## Chapter 2

## Measuring and reporting financial position

Discussion questions – Easy

2.1 What are the main characteristics of assets and liabilities from an accounting perspective? Is this consistent with a non-accounting definition?

*Solution:* As per the AASB Framework: (a) future economic benefits (i.e. in use or exchange); (b) control over these economic benefits (i.e. legal or other) and (c) exist as the result of a past transaction or event (i.e. purchase, construction, discovery, donation), and (d) must be able to be measured in monetary terms. Liabilities represent the claim of individuals and organisations (other than those of the owners) which have arisen from past transactions or events. Recognition criteria include probability of occurrence and reliability of measurement.

LO1 Explain the nature and purpose of the statement of financial position (balance sheet) and its component parts

2.2 What is the primary measure used for asset valuation on the statement of financial position? What is the source of this measure and justification for its use?

*Solution:* The primary measure used for asset valuation is historical cost. This is one of the fundamental accounting concepts being based on such values being fair, verifiable, conservative and representative of the asset at the purchase date.

LO5 Identify the main factors that influence the content and values in a statement of financial position

2.3 What sort of account is ‘retained earnings’?

*Solution:* ‘Retained earnings’ is an equity account. The balance in retained earnings represents the undistributed profits of the reporting entity, and represents a distributable reserve.

LO3 Classify assets and claims

2.4 What sort of accounts would be included in the intangible asset category?

*Solution:*

Intangible assets

Identifiables • Development costs

• Patent

• Copyright

• Franchise

• Trademark

• Masthead

Unidentifiables • Purchased goodwill

LO3 Classify assets and claims

Discussion questions – Intermediate

2.5 Provide examples of valuable resources of a business that will not be included as assets on the statement of financial position. Why does this occur?

*Solution:* Valuable resources, e.g. high quality staff, reputation, potential, green credentials, are typically excluded on two grounds: either they do not meet the definition test (i.e. control or past transaction) or there is insufficient likelihood of the future economic benefits arising or problems with measurement reliability.

LO1 Explain the nature and purpose of the statement of financial position (balance sheet) and its component parts

LO7 Identify the main deficiencies or limitations in the statement of financial position

2.6 Why is the accounting equation always in balance?

*Solution:* The accounting equation must always be in balance by definition. That is the assets must always equal the claims against those assets (internal claims- equity; external claims-liabilities).

All transactions result in balanced changes to this relationship (A=OE + L).

LO2 Explain the accounting equation, and use it to build up a statement of financial position at the end of a period

2.7 Describe the basis used to determine whether an asset is classified as current or non-current. Is the same basis used for the classification of liabilities?

*Solution:* The main criteria determining current vs non-current is whether the asset is expected to be converted to cash within 12 months or the current operating cycle if this is longer than 12 months. Yes, non-current in relation to liabilities refers to obligations that are expected to be satisfied (paid/met) in that same time period.

LO3 Classify assets and claims

2.8 Why is the statement of financial position also called a ‘balance sheet’?

*Solution:* It is called the ‘balance sheet’ because it represents the balances in the permanent accounts (assets, liabilities, (owners’) equity) at a point in time (normally the end of the accounting period).

LO2 Explain the accounting equation, and use it to build up a statement of financial position at the end of a period

2.9 The prudence convention has significantly influenced financial transactions recording and reporting.

(a) What is the prudence convention?

(b) Provide examples of how it has influenced transaction recording and reporting.

*Solution:*

(a) The prudence (or conservatism) assumption refers to the practice of caution on behalf of accountants where they tend to:

(i) Understate assets.

(ii) Overstate liabilities.

(iii) Defer recognition of revenues (understate).

(iv) Bring forward recognition of expenses (overstate).

(b) (i) Research expenditure is often immediately expensed (rather than capitalised and treated as an asset).

(ii) Inventories are valued on the basis of the ‘lower of cost or market’.

(iii) Property revaluations upwards go to a reserve while downward revaluations are treated as expenses (losses) in the statement of statement of comprehensive income (profit and loss).

LO5 Identify the main factors that influence the content and values in a statement of financial position

2.10 What other financial measures besides historical cost might be used for asset valuation?

*Solution:* Other monetary measures include market price, replacement cost and disposal value.

LO6 Explain the main ways in which the statement of financial position can be useful for users of accounting information

2.11 What is an accounting convention?

*Solution:* A rule of practice adopted by common consent, expressed or implied. For example, it is a convention (established by long usage) that the debits are placed on the left-hand side of a T account and credits on the right hand side.

LO2 Explain the accounting equation, and use it to build up a statement of financial position at the end of a period

LO5 Identify the main factors that influence the content and values in a statement of financial position

2.12 It has been said that all costs (expenditure) become expenses.

(a) Do you agree with this statement?

(b) Provide examples to support your position.

*Solution:* The words ‘costs’ and ‘expenses’ are often interchanged. However, in an accounting context the term ‘cost’ represents an exchange equivalent (cash; other assets; liabilities assumed) for the acquisition of a good or service (e.g. the cost of equipment; the cost of advertising, the cost of insurance, the cost of depreciation etc.). The term ‘expense’ on the other hand represents the using up of economic benefits.

