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Chapter 2
Measuring and evaluating financial position and financial performance

Discussion questions

**1** If you had trouble with any of the terms, the Glossary at the end of the text will help you.

**2** Assets are usually separated into shorter-term (current) and longer-term (noncurrent) assets. Current assets are those that are expected to be used, sold or collected within the next year. Noncurrent assets are therefore expected to have benefits for more than one year into the future.

**3** Like assets, liabilities are usually separated into shorter-term (current) and longer-term (noncurrent) liabilities. Current liabilities are those that are due (expected to be paid or otherwise discharged) within the next year, and noncurrent liabilities are therefore due more than one year into the future. Some liabilities, such as many loans, extend for years into the future but are partly paid each year, so the balance sheet would show both a current and a noncurrent portion for them.

**4** Not all liabilities are expected to be paid in cash; some are ‘paid’ by providing goods or services. An example is a deposit received from a customer for goods to be shipped later. The enterprise has the money (an asset) and records a corresponding liability for the deposit, but expects to give the customer the agreed-upon goods to discharge the liability. In the meantime, the customer has a claim on the enterprise, expecting to get either the goods or the cash back if the goods are not supplied. Also, some liabilities, such as provision for warranty, require future work to be done.

**5** The company could have paid a dividend, thereby reducing retained profits. Alternatively, retained profits also decrease when the entity makes a loss.

**6** **a** A balance sheet can indicate whether a company is financially sound by a comparison of the amount of finance raised by debt with the amount raised from owners. The higher the proportion raised by debt, the higher the risk to the creditors.

**b** Working capital (i.e. current assets less current liabilities) indicates a company’s ability to pay its bills on time. This assumes that the current assets can be readily turned into cash.

**c** To declare a dividend, a company must have adequate cash (or overdraft facilities) and adequate retained profits. The decision will be influenced by shareholder expectations.

**d** The age of equipment can be ascertained by comparing the cost of equipment to accumulated depreciation.

**7**

|  |
| --- |
| Balance sheet format(all figures are as at a particular date) |
|  |  |  |  |
| Side-by-side style |  | *OR* | Vertical style |
| **Assets** | **Liabilities** |  | **Assets** |
| Useful financial resources | Obligations to be paid |  | Useful financial resources |
|  | **Equity** |  | **Liabilities** |
|  | Owners’ investment |  | Obligations to be paid |
|  |  |  | **Equity** |
| In both styles, sum A = Sum L + Sum E |  | Owners’ investment |

**8**

– Some long-term loans have portions that are repayable in the coming year, while the remainder is due in the longer term.

– Employee entitlements may be partly payable within 12 months and partly payable in the longer term.

– Income tax liability may be partly payable in the coming year and partly due in following years.

**9** An asset is defined as a future economic benefit controlled by the entity as a result of a past transaction. It is debatable whether or not staff members are actually ‘controlled’ by an entity, since they could leave if they so chose. Also, the criteria must be satisfied for an asset to be recognised are that the value of the asset can be measured reliably, and that it is probable that future benefits will eventuate. Even though employees may provide future benefits to a business, it is very hard to measure reliably or with any consistency the benefits they provide to the enterprise.

**10** Your explanations will have been in your own words – perhaps something like the following:

**a** Net profit is part of shareholders’ equity because the increase in resources earned, as mentioned above, belong to the owners, who may withdraw it as dividends. Until directors declare these dividends, they are part of their ownership interest.

**b** Companies earn profits when their revenues are greater than the expenses incurred in earning those revenues. Dividends are a distribution of profit to shareholders, not an expense of running a business.

**11** Inventory and accounts receivable are normally current assets, because the inventory is expected to be sold within a year of its purchase and accounts receivable are expected to be collected within a year. These assets would not be current assets if inventory was not expected to be sold within a year, and accounts receivable is not expected to be collected within a year.

**12** – Investments could be shares in other companies (such as BHP, Commonwealth Bank, Woolworths).

– Prepayments (or ‘prepaid expenses’) are amounts that have been paid in advance but for which the benefits have not yet been received. For example, if we pay a 12-month insurance premium on 1 April 2019, at 31 May 2019 we will have a prepayment equal to ten-twelfths of the amount paid. Prepayments are assets because they represent future economic benefits.

– Intangible assets are noncurrent assets that have no physical substance, such as copyrights, patents, trademarks, brand names and goodwill.

