Chapter 2 – Measuring and reporting financial position

Discussion Questions – Easy

2.1 LO1 What are the main characteristics of assets from an accounting perspective? Is this consistent with a non-accounting definition?

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.

2.2 LO1 What are the main characteristics of liabilities from an accounting perspective? Is this consistent with a non-accounting definition?

Liabilities are the future sacrifice of economic resources. They can be legal debts (e.g. credit purchases or bank loans) or provision estimates (e.g. for future warranty claims).

2.3 LO3 Provide three examples for (a) current assets, (b) non-current assets, (c) current liabilities and (d) non-current liabilities.

Typical current assets include cash, accounts receivable, inventory, supplies and various prepaid amounts while non-current assets include land, buildings, machinery, equipment and motor vehicles. Typical current liabilities include bank overdrafts, accounts payable, interest payable and wages payable while non-current liabilities typically consist of bank loans, debentures and mortgages.

2.4 LO5,6 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?

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.

2.5 LO3 What sort of account is 'retained earnings'?

'Retained earnings' is an equity account. The balance in retained earnings represents the undistributed profits of the reporting entity, and represents a distributable reserve.

2.6 LO3 What sort of items would be included in the intangible asset category?

Intangible assets	
Identifiables	• Development costs
	• Patent
	• Copyright
	• Franchise
	• Trademark
	• Masthead
Unidentifiables	• Purchased goodwill

Discussion Questions – Intermediate

2.7 LO1 What are the main characteristics of equity from an accounting perspective? Is this consistent with a non-accounting definition?

Equity is the claim of the owner(s) against the business and is sometimes referred to as the owners' capital. Equity can be defined as the 'residual interest in the assets of the entity after deducting all its liabilities'.

2.8 LO 1,7 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?

Valuable resources 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.

2.9 LO3 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?

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.

2.10 LO5 Describe the two general types of claims against business assets. Provide examples of each.

Claims can be either external claims (liabilities) or internal claims (equity). Liabilities include bank overdrafts, accounts payable, loans and debentures while examples of equity include owners' contributions and retained earnings.

2.11 LO6 What other financial measures besides historical cost might be used for asset valuation?

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

2.12 LO5,6,7 Provide two exceptions to the usual method of asset valuation on the statement of financial position. What is the justification for these exceptions?

Exceptions include write-downs of inventory to net realisable value, the provision of an allowance for doubtful accounts for accounts receivable and the revaluation of long-term assets to current value. The justification for these exceptions is that they allow the balance sheet to provide more relevant and useful values for various users.

2.13 LO5 What is the primary measure used for liability valuation on the statement of financial position? Why is liability valuation not normally an issue?

Liabilities are usually recorded at their monetary face value. Valuation is less of an issue than for assets as the statement of financial position values are the same as the organisation's legal liability.

2.14 LO2 Why is the statement of financial position also called a 'balance sheet'?

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).

2.15 LO5 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.

(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 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).

Discussion Questions – Challenging

2.16 LO1 '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.

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.

2.17 LO6,7 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?

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.

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2.18 LO1,7 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?

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.

2.19 LO5 'The statement of financial position shows how much a business is worth.' Do you agree with this statement? Discuss.

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

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.

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.

Application Exercises – Easy

AE2.1 LO2 Calculate the missing amounts.

	Assets	Liabilities	Equity
Company #1	$50,000	$40,000	?
Company #2	$200,000	?	$120,000
Company #3	?	$350,000	$250,000
Sole trader #1	$20,000	?	$12,000
Sole trader #2	$5,000	$4,000	?
Sole trader #3	?	$35,000	$25,000
Partnership #1	$25,000	$20,000	?
Partnership #2	$100,000	?	$60,000
Partnership #3	?	$175,000	$125,000

	Assets	Liabilities	Equity
Company #1	$50,000	$40,000	**$10,000**
Company #2	$200,000	**$80,000**	$120,000
Company #3	**$600,000**	$350,000	$250,000
Sole trader #1	$20,000	**$8,000**	$12,000
Sole trader #2	$5,000	$4,000	**$1,000**
Sole trader #3	**$60,000**	$35,000	$25,000

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Partnership #1	$25,000	$20,000	**$5,000**
Partnership #2	$100,000	**$40,000**	$60,000
Partnership #3	**$300,000**	$175,000	$125,000

AE2.2 LO2 Complete the table by inserting the missing figures.