In practice, there are many occasions in which the ‘cost’ of an asset or service represents the ‘expense’ at the time of the commitment (e.g. wages; advertising; fuel; repairs; postage; research etc.). However, there are also many occasions in which the ‘cost’ of an asset or service is initially treated as an asset (e.g. land; equipment; supplies; inventory; pre-payments; development costs; work in progress etc.) and later becomes an expense (e.g. land-carrying amount of land sold; equipment-depreciation; supplies-supplies used; inventory-cost of goods sold; pre-payment-expense; development-amortisation expense; construction-in-progress-construction expense).

Therefore, we should conclude that ‘all costs become expenses’.

LO2 Explain the accounting equation, and use it to build up a statement of financial position at the end of a period

LO3 Classify assets and claims

2.13 Distinguish between a ‘legal entity’ and an ‘accounting entity’ in relation to different business types.

*Solution:* An important assumption of accounting is that the ‘accounting entity’ (unit of account) is separate from the owners. However, many ‘accounting entities’ are not separate from the owner(s) from a legal perspective (e.g. sole proprietorship; partnership). In the case of a company, it is both a separate ‘accounting entity’ and a separate ‘legal entity’.

LO2 Explain the accounting equation, and use it to build up a statement of financial position at the end of a period

Discussion questions – Challenging

2.14 ‘Human capital’ and ‘intellectual property’ are of significant value in many organisations. Provide arguments for and against their inclusion on the statement of financial position.

*Solution:* Some people object to the idea of humans being treated as assets for inclusion on the statement of financial position. It can be seen as demeaning for humans to be listed alongside inventory, plant and machinery and other assets. However, others argue that humans are often the most valuable resource of a business and the placing of a value on this resource will help bring to the attention of managers the importance of nurturing and developing this ‘asset’. There is a saying in management that ‘the things that count are the things that get counted’. As the value of the ‘human assets’ is not stated in the financial statements, there is a danger that managers will treat these ‘assets’ less favourably than other assets which are on the statement of financial position.

Humans are likely to meet the first criterion of an asset listed in the chapter, that is, a probable future economic benefit exists. There would be little point in employing people if this were not the case. The second criterion concerning exclusive right of control is more problematic. Clearly a business cannot control humans in the same way as most other assets. However, a business can have the exclusive right to the employment services that a person provides. This distinction between control over the services provided, and control over the person, makes it possible to argue that the second criterion can be met.

Humans normally sign a contract of employment with the business and so the third criterion is normally met. The difficulty, however, is with the fourth criterion, that is, whether the value of humans (or their services) can be measured with any degree of reliability. To date, none of the measurement methods proposed enjoy widespread acceptance.

LO1 Explain the nature and purpose of the statement of financial position (balance sheet) and its component parts

LO5 Identify the main factors that influence the content and values in a statement of financial position

2.15 Does the use of some sort of ‘current cost’ for statement of financial position valuation increase the usefulness of the statement? Does it cause problems?

*Solution:* The use of some sort of current cost measure has the potential to dramatically increase the usefulness of the balance sheet. However, the use of such measures is problematic in many regards. This is the classical dilemma or balancing act between relevance and reliability.

Current accounting standards already allow limited use of current cost measures. Examples include the write-down of inventory to net realisable value and the provision for doubtful debts or accounts receivable and the revaluation of long-term assets to current value.

LO1 Explain the nature and purpose of the statement of financial position (balance sheet) and its component parts

LO2 Explain the accounting equation, and use it to build up a statement of financial position at the end of a period

LO5 Identify the main factors that influence the content and values in a statement of financial position

## 2.16 An accountant prepared a statement of financial position for a business using the horizontal layout. In this statement, the capital of the owner was shown next to the liabilities. This confused the owner, who argued: ‘My capital is my major asset and so should be shown as an asset on the statement of financial position.’ How would you explain this misunderstanding to the owner?

*Solution:* The confusion arises because the owner seems unaware of the business entity convention in accounting. This convention requires a separation of the business from the owner(s) of the business, for accounting purposes. The business is regarded as a separate entity and the statement of financial position is prepared from the perspective of the business rather than that of the owner. As a result, funds invested in the business by the owner will be regarded as a claim which the owner has on the business. In a statement of financial position (balance sheet) prepared using the horizontal format, this claim will be shown alongside other claims on the business from outsiders.

LO1 Explain the nature and purpose of the statement of financial position (balance sheet) and its component parts

LO2 Explain the accounting equation, and use it to build up a statement of financial position at the end of a period

LO5 Identify the main factors that influence the content and values in a statement of financial position

2.17 ‘The statement of financial position shows how much a business is worth.’ Do you agree with this statement? Discuss.

*Solution:* A statement of financial position (balance sheet) does not show what a business is worth for two major reasons:

1. The money measurement convention ensures that only those items which can be measured reliably are shown on the balance sheet. Thus, items such as the reputation for product quality, skills of employees etc., will not normally appear in the statement.
2. The historic cost convention results in assets being recorded at their outlay cost rather than their current value. For certain assets, the difference between historic cost and current value may be significant.

