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PART 1

Introduction to accounting on a cash flow and accrual accounting basis

CHAPTER 1

Accounting and reporting on a cash flow basis

Question 1 – Sasha Parker

(a) Cash budget (£000)

	Jan	Feb	Mar	Apr	May	June	Total
Initial capital	150.00			82.50			232.50
Customers					60.00	75.00	135.00
Total receipts	150.00			82.50	60.00	75.00	367.50
Machinery	30.00						30.00
Motor vehicles	24.00						24.00
Premises	75.00						75.00
Drawings	1.20	1.20	1.20	1.20	1.20	1.20	7.20
Suppliers		30.00	48.00	60.00	60.00	60.00	258.00
Rates		1.20					1.20
Wages	2.25	2.25	2.25	2.25	2.25	2.25	13.50
General expenses		0.75	0.75	0.75	0.75	0.75	3.75
Insurance	–	–	–	–	–	2.10	2.10
Total payments	132.45	35.40	52.20	64.20	64.20	66.30	414.75
Net cash flow	17.55	(35.40)	(52.20)	18.30	(4.20)	8.70	
Balance b/f	–	17.55	(17.85)	(70.05)	(51.75)	(55.95)	
Balance c/f	17.55	(17.85)	(70.05)	(51.75)	(55.95)	(47.25)	(47.25)

(b) Statement of cash flows (£000)

Realised operating cash flows for the period ended 30 June 20X1

Receipts from customers	135.00
Payments:	
Suppliers	258.00
Rates	1.20
Wages	13.50
General expenses	3.75
Insurance	2.10
	<u>278.55</u>
	<u>(143.55)</u>

For information only

Statement of financial position as at 30 June 20X1

	£000
Capital – introduced	232.50
– withdrawn	(7.20)
Net operating cash flows: Realised	(143.55)
Unrealised	(7.80)
	<u>73.95</u>
Premises (NRV)	75.00
Vehicles (NRV)	19.20
Machinery (NRV)	27.00
Net cash balance	(47.25)
	<u>73.95</u>

(c) Further information regarding Sasha Parker

Nature of business linked to Parker's business background, technical ability, special skills, know-how, existing/terminated business involvement, contacts, associates and related parties.

Type of business unit to be used, and rationale for its selection.

Sources of long- and short-term capital.

Products' life cycle and cash flow projections over product life cycle.

Initial investment in fixed assets and their terminal value at the end of the life cycle.

Parker's attitude to risk, and how this affects the choice of discount rate and payback period.

Question 2 – Mr Norman

(a) Purchases budget (€000)

	<i>Jan</i>	<i>Feb</i>	<i>Mar</i>	<i>Apr</i>	<i>May</i>	<i>June</i>
Sales	15.00	20.00	35.00	40.00	40.00	45.00
Gross profit	3.00	4.00	7.00	8.00	8.00	9.00
Purchases	12.00	16.00	28.00	32.00	32.00	36.00
Payments		12.00	16.00	28.00	32.00	32.00

Notes:

This is a start-up situation.

Purchases equal projected sales less a gross margin on sales at 20%.

Goods are bought in the month of sale; assume stocks remain constant.

(b) Statement of cash flows (£000)

	<i>Jan</i>	<i>Feb</i>	<i>Mar</i>	<i>Apr</i>	<i>May</i>	<i>June</i>	<i>Total</i>
Initial capital	50.00						50.00
Cash sales	7.50	10.00	17.50	20.00	20.00	22.50	97.50
Credit sales	—	7.50	10.00	17.50	20.00	20.00	75.00
	57.50	17.50	27.50	37.50	40.00	42.50	222.50
Premises	80.00						80.00
Rent and rates	2.20	2.20	2.20	2.20	2.20	2.20	13.20
Suppliers		12.00	16.00	28.00	32.00	32.00	120.00
Commission		0.30	0.40	0.70	0.80	0.80	3.00
Wages	0.60	0.60	0.60	0.60	0.60	0.60	3.60
Insurance	3.50	—	—	—	—	—	3.50
	86.30	15.10	19.20	31.50	35.60	35.60	223.30
Net cash flow	(28.80)	2.40	8.30	6.00	4.40	6.90	
Balance b/f	—	(28.80)	(26.40)	(18.10)	(12.10)	(7.70)	
Balance c/f	(28.80)	(26.40)	(18.10)	(12.10)	(7.70)	(0.80)	(0.80)

(c) Statements of operating cash flows and financial position***Realised operating cash flows for the period ended 30 June 20X8***

	<i>£000</i>
Receipts from customers	172.50
Payments:	
Suppliers	120.00
Rates	13.20
Wages	3.60
Commission	3.00
Insurance	3.50
	143.30
	<u>29.20</u>

Notes:

The cash flow statement with summary attached is effectively a six-month cash budget showing the cash received, cash paid each month and the resulting month-end balances.

