

Harrington Books

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Report to: Peter Harrington

Subject: Accounting Policies and Records for Harrington Books.

Introduction

In this report, I will outline key accounting policies and records for Harrington Books. As Harrington Books is a new company, I am going to try and keep my comments and recommendations as straightforward as possible.

From my perspective, the following are the key users of the financial statements, and their objectives:

Peter Harrington – as the owner your concerns centre around tax minimization, internal control and of course, maximizing profit.

Bank – since the bank has provided a line of credit to Harrington books, and has taken business assets as collateral, they will also be interested in financial information

Manager – since the newly hired manager is on a variable compensation plan with a bonus based on year end profits, he or she will be concerned with how those profits are derived

CCRA – the tax authorities will also be interested in the financial information as the basis of fair tax payments by the business. They will likely not support aggressive accounting methods.

Since the bank has provided assets as collateral, I are going to presume them to be the most important user. It is essential that the information is useful for their purposes. As sole proprietor, Peter Harrington will be second, with key objectives of maintaining a strong system of internal control and tax minimization.

Key Facts

Some key facts we need to keep in mind as we assess accounting policies are:

- the bank is presumably a sophisticated user of financial information, and therefore will understand the importance of HB minimizing taxes.
- As Harrington books is a sole proprietorship, in the case of bankruptcy, they can look to the owner's personal assets if the assets of HB taken as collateral are insufficient to pay off the loan.
- The manager has a compensation plan based on profit; we will not have a problem with this as long as accounting profit represents the underlying economic reality.

Constraints

Other than the constraints placed by the tax authorities, HB is not subject to statutory constraints. It is presumed that the bank will not impose GAAP financial statements on HB, or require them to be audited.

In summary, to balance the objectives of various users, our overall direction is to choose accounting policies that best reflect the underlying economic reality. We will not necessarily follow GAAP principles, although in some cases we may consider GAAP as a set of principles that can guide our decision making.

Discussion of Major Accounting Issues and Recommendations:

The following are the major accounting issues; alternatives are considered and recommendations are made for each.

1) Valuation of inherited books

- * most probably books are rare and difficult to value
- * we must estimate their value at the time they are introduced into the business as inventory
- * the inventory can be revalued at year end
- * there are no other feasible alternatives. This approach satisfies the objectives of internal control and will likely be acceptable to the tax authorities

2) Lease of Shop Space

- * shop is leased for two years
- * this should likely be disclosed to the bank so that they are aware of the arrangement

3) Website Development Costs

- * the decision needs to be made whether to expense or capitalize the website development costs that have been incurred
- * these costs have possible long term benefits to HB
- * the tax authority would probably allow a write off of the costs, which would help reduce taxes payable
- * however, a better alternative might be to capitalize the costs and write off the costs over a number of years.
- * the length of time of the contract for web hosting might be a reasonable choice of period for write off.

- * the costs can be reviewed annually and considered for write off. For example, if HB is unsuccessful in developing website business, we may write off the costs more quickly.

4) Distributorship Costs

- * these costs will benefit HB for the period of the contract.
- * Therefore, at least initially, these costs should be capitalized and amortized over the life of the contract
- * we may wish to consider whether to keep records for each distributorship individually. Keeping individual records and amortizing them individually may support stronger internal control

5) Copyright Costs

- * similar to the distributorships, these costs will benefit HB in the future, and should be capitalized.
- * if books for which HB has the copyrights are not selling well, then the copyrights should be written down

6) Valuation of time spent in the business by Peter Harrington

- * the owner, Peter Harrington, spends a significant amount of time working on the business, for which he does not draw a salary
- * this makes no difference from a tax point of view, since if he drew a salary, it would be taxed in his hands.
- * however, since the manager is being paid a bonus based on profits, it is probably better if he draws a salary.
- * if Peter draws a salary, the profit will be a better reflection of the economic reality of the business. As a key contributor, Peter's time will be included.

7) Books Sent to others

- * should be included in HB inventory
- * commissions and sales revenues should be accrued
- * revenue should be recognized when the books are sold to a customer. Recognizing revenue when the books are shipped out is too aggressive as the booksellers can return the books anytime.

8) Six Books for a Dollar

- * the value of the six books sold for a dollar is likely much higher than a dollar
- * our objective is to match revenues and expenses
- * the sale can be construed as a single sale of 12 books, and the revenue from the sale needs to be matched with the expenses
- * a provision needs to be made for those that will not fulfill their promise to purchase the additional six books at regular prices
- * a note to the financial statements can be used to explain this marketing plan

Accounting Records

I have also been asked to comment on what accounting records HB should keep. My suggestions include:

- * the web versus shop records should be kept separately, to a reasonable extent. For example it might make sense to keep separate records of cash receipts and payments.
- * Inventory accounts for different books, so that flows can be monitored, and slow moving books identified
- * Periodic inventory counts should be taken Monthly and annual income statement, balance sheet and cash flow statements. A cash flow forecast might also be valuable in that it could help predict future cash flow needs.