LO5 Identify the main factors that influence the content and values in a statement of financial position

LO6 Explain the main ways in which the statement of financial position can be useful for users of accounting information

LO7 Identify the main deficiencies or limitations in the statement of financial position

2.18 The statement of financial position can be used to assess the following aspects of the reporting entity:

• liquidity

• asset mix

• financial structure (solvency).

(a) What do these terms mean?

(b) How could they be assessed from the statement of financial position figures?

(c) Which external stakeholders would have a particular interest in each aspect?

*Solution:* The answers to this question will vary. The table identifies some general aspects you may have considered.

|  |  |  |  |
| --- | --- | --- | --- |
| Question/Term | Liquidity | Asset Mix | Financial Structure |
| (a) Meaning | The ability to pay debts when they are due.  The speed with which assets can be converted to cash. | The relative proportions of assets:  \* Current/Non-current  \* Tangible/Intangible  \* Monetary/Non-monetary. | The level of funding:  \* Short-term/Long-term  \* Internal/External. |
| (b) Assessed | \* Current Ratio: CA/CL  \* Quick Ratio: Liquid Assets/Liquid Liabilities  \* Asset turnover ratios | Based on the above ratios | Based on the above ratios:  \* Liabilities/Assets  \* Long-term liabilities/OE  \* Interest Cover. |
| (c) Interested party | Those with a short-term focus. | Those concerned with the efficient use of assets to generate returns. | Those with a longer-term focus. |

LO6 Explain the main ways in which the statement of financial position can be useful for users of accounting information

Application exercises – Easy

AE2.1

*Solution:*

a) Would the following accounts be classified as assets? If not, how would they be classified?

|  |  |  |  |
| --- | --- | --- | --- |
| No. | Account | Yes | No–reason |
| 1 | Accounts receivable | Yes |  |
| 2 | Accumulated depreciation | Yes | Contra asset (a deduction from another asset). |
| 3 | Investments purchased | Yes |  |
| 4 | Advance to employees | Yes |  |
| 5 | Prepaid insurance | Yes |  |
| 6 | Supplies used | No | An expense (the asset used up during the period). |
| 7 | Unearned service fees | No | A liability to provide future services as a result of being paid in advance. |

b) Would the following accounts be classified as liabilities? If not, how would they be classified?

|  |  |  |  |
| --- | --- | --- | --- |
| No. | Account | Yes | No–reason |
| 1 | Accounts payable | Yes |  |
| 2 | Loan taken out | Yes |  |
| 3 | Loan guarantee |  | It is a contingent liability, only to be shown in the notes where the possibility of a future obligation is not remote and it is material in amount. |
| 4 | Unused bank overdraft |  | There is no transaction.  There is no present obligation to an external party. |
| 5 | Provision for major maintenance |  | There is no transaction.  There is no present obligation to an external party. |
| 6 | Provision for warranty | Yes | The only concern being with the recognition rules in terms of the probability of claims, and the amount of the claims. |

AE2.2

*Solution:*

(a)

|  |  |  |
| --- | --- | --- |
| Martin Russel Consulting | | |
| Statement of Financial Position | | |
| as at 15 November | | |
|  | ASSETS |  |
| Current assets | |  |
|  | Cash at bank | $16,500 |
|  | Accounts receivable | 5,000 |
|  | Total current assets | $21,500 |
| TOTAL ASSETS | | $21,500 |
|  |  |  |
|  | LIABILITIES |  |
| TOTAL LIABILITIES | | $ - |
|  |  |  |
|  | EQUITY |  |
|  | Contributed capital | $20,000 |
|  | Plus profit | 1,500 |
| TOTAL EQUITY | | $21,500 |
| TOTAL LIABILITIES and EQUITY | | $21,500 |

(b) *NB:* There is an error in the question. Please ignore the third sentence, ‘All of Martin’s transactions are listed below.’

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  | Martin Russel Consulting | | |  |  |  |  |
| Statement of Financial Position | | | | | | | | |
|  | as at 21 November | | | | | | | |
|  | ASSETS |  |  | TOTAL LIABILITIES | | |  |  |
| Current assets | |  |  |  |  |  |  |  |
|  | Cash at bank | $19,500 |  |  | EQUITY | |  |  |
|  | Accounts receivable | 2,000 |  |  | Contributed capital | |  | $20,000 |
|  | Total current assets | 21,500 |  |  | Plus profit | |  | 1,500 |
| TOTAL ASSETS | | $21,500 |  | TOTAL EQUITY | | |  | $21,500 |

(cont’d…)

(c)

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Martin Russel Consulting | | | | |
| Statement of Financial Position | | | | |
| as at 30 November | | | | |
|  | ASSETS |  | | |
| Current assets | |  | | |
|  | Cash at bank | $39,500 | | |
|  | Supplies | 4,000 | | |
|  | Accounts receivable | 2,000 | | |
|  | Total current assets | $45,500 | | |
| TOTAL ASSETS | | $45,500 | | |
|  |  |  | | |
|  | LIABILITIES |  | | |
|  | Current liabilities  Accounts payable $4,000 | | |  |
| Non-current liabilities  Bank loan $20,000 | | |  | |
|  | |  | | |
| TOTAL LIABILITIES | | $24,000 | | |
|  |  |  | | |
|  | EQUITY |  | | |
|  | Contributed capital | $20,000 | | |
|  | Plus profit | 1,500 | | |
| TOTAL EQUITY | | $21,500 | | |
| TOTAL LIABILITIES + EQUITY | | $45,500 | | |

