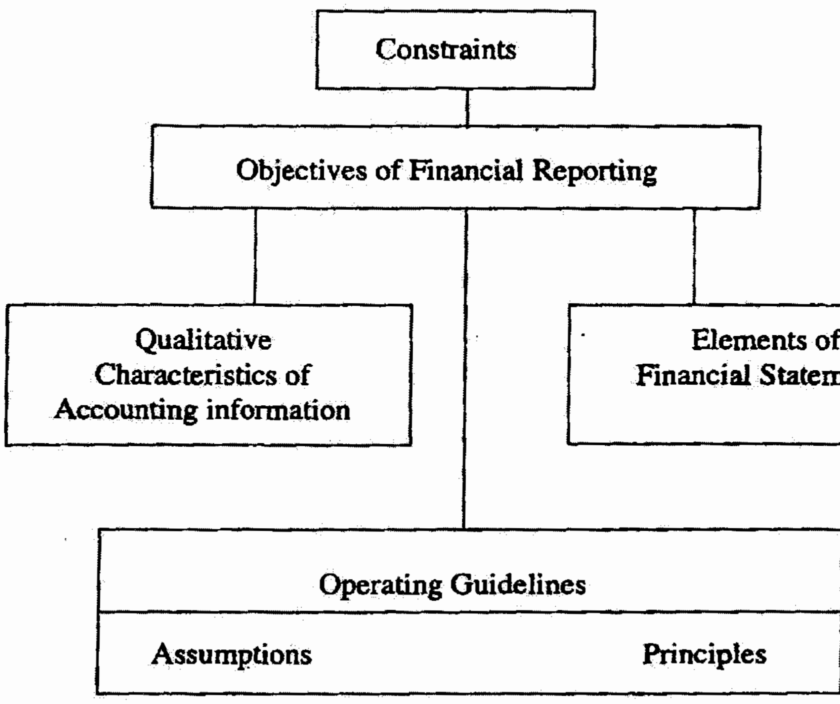
1.

Conceptual Framework of Accounting



(a) The above diagram represents the elements of the conceptual framework of accounting. EACH of the SEVEN elements identified in the diagram is an essential component of the framework. Select ANY FOUR of the elements identified and write **short notes** on **EACH**. **[20 marks]**

(b) Deryk Jones has been working with Dr Mary Carmichael for several years. He has not taken a vacation in the last three years. One of Deryk's main duties at the medical office is to open the mail and list the cheques received. He also takes cash from patients at the front desk as patients leave. From time to time when the office is busy Deryk does not bother to give each patient a receipt for the cash paid on their accounts. He promises that he will see to it that they receive the proper credit. When the office is not too busy Deryk offers to help another employee, Joanne, to post the payments to the patients' accounts receivable. Joanne is always happy to receive his help, because Deryk is a very conscientious worker.

Write a brief report outlining how the situation in the medical office is NOT in keeping with internal control principles. **[10 marks]**

(c) Why it is important to have an effective internal control system in an organisation? **[5 marks]**

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2. (a) Clarke's Sales and Services is a small trading business offering a variety of consumer goods. It also provides a sales outlet for the goods produced by persons in the rural community of Argos. John Clarke is the owner and manager of this business. Clarke started this business in early 2001. At first the business was set up to provide much needed consumer items that would save the villagers from having to travel over 45 miles to the nearest town to purchase the same goods. Clarke is considering expanding the business and would need an injection of capital from investors. However, he is unsure about the type of business structure he should form. He began reading about the different types of business entities and is now confused as whether to form a private company, a public company, or a partnership. What is troubling to Clarke are the issues relating to liability and ownership.

Outline to Clarke the differences with respect to **liability** and **ownership** among private companies, public companies and partnerships. **[4 marks]**

(b) To expand the business Clarke needs to provide the potential investors with audited financial statements. Clarke is quite surprised at this requirement and began assembling some information from his diary and notes that he kept on business transactions for the last year.

The following is a summary of the business transactions that Clarke provided:

1. Clarke began operations by investing $500 000 in cash.

2. Clarke obtained a loan from First National Bank for $750 000 on January 1, 2001. The loan is repayable in five annual installments and carries an annual interest rate of 9 %. Interest is to be paid on June 30 and December 31. The first installment on the loan was paid on December 31, 2001.

3. On January 5, 2001 land and buildings were purchased for $800 000 cash. The market value of the land was $200 000 and buildings $600 000. The buildings are estimated to have a useful life of 10 years with NO residual value.

4. Clarke made the following temporary investments during the year.

Investment	Cost	Market value
Argos Inc. shares	$35 000	$40 000
Dey Inc. shares	$20 000	$14 000

5. Clarke purchased equipment on April 1, 2001 for $100 000 cash. The equipment has an estimated useful life of 5 years and $10 000 residual value.

6. Clarke uses the services of Leon's Trucking for the delivery of the merchandise, both credit and cash purchases. Leon charges Clarke 5 % of the cost of the inventory for delivery. Clarke pays in cash on delivery.