	(a)	(b)	(c)	(d)
Current assets	13,900	18,300	13,200	?
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	?	41,500	51,200
Opening capital	20,700	29,200	?	26,700
Profit or loss	19,600	17,900	37,400	(9,500)
Drawings	?	8,700	11,700	7,200

	(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

AE2.3 LO2 For each of the following transactions, identity the effect on the statement of financial position equation.

	Transaction	**A**	**L**	**0E**
A	The owner, ‘Bill’, contributes cash to the business ‘Bill’s Electrical Services’			
B	The business purchases supplies on credit			
C	The business purchases equipment with a bank loan			
D	Services provided on credit to a client			
E	Cash payment for rent of a storage shed for the next six months			
F	Cash payment at the end of the month for electricity used during the month			
G	Paid for supplies purchased on credit during the month			
H	Used up supplies during the month			
I	Interest owing on bank loan at the end of the month			
J	Customer pays for services provided on credit earlier in the month			

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	Asset	Liability	Equity
A	Up		Up
B	Up	Up	
C	Up	Up	
D	Up		Up
E	Up / Down		
F	Down		Down
G	Down	Down	
H	Down		Down
I		Up	Down
J	Up / Down		

AE2.4 LO1,3,4 The following is a list of the assets and claims of Crafty Engineering Ltd as at 30 June 2014:

	$
Accounts payable	86,000
Motor vehicles	38,000
Loan from bank	260,000
Machinery and tools	207,000
Bank overdraft	116,000
Inventory	153,000
Freehold premises	320,000
Accounts receivable	185,000

(a) Using the vertical format, prepare the statement of financial position of the business as at 30 June 2014 from the above information.
(b) Discuss the significant features revealed by this financial report.

(a) **Crafty Engineering Ltd — Statement of Financial Position as at 30 June 2014**

	$'000	**$'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

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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%).

Application Exercises – Intermediate

AE2.5 LO2 Calculate the missing amounts.

???	Easy
??????	Intermediate

	Business 1	Business 2	Business 3
Total assets—day 1	$10,000	$500,000	???
Total liabilities—day 1	$4,000	???	$2,500,000
Equity—day 1	???	$150,000	$1,000,000
Total assets—day 31	$11,500	$550,000	???
Total liabilities—day 31	???	$270,000	$2,800,000
Equity—day 31	??????	???	$1,200,000
Profit—days 1–31	$2,500	??????	$460,000
Drawings—days 1–31	$300	$8,500	??????

???	Easy
??????	Intermediate

	Business 1	Business 2	Business 3
Total assets—day 1	$10,000	$500,000	**$3,500,000**
Total liabilities—day 1	$4,000	**$350,000**	$2,500,000
Equity—day 1	**$6,000**	$150,000	$1,000,000
Total assets—day 31	$11,500	$550,000	**$4,000,000**
Total liabilities—day 31	**$3,300**	$270,000	$2,800,000
Equity—day 31	**$8,200**	**$280,000**	$1,200,000
Profit—days 1–31	$2,500	**$138,500**	$460,000

Drawings—days 1–31	$300	$8,500	**$260,000**

AE2.6 LO 3,4 Balances of assets and claims for Erasmus Traders at 30 June are provided below:

	$
Cash at bank	18,000
Cash on hand	500
Land and buildings	320,000
Inventory	180,000
Accounts payable	30,500
Plant and machinery	????
Bank loan	600,000
Motor vehicles	144,000
Accounts receivable	74,000
Equity	450,000

Determine the missing value for the 'Plant and machinery' account. Prepare a statement of financial position in the standard vertical format.