– Accrued expenses relate to expenses that have been incurred during the year but not yet paid (e.g. accrued wages).

**13** An indicator of whether a company is financially sound is the relationship between borrowed funds and shareholders’ funds. This is known as the debt-to-equity ratio. A higher ratio is a warning about risk.

**14** To pay its bills on time, an organisation will have to collect cash from its customers, by either by getting them to pay what they already owe or selling them some unsold products for cash.

To predict whether an entity will be able to pay its bills on time, a calculation of working capital (Current assets – Current liabilities) may provide insight, as would the working capital ratio (also called the current ratio), which is Current assets / Current liabilities. If the working capital is positive and the current ratio indicates there are more current assets than current liabilities (i.e. if it is greater than 1), the entity’s ability to pay bills on time would probably be good.

**15** The list might look something like the following:

|  |  |
| --- | --- |
|  Person (decision-maker)  |  Use (decision to be made)  |
| Manager | Resource acquisition/allocation |
|  | Improving the way company is managed |
| Owner (e.g. investor) | Invest/divest/hold |
|  | Hire/fire managers |
| Lender (creditor) | New lending, extension of credit |
|  | Response to inadequate repayment |
| Regulator  | Monitoring company’s actions |
|  | Assessing any needed penalties |
| Employee (alone or union) | Whether to be/stay employed |
|  | Contract negotiations |
| Public interest group | Social impact of company |
|  | Cost of improving environment |
| Competitor | Improve competition strategy |
|  | Learn from successes/failures |
| Customer | Assurance of ability to deliver services |
| Supplier | Assurance of ability to pay |
| Taxation authority | Assessment of some taxes |

**16** A few centuries ago, it was common practice to wait until the conclusion of a trading venture before extracting any information regarding the result of the operations. In modern times, however, frequent and regular information is needed by owners, management, leaders and government. To meet these demands, it is customary to divide the life of accounting entities into a succession of equal periods and to prepare reports for these periods. For some parties, such as taxation authorities and shareholders, annual or six-monthly accounts may be adequate, whereas for others, such as management, weekly reports may be required. There is normally some delay before such reports are available.

However, these reports relate to the past. Financial analysts and the stock market react quickly to information. They are likely to have reacted to any ‘news’ included in the financial statements by the time they are published and analysed. It is difficult to ‘beat the market’ using financial statement information, because the statements reflect business events people already know something about, and there are many others trying to analyse what is happening.

Although financial reports may be of limited use in investment decisions, they do provide a useful way to develop a good understanding of the financial and operating strategy of the company.

**17** There are many approaches that could be used to answer this question. Students’ paragraphs should recognise that there are arguments on both sides; for example:

**i** Pro-a single balance sheet:

– Everyone gets the same information; no one gets an advantage

– Reduces cost of preparing and auditing the information

– Avoids making assumptions (possibly paternalistic ones) about who needs what information for what decision

– Multiple ‘messages’ would be confusing.

**ii** Pro-multiple balance sheets:

– Allows information to be designed to suit particular needs

– Different reports could be released at different times of the year, or as required

– May reduce the cost of transmitting the information (e.g. annual reports are expensive, and few people may actually pay much attention to them)

– To serve sophisticated users, balance sheets have become so complex and jargon-laden that most other users cannot understand them and so do not benefit from them.

**18** A balance sheet is a measure of assets, liabilities and shareholders’ equity at a certain date. It is a snapshot of the enterprise, setting out its resources, obligations and ownership interest at that date. Accounting is generally an historical measurement system: it records what has occurred, not what will occur in the future. Thus, asset and liability values are derived from the past. In general, assets are valued at what they cost when they were acquired, and liabilities are valued at what was promised when the obligation arose. In most countries, assets and liabilities are not valued at the current prices they might fetch if they were sold or marketed right now.

 Thus, a perfectly accurate balance sheet cannot be prepared until the end of the life of assets held and until debts of the business have been paid or otherwise satisfied. This may be many years in the future, and, of course, if the business is continuing, other assets will have since been acquired and other obligations entered into. Valuation of these elements will continue to present difficulty even 50 years from now.

**19** Those that are current need to be repaid within one year or refinanced. This is where the immediate pressure is.

**20** The dollar amounts ofaccrued expenses are known or easily calculated, while provisions are estimates. For example, accounts such as wages payable or electricity payable can be calculated with a high level of accuracy, but provisions such as provision for warranty or provision for long service leave can be very difficult to estimate. Sometimes the difference can be subtle, but it does relate to this level of uncertainty.