(d)

Workings

Bank Capital +20,000 +105,000-10,500 -1,000

+20,000 +80,000 -10,500 -9,500

+20,000 -12,000 -10,000 +15,000

Receivables +105,000 – 80,000 Loan +20,000

Payable car dealership +30,000

Office supplies +14,000 Payables +14,000 -9,500

Deferred revenues +15,000

Prepaid rent +12,000 -1,000

Car +40,000

(cont’d…)

|  |  |  |
| --- | --- | --- |
| Martin Russel Consulting | | |
| Statement of Financial Position | | |
| as at 31 January | | |
| ASSETS |  |  |
| Current assets | |  |
| Cash at bank | $93,000 |  |
| Prepaid rent | 11,000 |  |
| Office supplies | 14,000 |  |
| Accounts receivable | 25,000 |  |
| Total current assets | $143,000 |  |
| Non-current assets | |  |
| Motor vehicles | $40,000 |  |
| TOTAL ASSETS | $183,000 |  |
| LIABILITIES |  |  |
| Current liabilities |  |  |
| Accounts payable | $4,500 |  |
| Revenue received in advance | 15,000 |  |
| Total current liabilities | $19,500 |  |
| Non-current liabilities |  |  |
| Bank loan | $20,000 |  |
| Car dealership debt | 30,000 |  |
| Total non-current liabilities | $50,000 |  |
| TOTAL LIABILITIES | $69,500 |  |
| EQUITY |  |  |
| Contributed capital | 20,000 |  |
| Plus profit to date | 93,500 |  |
| TOTAL EQUITY | $113,500 |  |
| TOTAL LIABILITIES + EQUITY | $183,000 |  |

(cont’d…)

(e)

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Martin Russel Consulting | | | | |
| Statement of Financial Position | | | | |
| as at 31 January | | | | |
| ASSETS |  |  | LIABILITIES |  |
| Current assets | |  | Current liabilities |  |
| Cash at bank | 93,000 |  | Accounts payable | $4,500 |
| Prepaid rent | 11,000 |  | Revenue received in advance | 15,000 |
| Office supplies | 5,000 |  | Total current liabilities | $19,500 |
| Accounts receivable | 25,000 |  | Non-current liabilities |  |
| Total current assets | $134,000 |  | Bank loan | $20,000 |
|  |  |  | Car dealership debt | 30,000 |
| Non-current assets | |  | Total non-current liabilities | $50,000 |
| Motor vehicles | $40,000 |  | TOTAL LIABILITIES | $69,500 |
| Total non-current assets | $40,000 |  | EQUITY |  |
|  |  |  | Contributed capital | 20,000 |
|  |  |  | Plus profit to date | 84,500 |
|  | \_\_\_\_\_ |  | TOTAL EQUITY | $104,500 |
| TOTAL ASSETS | $174,000 |  | TOTAL LIABILITIES + EQUITY | $174,000 |
|  |  |  |  |  |

AE2.3

*Solution:*

|  |  |  |
| --- | --- | --- |
|  | Equation Effects | Examples |
| (a) | A↑ = L↑ | • Borrowing  • Credit purchase of assets |
| (b) | A↑ = OE↑ | • Owners’ contributions  • Revenues |
| (c) | A↑ = A↓ | • Cash purchase of assets  • Collect from accounts receivable |
| (d) | A↓ = L↓ | • Repay loan  • Payment to accounts payable |
| (e) | A↓ = OE↓ | • Cash expenses  • Allocation expenses (e.g. depreciation)  • Asset drawings |
| (f) | L↑ = OE↓ | • Accrued expenses  • Drawings from overdraft |
| (g) | L↓ = OE↑ | • Owners pay business debts  • Sales to creditors  • Credit purchase returns |

LO2 Explain the accounting equation, and use it to build up a statement of financial position at the end of a period

AE2.4

*Solution:*

|  |  |  |  |
| --- | --- | --- | --- |
| Transaction | Asset | Liability | Equity |
|  | Up |  | Up |
|  | Up | Up |  |
|  | Up | Up |  |
|  | Up |  | Up |
|  | Up/Down |  |  |
|  | Down |  | Down |
|  | Down | Down |  |
|  | Down |  | Down |
|  |  | Up | Down |
|  | Up/Down |  |  |

LO2 Explain the accounting equation, and use it to build up a statement of financial position at the end of a period

AE2.5

*Solution:*

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  | (a) | (b) | (c) | (d) |
| Current assets | 13,900 | 18,300 | 13,200 | 9,100 |
| Non-current Assets | 51,600 | 71,600 | 110,700 | 69,600 |
| Current liabilities | (14,200) | (11,900) | (9,600) | (17,500) |
| Non-current Liabilities | (17,900) | (39,600) | (41,500) | (51,200) |
| Opening capital | (20,700) | (29,200) | (47,100) | (26,700) |
| Profit or Loss | (19,600) | (17,900) | (37,400) | 9,500 |
| Drawings | 6,900 | 8,700 | 11,700 | 7,200 |