Erasmus Traders
Statement of Financial Position as at 30 June

	$	**$**
Current assets		
Cash	18,500	
Accounts receivable	74,000	
Inventory	180,000	272,500
Non-current assets		
Land and buildings	320,000	
Plant and machinery	344,000	
Motor vehicles	144,000	808,000
Total assets		1,080,500
Current liabilities		
Accounts payable		30,500
Non-current liabilities		
Bank loan		600,000
Equity		450,000
Total liabilities and equity		1,080,500

AE2.7 LO2,3 **The statement of financial position of a business at the start**

of a week is as follows:

Assets	**$**	**Claims**	**$**
Accounts receivable	33,000	Accounts payable	23,000
Inventory	28,000	Bank overdraft	43,000
Furniture and fittings	63,000	Owners' equity	203,000
Freehold premises	145,000		
Total assets	269,000	*Total liabilities and owners' equity*	269,000

During the week the following transactions take place:

- Sold inventory for $11,000 cash. This inventory had cost $8,000.
- Sold inventory for $23,000 on credit. This inventory had cost $17,000.
- Received cash from accounts receivable totalling $18,000.
- The owners of the business introduced $100,000 of their own money, which was placed in a business bank account.
- The owners bought a second-hand motor vehicle, valued at $10,000, to be used in the business.
- Bought inventory on credit for $14,000.
- Paid accounts payable $13,000.

Prepare the statement of financial position after all these transactions have been reflected.

Statement of financial position as at the end of the week

Accounts receivable (33,000 + 23,000 − 18,000)	38,000	Accounts payable (23,000 + 14,000 − 13,000)	24,000
Inventory (28,000 − 8,000 − 17,000 + 14,000)	17,000	Bank (43,000 − 11,000 − 18,000 − 100,000 + 13,000)	(73,000)
Motor van	10,000		
Furniture & fittings	63,000		
Freehold premises	145,000	Capital (203,000 + 11,000 − 8,000 + 23,000 − 17,000 + 100,000 + 10,000)	322,000
	273,000		273,000

Which can be rewritten as follows:

Statement of financial position as at the end of the week

	$	$
Current assets		
Cash at bank	73,000	
Accounts receivable	38,000	
Inventory	17,000	
		128,000
Non-current assets		
Motor van	10,000	
Furniture & fittings	63,000	
Freehold premises	145,000	

	218,000
	346,000
Current liabilities	
Accounts payable	24,000
Capital (owners' equity)	322,000
	346,000

AE2.8 LO2,4 **On 1 March 2014, Joe Conday started a new business. During March he carried out the following transactions:**

1 March	Deposited $20,000 in a bank account.
2 March	Purchased fixtures and fittings for $6,000 cash, and inventory valued at $8,000 on credit.
3 March	Borrowed $5,000 from a relative and deposited it in the bank.
4 March	Purchased a car for $27,000 cash and withdrew $200 for own use.
5 March	Purchased another car costing $29,000. The car purchased on 4 March was given in part exchange at a value of $25,500. The balance of the purchase price for the new car was paid in cash.
6 March	Conday won $2,000 in a lottery and paid the amount into the business bank account. He also repaid $1000 of the loan.

(a) Prepare a statement of financial position for the business at the end of each day using the horizontal format.
(b) Show how the statement of financial position you have prepared as at 6 March 2014 would be presented in the vertical format.

Joe Conday

Statement of financial position as at 1 March 2014

	$		$
Bank	20,000	Capital	20,000

Statement of financial position as at 2 March 2014

	$		$
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 2014

	$		$
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 2014

	$		$
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 2014

	$		$
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 2014

	$		$
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

Statement of financial position as at 6 March 2014

	$	$
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

AE2.9 LO 3, 4 Use the 31 December account balances for Sophia Partnership below to prepare a

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statement of financial position using the horizontal format.

	$
Accounts payable	25,000
Accounts receivable	32,000
Bank overdraft	1,000
Bank loan (due in 2022)	45,000
Drawings	5,000
Equity—opening	152,000
Furniture and fittings	20,000
Inventory	85,000
Motor vehicles	144,000
Prepaid insurance	2,000
Profit	65,000

Sophia Partnership
Statement of Financial Position as at 31 December

		$			$
Current assets			***Current liabilities***		
Accounts receivable	32,000		Bank overdraft	1,000	
Inventory	85,000		Accounts payable	25,000	26,000
Prepaid insurance	2,000	119,000			
			Non-current liabilities		
Non-current assets			Bank loan		45,000
Furniture and fittings	20,000				
Motor vehicles	144,000	164,000	***Equity***		212,000
Total assets		283,000	**Total liabilities & equity**		283,000

Application Exercises – Challenging

AE2.10 LO5, 7 For each of the following transactions determine:
(a) Should an asset be recognised?
(b) If yes, what would it be called?
(c) If no, why is no asset recognised?