Problems

Problem 2.1

|  |  |
| --- | --- |
| **1** | SE  |
| **2** | L  |
| **3** | A |
| **4** | A |
| **5** | L |
| **6** | L |
| **7** | L |
| **8** | A |
| **9** | A |
| **10** | SE |

Problem 2.2

Both statements refer to a strong balance sheet. Recall that the basic accounting equation is A = L + SE. A strong balance sheet usually refers to the fact that the percentage of assets financed by debt (liabilities) is relatively small. The lower levels of debt mean it is easier for the company to borrow more if it wishes to expand or buy other companies. Companies with strong balance sheets are in a better position to acquire other companies (e.g. it is easier for them to borrow).

Problem 2.3

|  |
| --- |
| **JKL Limited****Statement of financial position as at 30 June 2019** |
|  | $000 |
| Current assets |  |
| Cash | 63 382 |
| Accounts receivable | 98 264 |
| Inventory | 110 234 |
|  | 271 880 |
| Non-current assets |  |
| Property, plant and equipment | 181 148 |
| **Total assets** | **453 028** |
|  |  |
| Current liabilities |  |
| Accounts payable | 105 344 |
| Interest-bearing liabilities | 192 370 |
| Provisions |  70 876 |
|  | 368 590 |
| Shareholders’ equity |  |
| Share capital | 45 092 |
| Retained profits |  39 346 |
|  |  84 438 |
| **Total liabilities and equity** | **453 028** |

Problem 2.4

Cobin Ltd

Balance sheet as at 30 June 2019

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Current assets** | $ | $ | **Current liabilities** | $ |
| Cash and cash equivalent |  | 43 000 | Accounts payable | 61 000 |
| Accounts receivable |  | 68 000 | Notes payable | 30 000 |
| Inventory |  | 81 000 | Income taxes payable | 32 000 |
| Prepayments |  |  10 000202 000 | Current portion of long-term debt |  25 000148 000 |
| **Noncurrent assets** |  |  | **Noncurrent liabilities** |  |
| Long-term investments |  | 110 000 | Long-term debt | 200 000 |
| Property, plant and equipmentLess accumulated depreciation | 550 000190 000 | 360 000 | Provision for employee entitlements |  34 000234 000 |
| Patents and trademarks |  |  44 000 | Total liabilities | 382 000 |
|  |  | 514 000 | **Shareholders’ equity**Share capital | 150 000 |
|  |  |  | Retained profits | 184 000 |
|  |  |               |  | 334 000 |
|  |  | 716 000 |  | 716 000 |

Problem 2.5

In this question, something of Solden’s personality was indicated. The outline below takes this into account and answers Solden directly, though informally.

**1** The idea of ‘balancing’ the accounting figures arose hundreds of years ago. Recording each transaction twice provided some arithmetic control over the records, because the two sides of the records should be equal. This step is perhaps less important today, when there are more accurate methods of record-keeping, including computers to keep track of amounts; however, errors are still occasionally discovered because the figures do not balance. More importantly, to you, the balanced balance sheet shows how all of your resources (assets) have been financed. It provides a handy comparison: dollar amount of assets equals financing sources (liabilities and equity).

**2** The balance sheet is a history: it reports the assets, liabilities and equity that have built up over time until the date of balance sheet. Such a history is useful mainly if it indicates things that will affect the future. Two examples of such factors might be: (1) if your company has a lot of debt, which will be shown in the balance sheet, and which will affect your ability to operate in the future, because the debt has to be repaid; and (2) if the balance sheet indicates you have been a good (or bad) financial manager, this might suggest you will continue to be a good (or bad) financial manager in the future.

**3** The accountants and auditors were probably thinking of the accounting definition of an asset as being something owned or controlled that will provide future benefit. Since we do not practise slavery, it is hard to count people as assets, because people can leave any time they like. Employment contracts do not amount to ownership of the person, because it is difficult to force productive effort on a reluctant person who wants to leave. (You might be interested to know that some sports teams do show as assets amounts spent to acquire or develop players, because players can be ‘sold’ or traded.)