LO2 Explain the accounting equation, and use it to build up a statement of financial position at the end of a period

AE2.6

*Solution:*

|  |  |  |  |
| --- | --- | --- | --- |
|  | Principle | Asset | Influence |
| A | Historical cost | Land | Recorded on the basis of the initial exchange price |
| B | Prudence | Inventory | Valued at the lower of cost or market (net realisable value) |
| C | Matching | Accounts receivable | Recognise bad debts expense using the allowance (estimation) method rather than the realisation method |
| D | Going concern | Equipment | Depreciate equipment on the basis that it will continue to be used in the future as it has in the past |
| E | Period | Prepaid insurance | Determine how much of the prepaid insurance has been expensed during the period and how much is still prepaid at the end of the period. |
| F | Materiality | Loose tools | Immediately expense the outlay on loose tools as the cost of capitalising and depreciating such assets is excessive, and will provide little useful information. |

LO5 Identify the main factors that influence the content and values in a statement of financial position

#### AE2.7

#### *Solution:*

Statement of Financial Positionas at a particular point in time

$000 $000

*Current assets*

Accounts receivable 34

Inventory 46

80

*Non-current assets*

Delivery vans 54

Plant & machinery 127

Freehold premises 245

426

506

*Current liabilities*

Accounts payable 23

Bank overdraft 22

45

*Non-current liabilities*

Loan from NAB 100

*Capital (Equity)* 361

506

LO2 Explain the accounting equation, and use it to build up a statement of financial position at the end of a period

LO4 Apply the different possible formats for the statement of financial position

AE2.8

#### *Solution:*

|  |  |  |  |
| --- | --- | --- | --- |
| Statement of financial position for \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ | | | |
| As at \_\_\_\_\_\_\_\_ | | | |
| Assets: Current Cash at Bank  Accounts Receivable  Prepayments  Inventory  Non-Current Freehold land & buildings  Plant and Equipment  Total Assets  Liabilities: Current Bank Overdraft  Accrued Expenses  Non-Current Bank Loan  Owner Equity  Opening Capital  Profit  Drawings | 2,000  11,000  1,000  23,000  80,000  27,000  15,000  3,000  89,000  27,000  <15,000> | 37,000  107,000  18,000  25,000  101,000 | 144,000  144,000 |

LO2 Explain the accounting equation, and use it to build up a statement of financial position at the end of a period

LO4 Apply the different possible formats for the statement of financial position

AE2.9

#### *Solution:*

Opening equity 200,000

Plus

Sales 250,000

Less cost of sales (100,000)

Less expenses (50,0000)

Profit 100,000

Less drawings (25,000)

Plus introduced equity 20,000

Equity at 31 December 2017 295,000

LO2 Explain the accounting equation, and use it to build up a statement of financial position at the end of a period

## AE2.10

#### *Solution:*

Statement of financial position as at Year-end

Current assets Current liabilities

Cash at bank 16,000 Payables 32,000

Receivables 42,000

Inventories 80,000

Non-current assets Long-term loan 100,000

Motor van 36,000

Equipment 126,000

Fixtures and fittings 26,000 Equity 344,000

Property 150,000 \_\_\_\_\_

476,000 476,000

Equity start 240,000

Injection 50,000

Profit 110,000

400,000

Less drawings x = 56,000

Closing equity 344,000

LO2 Explain the accounting equation, and use it to build up a statement of financial position at the end of a period

AE 2.11

#### *Solution:*

#### Crafty Engineering Ltd — Statement of Financial Position as at 30 June 2017

$’000 $’000

*Current assets*

Accounts receivable 185

Inventory 153 338

*Non-current assets*

Freehold premises 320

Machinery and tools 207

Motor vehicles 38 565

*Total assets* 903

*Current liabilities*

Bank overdraft 116

Accounts payable 86 202

*Non-current liabilities*

Loan from bank 260

Total liabilities 462

Equity/capital 441

*Total liabilities and equity* 903

(b) Financial assessment.

From reviewing the statement of financial position above you can observe:

* 1. A significant level of funds provided by the owners (48.8%).
  2. The current assets adequately cover the current liabilities (1.67 times).
  3. A significant proportion of the assets are non-current (62.6%).
  4. Long-term funds cover the non-current assets adequately (124.1%).

LO2 Explain the accounting equation, and use it to build up a statement of financial position at the end of a period

LO4 Apply the different possible formats for the statement of financial position

Application exercises – Intermediate

AE2.12

#### *Solution:*

Converting the report dollar figures into an index allows for an easy review of liquidity and solvency trends:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Type | Account | Year 1 % | Year 2 % | Year 3 % |
| Assets | Current | 33.3 | 27.5 | 20 |
|  | Non-current | 66.7 | 72.5 | 80 |
|  | Total | 100 | 100 | 100 |
| Liabilities | Current | 13.3 | 30 | 33.3 |
|  | Non-current | 20 | 15 | 26.7 |
|  | Total | 33.3 | 45 | 60 |
| Equity | Contributed | 66.7 | 50 | 33.3 |
|  | Reserves | 0 | 5 | 6.7 |
|  | Total | 66.7 | 55 | 40 |
| L + E | Total | 100 | 100 | 100 |

1. Solvency: The total liabilities to assets in year 1 being 33.3%. By year three the total liabilities to assets rose to 60%. This represents a dramatic increase in the level of debt funds.

