

Synoptic Questions and Answers

Financial Accounting

Fifth edition

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What is accounting?

SYNOPTIC QUESTION

‘Financial accounting should restrict itself to reporting on matters that can be objectively measured in money’. Outline the arguments for and against this statement. Your answer should be in the form of an essay of between 400 and 500 words.

SYNOPTIC ANSWER

This answer covers the main points for and against the proposition, but student answers may be structured and expressed differently.

Financial accounting has traditionally been concerned with measurement of and reporting on economic transactions. Indeed, the concept of ‘money measurement’ formalises this idea and states that only events and transactions that can be objectively measured in money terms, that is, can have a £ sign (or other currency) attached to them, should be recognised in accounting.

The key advantage of this approach is that it only includes assets, liabilities, equity, revenues and expenses which can be verified and are reasonably objective. Certainly, questions of valuation arise, especially of assets, but the key point is that only elements that can be valued in money terms, whatever that valuation, are recognised.

It is worth noting that one great advantage of the historical cost method of valuation is its objectivity. This leads to another advantage of restricting accounting to elements measurable in money, which is that the relative objectivity of money measurement results in a relative lack of controversy about routine accounting. In turn, this means that accounting is simpler and therefore cheaper to apply than if we had tried to take into consideration less objective issues.

In the short term, we could also note that this approach is generally understandable to users precisely because it is well established.

This approach has been criticised for a number of reasons. Primarily, it excludes from accounting any element that cannot be valued objectively in money terms. This implies, for example, that a ‘particularly skilled and motivated workforce’ is not something that an accountant would recognise. Such a workforce is self-evidently a good thing for the organisation and can be expected to result in higher profits, a better service to customers, and so on. Nevertheless, the accounting problem is that we have no way of objectively measuring the value of the workforce, since we find it hard to specify exactly what benefits will accrue to the organisation and, especially, how those benefits can then be measured. There is no argument that the benefits exist, only an argument about whether and how to recognise them.

Further, not only does money measurement exclude any non-measurable element from the existing financial statements, it also precludes a consideration of wider forms of accounting. In this category we could include social and environmental accounting. Matters such as the proportion of women in senior positions, or the tonnes of sulphur dioxide emitted by our organisation might be seen by some stakeholders of our organisation as useful information, but a restriction of accounting to those matters that can be objectively measured in £s would exclude reporting on such issues.

CHAPTER 2

The statement of financial position

SYNOPTIC QUESTION

Alpha Glasswares Ltd has the following assets and liabilities at 31 December 20X5. The 'shareholders' funds' balance has not been given and you will have to calculate this from the available information.

	£
Property	145,000
Trade receivables	32,000
Long-term loan	68,000
Bank overdraft	17,000
Vehicles	78,000
Inventory	15,000
Plant and machinery	40,000
Trade payables	57,000

The directors believe that the property is actually worth £180,000 and they are considering the inclusion of this asset at this valuation, instead of at the original valuation.

Required:

- (a) Prepare the statement of financial position for Alpha Glasswares at 31 December 20X5, including the property at its original, historical cost valuation.*
- (b) Outline the main advantages and disadvantages to the company as a result of including the property at its revised valuation.*
- (c) Indicate the main strengths and weaknesses of the company as revealed by the statement of financial position that you have constructed.*

SYNOPTIC ANSWER

(a)

ALPHA GLASSWARES LTD
STATEMENT OF FINANCIAL POSITION AT 31 DECEMBER 20X5

Non-current assets		
Property		145,000
Plant and machinery		40,000
Vehicles		78,000

		263,000
Current assets		
Inventory	15,000	
Trade receivables	32,000	

		47,000

		310,000
		=====
Shareholders' funds		168,000
Non-current liabilities		
Long-term loan		68,000
Current liabilities		
Trade payables	57,000	
Bank overdraft	17,000	

		74,000

		310,000
		=====

(b)

The main advantage of including the property at valuation would be that the valuation figure would be more up to date. Arguably, it would therefore be a better reflection of the worth of the property to the company and hence produce a more useful statement of financial position.

On the other hand, the valuation is not as objective a figure as the original historical cost. The disadvantage is thus that the valuation is likely to be a less reliable figure than the original. Further, if the valuation is to have credibility for external users then the directors may have to employ a surveyor to verify the valuation and this will be costly.

(c)

Major strengths of the company include the large block of non-current assets. Whatever the realism of the valuation, the company owns substantial assets and these could potentially be used to provide security for further loans, since the existing loan is much less than the asset values. In addition, the loans are at a reasonable level in relation to the shareholders' funds.

The main weakness of the company is the high level of current liabilities compared with the current assets, resulting in a substantial negative working capital. This implies that the company is likely to have difficulties in meeting its short-term obligations.