Problem 2.6

SPOM Ltd

Balance sheet as at 30 June 2019

|  |  |  |  |
| --- | --- | --- | --- |
| **Current assets** | $000 | **Current liabilities** |  $000 |
| Cash | 32 000 | Accounts payable | 57 634 |
| Accounts receivable (49,132 – 1,549) | 47 583 | Interest bearing liabilities | 8 732 |
| Inventory |  55 117 | Provisions  | 31 704  |
| Prepayments |  8 324 |  | 98 070 |
|  | 143 024 | **Noncurrent liabilities** |  |
|  |  | Provisions (35,438 – 31,704) |  3 734 |
| **Noncurrent assets** |  | Interest bearing liabilities |  87 453 |
| Property plant and equipment | 90 574 |  |  91 187 |
| Accounts receivable | 1 549 | **Total liabilities** | 189 257 |
| Intangibles | 49 053 |  |  |
| Other financial assets  |  19 390 | **Shareholders’ equity** |  |
|  | 160 566 | Share capital | 71 667 |
|  |  | Retained profits | 42 666 |
|  |  |  | 114 333 |
| **Total assets** | 303 590 | **Total liabilities and shareholders’ equity** | 303 590 |

Problem 2.7

**1** Retained profits is the accumulation of net profit minus dividends for each year of the company’s history. It is the accumulated residual undistributed earnings of the company, and is on the balance sheet because it is a source of present assets (because assets created in the process of earning profit were not all distributed to owners).

**2** Ending retained profits were $12 220. Subtracting profit that had been added ($2 350) and adding back dividends that had been deducted ($1 200) gives beginning retained profits of $11 070. To check this, going the other way gives $11 070 + $2 350 – $1 200 = $12 220.

**3** Ending retained profits would be $11 070 + $101 160 – $116 000 = ($3 770). There would have been a net loss for the year of $14 840, and that would have turned the retained profit at the beginning into a deficit at the end of $3 770.

Problem 2.8

1

Century Cinemas

Income statement

For the year ended 31 December 2019

|  |  |  |
| --- | --- | --- |
|  | $ | $ |
| **Ticket revenue** |  | **81 700** |
| Confectionery sales |  | 12 300 |
| Less cost of confectionery sold |  | (10 500) |
| **Gross profit** |  | **83 500** |
| Less operating expenses |  |  |
| Advertising expense | 42 780 |  |
| Rent expense | 33 200 |  |
| Electricity expense | 5 090 | (81 070) |
| **Net profit** |  | **2 430** |

Problem 2.8 (cont.)

2

Century Cinemas

Statement of retained profits

For the year ended 31 December 2019

|  |  |
| --- | --- |
|  | $ |
| Retained profits, 1 January 2019 | 59 720 |
| Net profit for 2019 |  2 430 |
|  |  |
| Retained profits, 31 December 2019 | 62 150 |

3

Century Cinemas

Balance sheet as at 31 December 2019

|  |  |
| --- | --- |
| **Current assets** | $ |
|  Cash | 4 610 |
|  Accounts receivable | 13 450 |
|  Inventory |  18 000 |
|  | 36 060 |
| **Noncurrent assets** |  |
|  Furniture and fittings | 34 000 |
|  Land and buildings | 60 000 |
|  Projection equipment |  41 000 |
|  | 135 000 |
|  |   |
| **Total assets** | 171 060 |
|  |  |
| **Current liabilities** |  |
|  Accounts payable | 13 910 |
|  |  |
| **Noncurrent liabilities** |  |
|  Loan payable | 35 000 |
|  **Total liabilities** | 48 910 |
| **Shareholders’ equity** |  |
|  Share capital | 60 000 |
|  Retained profits |  62 150 |
|  | 122 150 |
|  |  |
| **Total liabilities and shareholders’ equity** | 171 060 |
|  |  |
|  |  |
|  |  |

Problem 2.9

|  |  |  |
| --- | --- | --- |
|  | **Profit** | **Cash** |
| **1** | NE | –$40 000 |
| **2** | –$10 000 | NE |
| **3** | +$30 000 | NE |
| **4** | NE | –$8 000 |
| **5** | –$20 000 | –$20 000 |
| **6** | –$7 000 | –$7 000 |
| **7** | NE | –$100 000 |
| **8** | NE | –$13 000 |

Problem 2.10

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  | Assets | Liabilities | Shareholders’ equity | Notes |
| **1** | Increase | NE | Increase |  |
| **2** | Increase | Increase | NE |  |
| **3** | NE | NE | NE | Assets increased and decreased |
| **4** | Increase | Increase | NE |  |
| **5** | NE | NE | NE | Assets increased and decreased |
| **6** | Decrease | Decrease | NE |  |
| **7** | NE | NE | NE | Assets increased and decreased |
| **8** | Increase | Increase | NE |  |
| **9** | Increase | NE | Increase |  |

