow and accrual accounting data

The accounting profession attempted to provide users of financial statements with the benefits of both types of data, by requiring a cash flow statement to be prepared as well as the statement of comprehensive income and statement of financial position prepared on an accrual basis.

From the statement of comprehensive income prepared on an accrual basis (as in Figure 2.7) an investor is able to obtain an indication of a business's present ability to generate favourable cash flows; from the statement of financial position prepared on an accrual basis (as in Figure 2.8) an investor is able to obtain an indication of a business's continuing ability to generate favourable cash flows; from the cash flow statement (as in Figure 2.9) an investor is able to reconcile the income figure with the change in net cash balance.

Figure 2.9 reconciles the information produced in Chapter 1 under the cash flow basis with the information produced under the accrual basis. It could be expanded to provide information more clearly, as in Figure 2.10. Here we are using the information from Figures 1.9 and 1.12, but within a third statement rather than the statement of comprehensive income and statement of financial position.

2.10.1 Published cash flow statement

IAS 7 *Statement of cash flows*[26] specifies the standard headings under which cash flows should be classified. They are:

Figure 2.9 Reconciliation of income figure with net cash balance

	£
Income per income statement	(4,625)
Add: unrealisable cash outflow	8,000
	3,375
Add: unrealised operating cash flows	12,275
Operating cash flow	15,650
Other sources:	
Capital	50,000
Total cash available	65,650
Applications	
Lease	(80,000)
Net cash balance	(14,350)

Figure 2.10 Statement of cash flows netting amounts that have not been converted to cash

	£	£
Sales	195,000	
Trade receivables	(22,500)	172,500
Purchases	166,000	
Trade payables	(37,000)	(129,000)
Expenses	22,500	
Other payables	(900)	(21,600)
Rent	3,125	
Other receivables: Prepaid rent	3,125	(6,250)
Net cash inflow from operating activities		15,650
Cash flows from investing activities		
Lease		(80,000)
Cash flows from financing activities		
Issue of capital		50,000
Decrease in cash		(14,350)

- cash flows from operating activities;
- cash flows from investing activities;
- cash flows from financing activities;
- net increase in cash and cash equivalents.

To comply with IAS 7, the cash flows from Figure 2.10 would be set out as in Figure 2.11. IAS 7 is mentioned at this stage only to illustrate that cash flows can be reconciled to the accrual accounting data. There is further discussion of IAS 7 in Chapter 26.

Figure 2.11 Cash flow statement in accordance with IAS 7 *Statement of cash flows*

	£
Net cash inflow from operating activities	15,650
Investing activities	
Payment to acquire lease	(80,000)
Net cash outflow before financing	(64,350)
Financing	
Issue of capital	50,000
Decrease in cash	(14,350)
Reconciliation of operating loss to net cash inflow from operating activities	£
Operating profit/loss	(4,625)
Amortisation charges	8,000
Increase in trade receivables	(22,500)
Increase in prepayments	(3,125)
Increase in trade payables	37,000
Increase in accruals	900
	15,650

Summary

Accrual accounting replaces cash receipts and payments with revenue and expenses by adjusting the cash figures to take account of trading activity which has not been converted into cash.

Accrual accounting is preferred to cash accounting by the standard setters on the assumption that accrual-based financial statements give investors a better means of predicting future cash flows.

The financial statements are transaction based, applying the historical cost accounting concept which attempts to minimise the need for personal judgements and estimates in arriving at the figures in the statements.

Under accrual-based accounting the expenses incurred are matched with the revenue earned. In the case of non-current assets, a further accounting concept has been adopted, the going concern concept, which allows an entity to allocate the cost of non-current assets over their estimated useful life.

REVIEW QUESTIONS

1 *The Framework for the Preparation and Presentation of Financial Statements* identified seven user groups: investors, employees, lenders, suppliers and other trade creditors, customers, government and the public.

Discuss which of the financial statements illustrated in Chapters 1 and 2 would be most useful to each of these seven groups if they could only receive one statement.

2 'Accrual accounting is preferable to cash flow accounting because the information is more relevant to all users of financial statements.' Discuss.

3 'Cash flow accounting and accrual accounting information are both required by a potential shareholder.' Discuss.

4 'Information contained in a statement of comprehensive income and a statement of financial position prepared under accrual accounting concepts is factual and objective.' Discuss.

5 'The asset measurement basis applied in accrual accounting can lead to financial difficulties when assets are due for replacement.' Discuss.

6 'Accountants preparing financial statements in the UK do not require a standard such as IAS 18 *Revenue*.' Discuss.

7 Explain the revenue recognition principle and discuss the effect of alternative treatments on the reported results of a company.

8 The annual financial statements of companies are used by various parties for a wide variety of purposes. For each of the seven different 'user groups', explain their presumed interest with reference to the performance of the company and its financial position.

EXERCISES

An extract from the solution is provided on the Companion Website (www.pearsoned.co.uk/elliott-elliott) for exercises marked with an asterisk (*).

Question 1

Jane Parker is going to set up a new business in Bruges on 1 January 20X1. She estimates that her first six months in business will be as follows:

(i) She will put €150,000 into the firm on 1 January 20X1.