In year 1, long-term funds (86.7%) more than covered non-current assets (66.7%) but by year 3, long-term funds (66.7%) no longer covered non-current assets (80%). Therefore, current liabilities are being used to fund non-current assets which is a sign of financial instability. Non-current assets generate a return over the longer period, while current liabilities require repayment in the current period.

1. Liquidity: The current assets have significantly declined from 33.3% of all assets to just 20% of all assets. At the same time the current liabilities have significantly increased from 13.3% to 33.3%. In year 1, the current assets covered the current liabilities 2.5 times, while in year 3, the current assets represent on 60% of the current liabilities.

This entity faces an acute liquidity problem in being able to meet current obligations from current assets.

LO6 Explain the main ways in which the statement of financial position can be useful for users of accounting information

AE2.13

*Solution:*

|  |  |
| --- | --- |
| Account | Classification |
| Cash at Bank | Current |
| Patent | Non-current : Intangibles |
| Equipment | Non-current : PP&E |
| Pre-payment | Current |
| Land | Non-current : PP&E |
| Goodwill | Non-current : Intangibles |
| Accounts Receivable | Current |
| Shares in Telstra | Non-current : Investments |
| Accumulated Depreciation - Equipment | Non-current : PP&E |
| Inventories | Current |
| Leasehold Improvements | Non-current : PP&E |
| Interest Prepaid | Current |
| Government Bonds | Non-current : Investments |

LO2 Explain the accounting equation, and use it to build up a statement of financial position at the end of a period

LO3 Classify assets and claims

AE2.14

#### *Solution:*

|  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  | Beginning | Transactions | | | | | | | Ending |
| Assets |  | 1 | 2 | 3 | 4 | 5 | 6 | 7 |  |
| Cash | 3,000 |  | 4,000 | 2,000 | (7,000) | 10,000 | (6,000) | (2,000) | 4,000 |
| Accounts Receivable | 5,000 |  | (4,000) | 6,000 |  |  |  |  | 7,000 |
| Inventory | 7,000 | 5,000 |  | (6,000) |  |  |  |  | 6,000 |
| Freehold Premises | 60,000 |  |  |  |  |  |  |  | 60,000 |
| Furniture & Fittings | 18,000 |  |  |  |  |  | 6,000 |  | 24,000 |
|  | 93,000 |  |  |  |  |  |  |  | 101,000 |
| Liabilities |  |  |  |  |  |  |  |  |  |
| Accounts Payable | 3,000 | 5,000 |  |  | (7,000) |  |  |  | 1,000 |
| Bank Loan | 30,000 |  |  |  |  |  |  | (2,000) | 28,000 |
|  | 33,000 |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |
| Capital | 60,000 |  |  | 2,000 |  | 10,000 |  |  | 72,000 |
|  | 93,000 |  |  |  |  |  |  |  | 101,000 |

LO2 Explain the accounting equation, and use it to build up a statement of financial position at the end of a period

AE2.15

#### *Solution:*

(a)

Joe Conday

*Statement of financial position as at 1 March 2017*

$ $

Bank 20,000 Capital 20,000

*Statement of financial position as at 2 March 2017*

$ $

Bank 14,000 Capital 20,000

Fixtures and fittings 6,000 Accounts payable 8,000

Inventory 8,000 \_\_\_\_\_

28,000 28,000

*Statement of financial position as at 3 March 2017*

$ $

Bank 19,000 Capital 20,000

Fixtures and fittings 6,000 Accounts payable 8,000

Inventory 8,000 Loan 5,000

33,000 33,000

*Statement of financial position as at 4 March 2017*

$ $

Bank Capital 19,800

Fixtures and fittings 6,000 Accounts payable 8,000

Inventory 8,000 Loan 5,000

Motor car 27,000 Bank 8,200

41,000 41,000

*Statement of financial position as at 5 March 2017*

$ $

Bank Capital 18,300

Fixtures and fittings 6,000 Accounts payable 8,000

Inventory 8,000 Loan 5,000

Motor car 29,000 Bank 11,700

43,000 43,000

*Statement of financial position as at 6 March 2017*

$ $

Bank Capital 20,300

Fixtures and fittings 6,000 Accounts payable 8,000

Inventory 8,000 Loan 4,000

Motor car 29,000 Bank 10,700

43,000 43,000

(b) *Statement of financial position as at 6 March 2017*

$ $

*Current assets*

Bank

Inventory 8,000

8,000

*Non-current assets*

Motor car 29,000

Fixtures and fittings 6,000

35,000

43,000

*Current liabilities*

Bank 10,700

Accounts payable 8,000

18,700

*Non-current liabilities*

Loan 4,000

Capital (owners’ equity) 20,300

43,000

LO2 Explain the accounting equation, and use it to build up a statement of financial position at the end of a period