Problem 2.11

|  |  |  |  |
| --- | --- | --- | --- |
|  | Asset | Amount ($) | Assumptions |
| **1** | Prepayment | 35 000 | The insurance policy is used evenly over the period. 1.5 months of insurance has been used (expensed); 10.5 months remain. |
| **2** | Intangible asset | 20 000 | It is probable that the benefits the patent gives to XYZ will provide future economic benefit. |
| **3** | – |  |  |
| **4** | Land | 150 000 *or* 100 000 | Generally, the land will be recorded at historical cost; that is, it will be valued at $100 000. If the land has recently been revalued, the company can record it at the revalued amount of $150 000. |
| **5** | Equipment | 2 400 000 | Because the installation was necessary to the operation of the machine, the cost of installation is added to the purchase cost of the machine to give its opening book value. |
| **6** | Computer | 2 700 | It is the price paid for the computer that is relevant. |

Problem 2.12

|  |  |
| --- | --- |
|  | Liability |
| **1** | Tax payable |
| **2** | Wages payable |
| **3** | Provision for warranty claims |
| **4** | Revenue received in advance (also called unearned revenue). This is discussed in detail in Chapter 5. |
| **5** | No. |

Problem 2.13

Revenue for the month of February 2019

|  |  |  |
| --- | --- | --- |
|  |  | $ |
| **1** | Sales – credit | 200 000 |
| **2** | Sales – cash | 190 000 |
| **3** | Rental revenue | 8 000 |
| **4** |  |  –  |
| **5** |  |  –  |
|  | Total revenue | 398 000 |

Problem 2.14

Revenue for the year

|  |  |  |
| --- | --- | --- |
| **1** | Sales – credit, $30,000 |  |
| **2** | Nil | The motor vehicle will be recognised at cost of $31 200. |
| **3** | Nil | The ink cartridges are not delivered. The sales have not taken place yet. |
| **4** | Sales – credit, $22,000  |  |
| **5** | Nil | Money received from shares issuing will be recognised as share capital instead of revenue. |
| **6** | Sales – cash, $400 | The remaining $4 400 will be recognised as unearned revenue and will be realised when the product is delivered in the future.  |

Problem 2.15

|  |  |  |
| --- | --- | --- |
|  | Revenue earned | Rationale |
| **1** | Y | Sales are $9 500. This is revenue. Revenue is independent of the cost of goods sold. The cost of goods sold, deducted from the revenue, is an expense. |
| **2** | Y | Sales are $7 000. This is revenue.  |
| **3** | Y | Sales are $4 500. This is revenue. |
| **4** | Y | This is revenue for the surveyor, since even though she/he has not yet received the cash, he/she has performed the service, and therefore earned the revenue. |
| **5** | N | This is an expense, not a revenue. |
| **6** | Y | Dividends received are a revenue. (For a financial services company, dividends may be a main source of revenue.) |
| **7** | Y | The $1 600 is still revenue. Revenue need not be paid in cash in order to be recognised. It is the receipt of benefit – in this case, the saving of an outgoing. |

Problem 2.16

Expenses for the month of February, 2019

|  |  |  |  |
| --- | --- | --- | --- |
|  |  | $ |  |
| **1** | Salaries | 15 000 |  |
| **2** |  | – | This would be a January expense |
| **3** | Rent | 5 000 |  |
| **4** | Repairs & maintenance | 750 |  |
| **5** |  |  –  | This is an asset, not an expense. Land is not depreciated. |
|  | Total expenses |  20 750  |  |

Problem 2.17

|  |  |
| --- | --- |
| **1** | $10 000 |
| **2** | $1 200 |
| **3** | N/A |
| **4** | $6 000 |
| **5** | N/A |

Problem 2.18

The following list includes points for discussion. Other points not included here may also be valid.

– What are the CEO’s motivations?

– Will the proposed change to the balance sheet affect the CEO’s bonus?

– Is the CEO worried that the performance of the company is so poor that he/she may lose her/his position as CEO?

– Is the enterprise experiencing financial difficulties, such that it needs additional financing?

– Does the CEO’s suggested change to the balance sheet involve a change from one acceptable accounting method to another acceptable accounting method? If so, does the proposed accounting method better reflect the circumstances of the enterprise?