	Transaction	**Yes—asset name**	**No—reason**
1	Signed a contract for a $300,000 building		
2	Undertook basic research of $40,000 on a new product		
3	Delivered goods to a customer related to credit sales contract		
4	Special staff training program related to new regulations cost $10,000		
5	Cash purchase of a new computer for $23,000		
6	Paid initial payment of $5,000 related to the financial lease of a bus		

	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)	

AE 2.11 LO6 Provide a report based on your evaluation of the following three statements of financial position in terms of:

(a) liquidity
(b) solvency, and
(c) asset mix.

	A $'000	B $'000	C $'000
Current assets	500	300	700
Non-current assets	500	700	300
Total assets	1,000	1,000	1,000
Current liabilities	300	100	100
Non-current liabilities	200	200	600
Total liabilities	500	300	700
Owners' contributions	400	100	200
Reserves	100	600	100
Total owners' equity	500	700	300
Total equity and liabilities	1,000	1,000	1,000

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:

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(a) 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.

(b) 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.

(c) 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 tends to indicate that some of the assets are unproductive.

Case Study 2.1

Usefulness of the statement of financial position

If you were to do an internet search on 'balance sheet uses', you would get a series of hits ranging from Wikipedia through a number of commercial and academic sites. Undertake a search of this type and summarise your findings.

Your summary should include, but not necessarily be confined to, the following:

1. The balance sheet/statement of financial position provides a summary of the assets and liabilities controlled by the business.
2. It provides a snapshot of the assets and liabilities at a particular moment in time.
3. These assets and liabilities are broken down under appropriate categories.
4. It shows how the business is funded.
5. The amount of the owners' equity can be clearly seen.

6. Equity can be broken down into contributed capital and other retentions.
7. The level of debt, and the type of debt, can be clearly seen.
8. Liquidity can be ascertained.
9. The balance sheet follows a fairly standard form.

Questions
1. Do you agree that the statement of financial position provides a summary of the assets and liabilities of the business? What kind of omissions can you think of? What limitations does the statement have?
2. How useful is this summary in terms of making economic decisions?
3. The snapshot analogy is a good one, but what are the limitations of an approach of this type?
4. How does the statement of financial position help in assessing the financial health of a business?
5. Can you think of any reasons why the figure shown under equity in a statement of financial position could be misleading?
6. What do you think about the use of debt in a business? Why and when might the use of debt be appropriate?
7. Why might the absence of debt in a business be seen as displaying a sound financial approach?
8. What do you think were the main issues arising from the global financial crisis and how are they likely to have impacted on the levels of debt deemed to be acceptable or appropriate?
9. How important might financial flexibility be to a business?
10. Explain the terms 'current' and 'non-current'. Why do you think current and non-current items are separately classified? How might this distinction help you in assessing the appropriateness of funding the assets?
11. What can you learn from the statement of financial position about liquidity within the business? How might you decide what level of liquidity is appropriate?
12. How does the statement of financial position help in assessing the risk inherent in the business?

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:

    a. it represents a snapshot—a picture at a particular point in time, which may not represent a typical situation;

    b. there are some inherent conflicts in developing the statement, e.g. the conflict between relevance and reliability;

    c. consistency of valuation can be an issue;

    d. 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. By providing insights into the ways in which the business is financed and how its funds are spent.

    By providing insights into the liquidity of the business.
    Can help in providing a basis for valuing a business.
    It provides insights into the mix of assets held.
    It assists in performance evaluation.

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5. Assets may be inappropriately valued.

   Liabilities may be shown which are inappropriate.
   There may be mistakes or omissions.
6. 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.

7. 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.

8. The global financial crisis 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 before the GFC.

9. This depends on the nature of the business. Opportunistic businesses will require far greater financial flexibility than a stable business.

10. 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.

11. The statement 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.

12. 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.