LO4 Apply the different possible formats for the statement of financial position

Application exercises – Challenging

AE2.16

#### *Solution:*

|  |  |  |  |
| --- | --- | --- | --- |
|  | Transaction | Yes—asset name | No—reason |
| 1 | Signed building  contract |  | Fails definition test:  - No past transaction  - No economic benefits |
| 2 | Basic research |  | Fails recognition tests:  - Probability of future economic benefit  - Reliability of measurement |
| 3 | Delivered goods  purchased on credit | Accounts receivable |  |
| 4 | Staff training costs |  | Fails recognition tests:  - Probability of future economic benefit  - Reliability of measurement |
| 5 | Cash purchase of a  computer | Computer (PP&E) |  |
| 6 | Initial instalment on  financial lease | Lease asset (Bus) |  |

LO1 Explain the nature and purpose of the statement of financial position (balance sheet) and its component parts

LO2 Explain the accounting equation, and use it to build up a statement of financial position at the end of a period

LO3 Classify assets and claims

AE2.17

#### *Solution:*

Statement of financial position

|  |  |  |  |
| --- | --- | --- | --- |
| Assets | $’000 | Liabilities | $’000 |
| Current |  | Current |  |
| Cash at bank | 17.6 | Accounts payable | 37.8 |
| Accounts receivable | 16.7 | Short-term note payable | 15 |
| Prepaid insurance | 2.1 | Unearned Income | 6.4 |
| Inventory | 45.3 | Total | 59.2 |
| Total | 81.7 | Non-current |  |
| Non-current |  | Long-term debentures | 40 |
| Land | 123.9 | Total | 99.2 |
| Buildings (net) | 147.3 | Shareholders’ equity |  |
| Equipment (net) | 30.1 | Share capital | 200 |
| Intangible assets | 45 | Retained earnings | 53.7 |
| Total | 346.3 | Reserves | 15.4 |
|  |  | Total | 269.1 |
| TOTAL ASSETS | 428 | TOTAL LIABILITIES & EQUITY | 368.3 |
|  |  | Error | 59.7 |

LO2 Explain the accounting equation, and use it to build up a statement of financial position at the end of a period

AE2.18

#### *Solution:*

Statement of financial position of \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ as at \_\_\_\_\_\_\_\_\_\_\_\_

|  |  |  |  |
| --- | --- | --- | --- |
| Current Assets |  |  |  |
| • Cash at bank | 9,000 |  |  |
| • Inventory | 15,000 |  |  |
| • Accounts receivable | 6,000 |  |  |
| • Prepayments | 1,000 | 31,000 |  |
| Non-current Assets |  |  |  |
| • Land and Buildings | 50,000 |  |  |
| • Plant and Machinery | 26,000 |  |  |
| • Motor Vehicles | 18,000 | 94,000 | 125,000 |
| Current Liabilities |  |  |  |
| • Accounts payable | 11,000 |  |  |
| • Bank Overdraft | 14,000 | 25,000 |  |
|  |  |  |  |
| Non-current Liabilities |  |  |  |
| • Loan | 10,000 | 10,000 |  |
| Equity (Capital) |  |  |  |
| • Opening balance | 40,000 |  |  |
| • Asset revaluation | 20,000 |  |  |
| • Profit | 32,000 |  |  |
| • Drawings | <10,000> | 82,000 | 117,000 |
|  |  |  |  |
| Deficiency (Errors or Omissions) |  |  | 8,000 |

LO2 Explain the accounting equation, and use it to build up a statement of financial position at the end of a period

LO4 Apply the different possible formats for the statement of financial position

AE2.19

#### *Solution:*

Your report should consider the following relationships.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Aspect | Ratio | A | B | C |
| (a) Liquidity | Current | 1.67x | 3.0x | 7.0x |
| (b) Solvency | Debt/Assets | 50% | 30% | 70% |
|  | NCL/OE | 40% | 29% | 200% |
|  | CL/TA | 30% | 10% | 10% |
| (c) Asset mix | CA/TA | 50% | 30% | 70% |
|  | CL/TA | 30% | 10% | 10% |

In your report you may raise the following:

1. Liquidity generally relates to the ability of a business to meet its short-term obligations. Generally, this is measured by relating the level of current assets to the level of current liabilities. The ratios for the three businesses are 1.67, 3 and 7, respectively. A ratio that is too low will suggest that there is not a good ability to meet short-term obligations. One that is too high suggests that current assets are not being used productively. The question as to just what level is appropriate is one that will be considered in more detail in Chapter 8. At this stage, the critical issue is probably about the level of the ratio in B and C, where the level of current assets relative to current liabilities is very high.
2. Ability to pay off debts, often known as solvency, requires an extension of consideration of the short-term ratio used for liquidity, to incorporate consideration of long-term debt. Typical questions might be about the level of debt to assets, of the level of non-current (long-term) liabilities to the amount of owners’ equity, or the relationship between current liabilities and total assets. The respective figures for these are:

A B C

Debt to assets 50% 30% 70%

Non-current liabilities

to owners’ equity 40% 29% 200%

Current liabilities to

total assets 30% 10% 10%

From this, it can be seen that C has the highest level of debt and relies heavily on non-current liabilities, while B has the lowest level of debt and relies heavily on ownership funding. A is using a much greater proportion of current (short-term) liabilities to fund total assets, which can create problems in relation to servicing and repaying debt.