It is necessary to separate sales and purchase transactions into cash and on-credit, and to identify clearly the month of receipt and payment.

Commission is paid in the month after the sale is made, and all other cash flows are clearly indicated and allocated to specific months.

Note that the format of the cash flow statement brings out key figures – for management decision and control. For example:

month-end balances – assist in the control of liquidity;

cash deficiencies – identify how much must be financed;

early warning – allows management to approach appropriate sources;

cash surpluses – identify amounts to be invested on the best terms.

Statement of financial position as at 30 June 20X8

	£000
Capital – introduction	50.00
Net operating cash flows: Realised	29.20
: Unrealised	(4.00)
	<u>75.20</u>
Premises (NRV)	76.00
Net cash balance	(0.80)
	<u>75.20</u>

Notes:

This statement shows net assets of £75,200.

Make up: premises £76,000 less the negative cash balance £800.

The negative cash balance indicates the need for overdraft arrangements.

The statement is based on cash flow concept:

It ignores accrual-based figures (£36,900 less £25,250).

Accruals are not regarded as real assets and liabilities.

Critics of the cash flow concept would maintain that its utility has, therefore, been seriously diminished.

(d) Letter to the bank requesting an overdraft facility

The maximum overdraft facility of £28,800:

will be required at the end of January;
will be eliminated by July.

Overdraft will fall progressively as per the cash budget.

It might be practical to request a limit of £30,000:
for the full six-month period;
reducing it to £15,000 thereafter to allow for contingencies. The facility is only to be called on
as required.

Refer to the cash budget to support the request:
confirm that it is based on the most likely scenario;
agree to a repayment schedule.

Specify that collateral security is available in the form of premises if it should be required.

If not an existing customer:
give outline details of business background;
explain future plans;
market.

CHAPTER 2

Accounting and reporting on an accrual accounting basis

Question 1 – Sasha Parker

(a) Cash budget (€000)

	<i>Jan</i>	<i>Feb</i>	<i>Mar</i>	<i>Apr</i>	<i>May</i>	<i>June</i>	<i>Total</i>
Initial capital	150.00					75.00	225.00
Customers				60.00	75.00	75.00	210.00
Total receipts	150.00			60.00	75.00	150.00	435.00
Machinery	30.00						30.00
Motor vehicles	24.00						24.00
Premises	75.00						75.00
Drawings	1.50	1.50	1.50	1.50	1.50	1.50	9.00
Suppliers		30.00	48.00	60.00	60.00	60.00	258.00
Rates							
Wages	2.25	2.25	2.25	2.25	2.25	2.25	13.50
General expenses		0.75	0.75	0.75	0.75	0.75	3.75
	132.75	34.50	52.50	64.50	64.50	64.50	413.25
Net cash flow	17.25	(34.50)	(52.50)	(4.50)	10.50	85.50	
Balance b/f	–	17.25	(17.25)	(69.75)	(74.25)	(63.75)	
Balance c/f	17.25	(17.25)	(69.75)	(74.25)	(63.75)	(21.75)	(21.75)

All balances are overdrawn except for January 20X1

	<i>Feb</i>	<i>Mar</i>	<i>Apr</i>	<i>May</i>	<i>June</i>
o/d	17.25	69.75	74.25	63.75	4.65

Note:

No entries will be made for the 20X0/X1 local taxes that are paid in Feb 20X2 – this situation arose because Sasha Parker had assumed that the business would only pay the taxes from the start of the tax year, e.g. 1.4.20X1.

However, there will be an entry in the profit and loss account and the statement of financial position.

(b) Sasha Parker – profit and loss account for six months ended 30 June 20X1

	€000	€000
Sales [60.00 + (5 × 75.00)]		435.00
Purchases	378.00	
Closing inventory	(30.00)	
Cost of sales		<u>348.00</u>
Gross profit		87.00
Wages	13.50	
General expenses	4.50	
Local taxes (1.1.X1–30.6.X1)	4.00	
Insurance	13.20	
Depreciation:		
– Vehicles	2.40	
– Machinery	<u>1.50</u>	<u>39.10</u>
Net profit		<u>47.90</u>

Budgeted statement of financial position as at 30 June 20X1

Capital		225.00
Net profit		47.90
Less: drawings		(9.00)
		<u>263.90</u>
Non-current assets		
Premises		75.00
Vehicles	24.00	
Less: depreciation	<u>2.40</u>	21.60
Machinery	30.00	
Less: depreciation	<u>1.50</u>	28.50
Current assets		
Inventory	30.00	
Trade receivables (3 × 75.00)	225.00	
Insurance	<u>13.20</u>	268.20
Current liabilities		
Trade payables	120.00	
Local taxes (1.1.X1–30.6.X1)	4.00	
Bank overdraft	4.65	
General expenses	<u>0.75</u>	(<u>129.40</u>)
Net current assets		<u>138.80</u>
		<u>263.90</u>

(c) Possible action to deal with exceeding agreed overdraft limit

Approach the bank to re-negotiate the overdraft or arrange a loan facility for an agreed term.