(ii) On 1 January 20X1 she will buy machinery €30,000, motor vehicles €24,000 and premises €75,000, paying for them immediately.

(iii) All purchases will be effected on credit. She will buy €30,000 goods on 1 January and she will pay for these in February. Other purchases will be: rest of January €48,000; February, March, April, May and June €60,000 each month. Other than the €30,000 worth bought in January, all other purchases will be paid for two months after purchase, i.e. €48,000 in March.

(iv) Sales (all on credit) will be €60,000 for January and €75,000 for each month after that. Customers will pay for goods in the third month after purchase, i.e. €60,000 in April.

(v) Inventory on 30 June 20X1 will be €30,000.

(vi) Wages and salaries will be €2,250 per month and will be paid on the last day of each month.

(vii) General expenses will be €750 per month, payable in the month following that in which they are incurred.

(viii) She will introduce new capital of €75,000 on 1 June 20X1. This will be paid into the business bank account immediately.

(ix) Insurance covering the 12 months of 20X1 of €26,400 will be paid for by cheque on 30 June 20X1.

(x) Local taxes will be paid as follows: for the three months to 31 March 20X1 by cheque on 28 February 20X2, delay due to an oversight by Parker; for the 12 months ended 31 March 20X2 by cheque on 31 July 20X1. Local taxes are €8,000 per annum.

(xi) She will make drawings of €1,500 per month by cheque.

(xii) All receipts and payments are by cheque.

(xiii) Depreciate motor vehicles by 20% per annum and machinery by 10% per annum, using the straight-line depreciation method.

(xiv) She has been informed by her bank manager that he is prepared to offer an overdraft facility of €30,000 for the first year.

Required:

(a) Draft a cash budget (for the firm) month by month for the period January to June, showing clearly the amount of bank balance at the end of each month.

(b) Draft the projected statement of comprehensive income for the first six months' trading, and a statement of financial position as at 30 June 20X1.

(c) Advise Jane on the alternative courses of action that could be taken to cover any cash deficiency that exceeds the agreed overdraft limit.

* Question 2

Mr Norman is going to set up a new business in Singapore on 1 January 20X8. He will invest $150,000 in the business on that date and has made the following estimates and policy decisions:

1 Forecast sales (in units) made at a selling price of $50 per unit are:

Month	*Sales units*	*Month*	*Sales units*
January	1,650	May	4,400
February	2,200	June	4,950
March	3,850	July	5,500
April	4,400		

2 50% of sales are for cash. Credit terms are payment in the month following sale.

3 The units cost $40 each and the supplier is allowed one month's credit.

4 It is intended to hold inventory at the end of each month sufficient to cover 25% of the following month's sales.

5 Administration $8,000 and wages $17,000 are paid monthly as they arise.

6 On 1 January 20X8, the following payments will be made: $80,000 for a five-year lease of the business premises and $350 for insurance for the year.

7 Staff sales commission of 2% of sales will be paid in the month following sale.

Required:

(a) A purchases budget for each of the first six months.

(b) A cash flow forecast for the first six months.

(c) A budgeted statement of comprehensive income for the first six months' trading and a budgeted statement of financial position as at 30 June 20X8.

(d) Advise Mr Norman on the investment of any excess cash.

Question 3

The Piano Warehouse Company Limited was established in the UK on 1 January 20X7 for the purpose of making pianos. Jeremy Holmes, the managing director, had 20 years' experience in the manufacture of pianos and was an acknowledged technical expert in the field. He had invested his life's savings of £15,000 in the company, and his decision to launch the company reflected his desire for complete independence.

Nevertheless, his commitment to the company represented a considerable financial gamble. He paid close attention to the management of its financial affairs and ensured that a careful record of all transactions was kept.

The company's activities during the year ended 31 December 20X7 were as follows:

(i) Four pianos had been built and sold for a total sum of £8,000. Holmes calculated their cost of manufacture as follows:

Materials	£2,000
Labour	£2,800
Overhead costs	£800

(ii) Two pianos were 50% completed at 31 December 20X7. Madrigal Music Limited had agreed to buy them for a total of £4,500 and had made a down-payment amounting to 20% of the agreed sale price. Holmes estimated their costs of manufacture to 31 December 20X7 as follows:

Materials	£900
Labour	£800
Overhead costs	£100

(iii) Two pianos had been rebuilt and sold for a total of £3,000. Holmes paid £1,800 for them at an auction and had spent a further £400 on rebuilding them. The sale of these two pianos was made under a hire purchase agreement under which the Piano Warehouse Company received £1,000 on delivery and two payments over the next two years plus interest of 15% on the outstanding balance.

At the end of the company's first financial year, Jeremy Holmes was anxious that the company's net profit to 31 December 20X7 should be represented in the most accurate manner. There appeared to be several alternative bases on which the transactions for the year could be interpreted. It was clear to him that, in simple terms, the net profit for the year should be calculated by deducting expenses from revenues. As far as cash sales were concerned he saw no difficulty. But how should the pianos that were 50% completed be treated? Should the value of the work done up to 31 December 20X7 be included in the profit of that year, or should it be carried forward to the next year, when the work would be completed and the pianos sold? As regards the pianos sold under the hire purchase agreement, should profit be taken in 20X7 or spread over the years in which a proportion of the revenue is received?