1. Asset mix is all about the kind of proportions that the various asset groupings have in the total asset mix. Generally, some measurement of the relationship between current assets and total assets is useful, as is a measure of current liabilities relative to total assets. The ratios for the three businesses are shown below.

A B C

Current assets

to total assets 50% 30% 70%

Current liabilities to

total assets 30% 10% 10%

From this, we can see that C has a very high proportion of its assets tied up in current assets, while B has a much lower proportion of current assets to total assets. Excess current assets tend to indicate that some of the assets are unproductive.

LO6 Explain the main ways in which the statement of financial position can be useful for users of accounting information

AE2.20

#### *Solution:*

1. Inventory: It should be recorded at the lower of cost or market. Market being the net realisable value (selling price less cost to sell). While the table gives cost ($27,000) and Net realisable value ($56,000), it is done on an aggregate basis. The assessment should be done on the basis of individual inventory items, as there may be some items of inventory where the NRV is below the cost.
2. Accounts receivable: The amount recorded for accounts receivables will be subject to an impairment test that is the higher of the value in use and value in exchange. Accounts receivable should be recorded at $10,800.
3. Prepayment: Will normally be recorded on the basis of the residual cost, or the cost of the benefits not used up. In this case that would be $800.
4. Equipment: Equipment can be recorded either on the basis of cost or fair value (market value). Under both approaches it will also be subject to an impairment test. Under the cost method it would be recorded at $48,000 with no impairment (value in use being $85,000). Under the fair value method it would be recorded at market value, but market value is not given. The replacement price being for a new asset and net realisable value is after the costs to sell.
5. Investments: Investments can either be recorded on the basis of cost or fair value (market value). Under the cost method it would be recorded at $20,000. Under the market value method, it would be recorded at market value, but market value is not given. The replacement price would most likely be the same as market value for many investments (e.g. shares) and that being the case. Investments would be recorded at $32,000.
6. Patent: Patents will normally be only recognised where they have been acquired externally and they will be recorded normally on the basis of residual cost and be subject to the impairment test. The residual cost being $15,000 with no impairment (value in exchange and use being both higher than $15,000. Patents can be recorded at fair value under restricted circumstances where there is an acceptable market in which a fair value can be determined. In this example we do not have sufficient information to determine if ‘fair value’ can be used. Additionally, the market values given being ‘replacement price’ and ‘net realisable value’, rather than ‘fair value’.

LO2 Explain the accounting equation, and use it to build up a statement of financial position at the end of a period

LO5 Identify the main factors that influence the content and values in a statement of financial position

## Case Study

## Usefulness of the statement of financial position

*Solution:*

1. In broad terms this is true. However, there are a number of examples of assets which are not included, usually because of difficulties in measuring them, notably in the area of human assets or brands. Limitations include:
   1. it represents a snapshot—a picture at a particular point in time, which may not represent a typical situation
   2. there are some inherent conflicts in developing the statement; e.g. the conflict between relevance and reliability
   3. consistency of valuation can be an issue
   4. there is considerable discretion when it comes to applying accounting principles and rules.
2. The summary is useful for decision-making, although its deficiencies need to be recognised. The financial statements encapsulate a considerable amount of information that is useful in assessing financial performance and position. The extensive use of financial statements provides clear evidence of their importance.
3. As identified in the solution to Activity 2.7, there are a lot of issues in ensuring that a photograph is a good one, and these can be applied to the notion of a statement of financial position as a snapshot.
4. The statement of financial position helps in assessing the financial health of a business by:

* providing insights into the ways in which the business is financed and how its funds are spent
* providing insights into the liquidity of the business
* helping to providing a basis for valuing a business
* providing insights into the mix of assets held
* assisting in performance evaluation.

1. Assets may be inappropriately valued.

Liabilities may be shown which are inappropriate.

There may be mistakes or omissions.

1. Judicious use of debt is fine, as long as it does not become excessive and increases the risks to the business beyond a reasonable level. Generally, debt will only be used successfully when the cost of debt is well below the returns on the assets purchased by use of debt. Levels of debt used in practice also need to reflect the underlying strength of the economy and of the business.
2. It might, because it shows a conservative and safe approach to use of investors’ funds. Alternatively, it can be seen as not using investors’ funds appropriately, by being too conservative. Higher risks associated with debt usually have an expectation of higher returns to investors.
3. The global financial crisis (GFC) reduced liquidity and essentially dried up sources of funds. The result was that many businesses could not replace (or rollover) their existing debt and were forced into liquidation. Generally, it appears that the levels of debt deemed acceptable post-GFC are much lower than pre-GFC.
4. This depends on the nature of the business. An opportunistic business will require far greater financial flexibility than a stable business.
5. ‘Current’ usually means something that will turn over within the next 12 months or within the operating cycle. Current and non-current items are fundamentally different in terms of their role in the business and need separate classification. Different funding methods are often associated with different types of assets. Non-current assets are typically funded by longer term methods, whereas current assets are typically funded using short-term methods.
6. The statement of financial position enables us to gauge the ability of the business to meet its short-term obligations. There should normally be sufficient liquid funds available to meet short-term obligations.
7. Liquidity risk can be assessed, that is, the risk of being unable to pay the business’s short-term obligations. Also, the longer term risks associated with the use of debt can be assessed.