The amount and the period for which additional facilities are required depend on preparing a projected cash flow statement for a longer period taking into account future plans, e.g. owner's drawings requirement and any additional capital expenditure.

In particular, consider alternatives such as the following:

Leasing vehicles and/or machinery

Mortgaging the property

Getting debts in quicker manner

Introducing more capital

Obtaining or providing loan capital.

Question 2 – Mr Norman**(a) Purchases budget (\$000)**

	<i>Jan</i>	<i>Feb</i>	<i>Mar</i>	<i>Apr</i>	<i>May</i>	<i>Jun</i>
Sales units	1.65	2.20	3.85	4.40	4.40	4.95
– Closing inventory		0.55	0.96	1.10	1.10	1.24
+ Closing inventory	0.55	0.96	1.10	1.10	1.24	1.38
Purchases units	2.20	2.61	3.99	4.40	4.54	5.09

		<i>Purchases</i>	<i>Sales</i>	
		<i>\$000</i>	<i>\$000</i>	
Jan	(2,200 × 40)	88.00	82.50	(1,650 × 50)
Feb	(2,610 × 40)	104.40	110.00	(2,200 × 50)
Mar	(3,990 × 40)	159.60	192.50	(3,850 × 50)
Apr	(4,400 × 40)	176.00	220.00	(4,400 × 50)
May	(4,540 × 40)	181.60	220.00	(4,400 × 50)
Jun	(5,090 × 40)	203.60	247.50	(4,950 × 50)
		913.20	1,072.50	

(b) Cash flow forecast (\$000)

	<i>Jan</i>	<i>Feb</i>	<i>Mar</i>	<i>Apr</i>	<i>May</i>	<i>June</i>	<i>Total</i>
Initial capital	150.00						150.00
Cash sales	41.25	55.00	96.25	110.00	110.00	123.75	536.25
Credit sales		41.25	55.00	96.25	110.00	110.00	412.50
	191.25	96.25	151.25	206.25	220.00	233.75	1,098.75
Premises	80.00						80.00
Commission		1.65	2.20	3.85	4.40	4.40	16.50
Suppliers		88.00	104.40	159.60	176.00	181.60	709.60
Administration	8.00	8.00	8.00	8.00	8.00	8.00	48.00
Wages	17.00	17.00	17.00	17.00	17.00	17.00	102.00
Insurance	0.35						0.35
Total payments	105.35	114.65	131.60	188.45	205.40	211.00	956.45
Net cash flow	85.90	(18.40)	19.65	17.80	14.60	22.75	
Balance b/f	–	85.90	67.50	87.15	104.95	119.55	
Balance c/f	85.90	67.50	87.15	104.95	119.55	142.30	

(c) Budgeted statement of income for six months ended 30 June 20X8

	<i>\$000</i>	<i>\$000</i>
Sales		1,072.50
Purchases	913.20	
Closing inventory (1,380 units × £40)	(55.20)	
Cost of sales	<u>858.00</u>	
Gross profit		214.50
Wages	102.00	
Administration	48.00	
Commission (2% of 1,072.50)	21.45	
Insurance	0.18	
Amortisation of lease	<u>8.00</u>	
		<u>179.63</u>
Net profit		<u>34.87</u>

Barry Elliott, *Financial Accounting and Reporting*, 18e, Instructor's Manual

Budgeted statement of financial position as at 30 June 20X8

	\$000	\$000
Capital		150.00
Net profit		<u>34.87</u>
		<u>184.87</u>
Non-current assets		
Leasehold premises	80.00	
Less amortisation	<u>(8.00)</u>	
		72.00
Current assets		
Inventory	55.20	
Trade receivables	123.75	
Pre-payments – insurance	0.17	
Cash	<u>142.30</u>	
	<u>321.42</u>	
Current liabilities		
Trade payables	203.60	
Commission	<u>4.95</u>	
	<u>208.55</u>	
Net current assets		<u>112.87</u>
		<u>184.87</u>

(d) Investment of surplus funds

Acid test ratio

At the end of the first six-month trading, Norman's statement of financial position shows that the acid test ratio is 1.28:1 (266.22/208.55) – this is higher than the basic 1:1 ratio but it should be compared with the ratio of similar businesses in the same industry in order to establish a norm. It would appear, however, that the business has surplus funds to invest.

Amount to invest

A projected cash flow statement is required, taking into account future plans regarding the owner's drawing requirements, future capital commitments and working capital criteria, e.g. debtor collection and creditor payment terms.

Period to invest

The projected cash flow will give an indication of the period of the investment, e.g. it could range from overnight on the money market to term investments.

The important aspect is that the owner should be aware of the projected cash flows, so that return on surplus funds can be maximised.