7. There were 140 000 units sold during the year for $1 260 000. All sales were made on account. Clarke stated that he estimated that 4 % of these sales on account would be uncollectible.

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2. (b) cont'd

8. The following inventory items were purchased for cash during the year:

Date	Units	Unit cost	Total cost
January 1	40 000	$4.10	$164 000
June 15	20 000	$4.20	$ 84 000
October 30	60 000	$4.40	$264 000

Clarke had also purchased inventory on credit from Blades and Hinkson in the following amounts:

Date	Units	Unit cost	Total cost
April 1	10 000	$4.10	$ 41 000
July 9	30 000	$4.25	$127 000
December 3	15 000	$4.40	$ 66 000

During the year Blades and Hinkson were paid a total of $174 000.

9. Clarke paid $4 500 per month for utilities, insurance and other expenses. On further investigation it was revealed that $250 related to the insurance policy of Clarke's son.

10. Clarke collected $1 105 000 on accounts receivable during the year, and Clarke withdrew for personal use $6 000 per month in cash during the year.

Clarke was also reading on some accounting principles that should be used in preparing financial statements. He informed you that he would be using the following as guidelines for the preparation of the financial statements:

- Straight line depreciation for all assets
- Lower of cost or market for all investments and inventory
- The FIFO method for the valuation of inventory

(i) Prepare schedules to compute the ending cash, accounts receivable and accounts payable. **[4 marks]**

(ii) Prepare an income statement for Clarke's Trading for the year ending December 31, 2001. **[11 marks]**

(iii) Prepare a balance sheet as at December 31, 2001. **[13 marks]**

(c) Clarke was impressed with the performance of the business. He decided to incorporate it as a private company on January 1, 2002 and issued 50 000 common shares with a par value of $10, and 10 000, 5 %, $1 preference shares. Clarke kept the common shares for his interest in the business and sold the preference shares to investors at $4 per share. The assets and liabilities were revalued. The market value of the assets and liabilities were equal to their book value with the exception of the land and buildings. The market value of the land stood at $300 000 and the buildings at $750 000.

Use the information above to prepare the **shareholders' equity section** of the opening balance sheet of Clarke's Sales and Services as at January 1, 2002. **[3 marks]**

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3. The books of the MM Manufacturing Co. shows that some outdated accounting terms are used, but on the whole its accounts have been accurately kept. After closing the books at December 31, 2002, the following accounts were submitted to you for the preparation of the balance sheet:

	$
Accounts payable ✓	33 200
Land and buildings ✓	20 000
Accounts receivable ✓	9 500
Accrued expenses ✓	800
Bonds payable, 14 % ✓	25 000
Capital stock ✓	70 000
Mortgage	19 000
Cash ✓	10 000
Earned surplus (to be determined)	??
Factory equipment ✓	31 200
Inventory ✓	45 000
Investment ✓	13 000
Office equipment ✓	9 500
Reserve for bad debts ✓	500
Reserve for depreciation ✓	9 000
Rent expense paid in advance ✓	3 000
Land held for future plant site ✓	15 000
Goodwill ✓	5 000
Notes receivable ✓	6 600
Sinking fund ✓	7 000

Additional Information

1. Two-thirds of the depreciation relates to factory equipment and one-third to office equipment.

2. Of the balance in the investments account, $4 000 will be converted to cash during the coming year; the remainder represents a long-term investment.

3. Rent paid in advance is for the next year.

4. The note receivable is a loan to the president of the company made on October 1, 2002. The principal amount is $6,600 at a rate of 9 % interest per annum and is due on September 30, 2006. No interest expense has been accrued for the year 2002.

5. The sinking fund is being accumulated to retire the bonds at maturity.

6. MM Manufacturing Co. is being sued for illness caused to local residents as a result of negligence on the company's part in permitting the local residents to be exposed to highly toxic chemicals from its plant. MM's lawyer states that it is probable that MM will lose the suit and be found liable for a judgement costing MM anywhere from $600 to $3 000.

7. MM Co. purchased factory equipment costing $13 500 on January 1, 2000. The entire cost was recorded as an expense. The equipment has a nine-year life span and a $900 residual value. The error was discovered on December 20, 2002.

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8. The authorised share capital of MM Co. is 900 ordinary shares with a par value of $100. The company issued 500 ordinary shares at $140 each and recorded this amount in the capital stock account.

9. The company uses the historical cost basis for recording and the straight-line method of depreciation.

10. St. Barths Ltd, a major client accounting for approximately 30 % of our annual sales, has filed for bankrupcy. At the time of filing for bankrupcy the balance in St. Barths Ltd account was zero.

11 The mortgage agreement requires the company to make annual payments of $2 000.

(a) Use the information provided above to prepare a classified balance sheet as at December 31, 2002, using the International Accounting Standards.
[16 marks]

(b) Notes are considered as part of the financial statements of a business. Briefly outline

(i) the basic purpose of notes **[4 marks]**

(ii) the general types of notes to financial statements **[3 marks]**

(c) Prepare ANY FOUR notes to accompany the balance sheet as presented.
[12 marks]

END OF TEST