– Does the CEO’s proposed change involve recording transactions that have not yet occurred (e.g. recording fictional sales)?

– Does the CEO’s proposed change involve changes in estimates (e.g. lower allowance for uncollectable accounts)? If so, does recent experience support the lower estimate?

– Is the CEO aware that the financial statements must be prepared according to acceptable accounting methods? The chief accountant should make the CEO aware that this is the case.

– Might the chief accountant jeopardise her/his employment with the company if he/she fails to agree with the CEO?

– The chief accountant should assess the CEO’s motivations.

– The chief accountant should assess whether the CEO’s proposed change falls within acceptable accounting methods and best reflects the economic circumstances of the enterprise. If it does not, the chief accountant can either record or not record the change.

– If he/she records the change in these circumstances, she/he will violate the rules of professional conduct for accountants.

– During the course of the audit, the auditors are likely to discover the change if the change is significant.

– The chief accountant could explain to the CEO the likelihood that the auditors would discover the change.

– Auditors report directly to the board of directors.

– The chief accountant could explain this to the CEO, if she/he is unaware of the fact, and persuade the CEO that making the change could damage the reputation of the CEO in the opinion of the board of directors.

Cases

2A

**1** The point of time at which the balance sheet is drawn up – 25 June 2017

**2** The currency in which accounts in the balance sheet are measured – Australian dollars

**3** The 2017 balance sheet of Woolworths Limited balances, as follows: Assets ($22 915.8m) = Liabilities ($13 039.7m) + Shareholders’ equity ($9 876.1m)

**4** The assets of $22 915.8m were financed by current liabilities of $8 824.2m, noncurrent liabilities of $4 215.5m and shareholders’ equity of $9 876.1m (including contributed capital of $5 615.0m and retained profits of $3 797.2m).

**5** The ‘net assets’ figure of $9 876.1m is determined by deducting liabilities, $13 039.7m, from assets, $22 915.8m.

**6** Balances at 25 June 2017 :

 $m

 Current assets 6 994.2

 Current liabilities 8 824.2

 Noncurrent assets 15 921.6

 Noncurrent liabilities 4 215.5

**7** Balance of working capital at 25 June 2017 = Current assets – Current liabilities = $6 994.2m – $8 824.2m = –$1 830.0m

**8** Dividends paid $540.9m, as per statement of cash flows, plus $21.5m to minority interests

**9** Amount of share capital issued – $5 615.0m (contributed equity)

**10** Companies included in the consolidated figures: Woolworths Supermarkets (Australia and New Zealand), Dan Murphy’s, BWS, Cellar Masters, Big W, Ezibuy & ALH Group (hotels)

**11** In 2017, the cost of goods sold amounted to $39 739.7m. This is referred to as cost of sales in the statement of profit and loss.

**12** As you would expect, the two figures are different. Net profit after income tax is $1 595.4 million, whereas the cash balance has decreased from $948.1 million in 2016 to $909.4 million in 2017. Note that this figure includes the net change in cash from operations and all investing and financing activities. As you will discover in Chapter 14, companies are required to reconcile the cash flow from operating activities to net profit after tax.

**13** $1 593.4 million

**14** $55 668.6 million operating revenue

**15** $4 080.4 million

**16** Cash decreased by $38.7 million (from $948.1 million in 2016 to $909.4 million).

2B

**1** Recall that the basic accounting equation is A = L + SE. A strong balance sheet usually refers to the fact that the percentage of assets financed by debt (liabilities) is relatively small. The lower levels of debt mean it is easier for the company to borrow more if it wishes to expand or buy other companies.

**2** By issuing shares, cash increases and so does share capital. The increase in these items reduces ratios such as debt-to-equity and debt-to-assets (i.e. it increases the strength of the balance sheet).

**3** A share buyback is when a company buys back its own shares from the market.

**4** Recall that A = L + SE. With a share buyback, assets (cash) will decrease (or liabilities will increase, if the company borrows the cash) and SE will decrease (via a decrease in share capital). In either case, ratios such as debt-to-equity and debt-to-assets change.

**5** Companies are given a debt rating, which is an indication of how secure the company is – for example, how certain it is that debt will be repaid by the company. As the debt rate gets lower, the company has to pay a higher rate of interest.

**6** Even for state and territory governments, a strong balance sheet is important. It means that, if the economy were to go into recession, it would be more likely that the government could still borrow to maintain its activities.