Required:

(a) Prepare a statement of comprehensive income for the year ended 31 December 20X7 on a basis that would reflect conventional accounting principles.

(b) Examine the problems implied in the timing of the recognition of revenues, illustrating your answer by the facts in the case of the Piano Warehouse.

(c) Discuss the significant accounting conventions that would be relevant to profit determination in this case, and discuss their limitations in this context.

(d) Advise the company on alternative accounting treatments that could increase the profit for the year.

Question 4

The following is an extract from the Financial Reporting Review Panel website (www.frrp.org.uk) relating to the Wiggins Group showing the restated financial results.

		Year					
		1995	*1996*	*1997*	*1998*	*1999*	*2000*
Turnover	As published	6.4	6.9	19.9	17.8	26.7	49.8
(£m)	Adjustments	(1.5)	(2.6)	(15.6)	(6.7)	(21.6)	(42.5)
	Restated	4.9	4.3	4.3	11.1	5.1	7.3
Profit/(loss)	As published	0.7	1.0	4.9	5.1	12.1	25.1
before tax	Adjustments	(1.3)	(1.9)	(10.2)	(8.5)	(17.2)	(35.0)
(£m)	Restated	(0.6)	(0.9)	(5.3)	(3.4)	(5.1)	(9.9)
Basic EPS	As published	0.14	0.20	0.66	0.64	1.21	2.87
(pence)	Adjustments	(0.26)	(0.38)	(1.67)	(1.14)	(1.91)	(4.06)
	Restated	(0.12)	(0.18)	(1.01)	(0.50)	(0.70)	(1.19)
Net assets	As published	10.2	11.4	17.5	37.5	52.2	45.8
(£m)	Adjustments	(1.3)	(3.2)	(12.0)	(19.8)	(33.8)	(35.4)
	Restated	8.9	8.2	5.5	17.7	18.4	10.4

Revenue recognition

The 1999 accounts contained an accounting policy for turnover in the following terms:

> Commercial property sales are recognised at the date of exchange of contract, providing the Group is reasonably assured of the receipt of the sale proceeds.

The FRRP accepted that this wording was similar to that used by many other companies and was not on the face of it objectionable. In reviewing the company's 1999 accounts the FRRP noted that the turnover and profits recognised under this policy were not reflected in similar inflows of cash; indeed, operating cash flow was negative and the amount receivable within debtors of £46m represented more than the previous two years' turnover of £44m. As a result, the FRRP enquired into the detailed application of the policy.

Required:
Refer to the website and discuss the significance of the revenue recognition criteria on the published results.

References

1 *Framework for the Preparation and Presentation of Financial Statements*, IASC, 1989, para. 12.
2 *Ibid*., para. 10.
3 *Ibid*., para. 14.
4 *Ibid*., para. 15.
5 *Ibid*., para. 17.
6 IAS 1 *Presentation of Financial Statements*, IASB, revised 2005, para. 8.
7 *Framework for the Preparation and Presentation of Financial Statements*, IASC, 1989, para. 7.
8 IAS 1 *Presentation of Financial Statements*, IASB, revised 2007, para. 10.
9 M. Page, *British Accounting Review*, vol. 24(1), 1992, p. 80.
10 *Statement of Financial Accounting Concepts No. 1*, *Objectives of Financial Reporting by Business Enterprises*, Financial Accounting Standards Board, 1978.

11 *Framework for the Preparation and Presentation of Financial Statements*, IASC, 1989, para. 20.
12 IAS 18 *Revenue*, IASC, revised 2005, para. 14.
13 http://www.chloridepower.com/en-gb/Chloride-corporate/Investor-relations/Financial-reports/
14 http://annualreport2008.wolseleyplc.com/wol_08/financial_statements/accounting_policies/
15 *Ibid*., para. 11 of the Appendix.
16 *Ibid*., para. 2 of the Appendix.
17 EITF 01-9, *Accounting for Consideration Given by a Vendor to a Customer*, FASB, 2001.
18 *Framework for the Preparation and Presentation of Financial Statements*, IASC, 1989, para. 49.
19 IAS 16 *Property, Plant and Equipment*, IASC, revised 2004, para. 6.
20 *Ibid*., para. 6.
21 *Ibid*., para. 60.
22 FRS 15 *Tangible Fixed Assets*, ASB, 1999, para. 81.
23 *Framework for the Preparation and Presentation of Financial Statements*, IASC, 1989, para. 102.
24 R.M. Bowen, D. Burgstahller and L.A. Daley, 'Evidence on the relationship between earnings and various measures of cash flow', *Accounting Review*, October 1986, pp. 713–725.
25 J.I.G. Board and J.F.S. Day, 'The information content of cash flow figures', *Accounting and Business Research*, Winter 1989, pp. 3–11.
26 *Statement of cash flows*, IASB, revised 2007.