



Pearson

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	<ul style="list-style-type: none">• Development costs• Patent• Copyright• Franchise• Trademark• Masthead
Unidentifiables	<ul style="list-style-type: none">• Purchased goodwill

L03 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.

L01 Explain the nature and purpose of the statement of financial position (balance sheet) and its component parts

L07 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 ($A = OE + L$).

L02 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.

L03 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 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

Discussion questions – Challenging

- 2.12** '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

- 2.13** 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

- 2.14** 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

- 2.15** '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:

- (i) 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.
- (ii) 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

- 2.16** Refer to Accounting and You. Do you consider that knowledge as to how the accounting systems work is necessary for managers?
Can you think of ways in which this knowledge might be useful to you, assuming that you are operating as a manager in a business, not as an accountant?

Solution: Detailed knowledge as to how the system works may be useful, but it is certainly not essential. What is essential is an understanding as to what the financial statements mean and how they interact.

Knowledge of the levels of profit and wealth would be useful in managing a business and the departments therein, as well as detail regarding the assets and liabilities under the control of the business. The financial statements provide information to assist in planning and control.

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

- 2.17** The figures on the value of brands in Real World 2.1 are interesting. What reliance would you place on them? Would you make any decisions based on them?

Solution: Not sure that too much reliance can be given to them because the valuation is based on a range of estimates, some of which are really subjective. However, they provide valuable insights into the business and just what creates value.

L05 Identify the main factors that influence the content and values in a statement of financial position

- 2.18** In Real World 2.2 it is interesting to note that the cost of registering its squad of players would not have included anything for 'home-grown' players. In earlier years the figures would have included the cost of Gareth Bale, who was purchased by Spurs quite a few years ago. Gareth was sold to Real Madrid for £148 million in September 2013, a price well in excess of the figure included under the net intangible assets. Comment on the relevance of the assets shown.

Solution: It needs to be recognised that the value in the accounts is not resale or current value, rather it is the cost or written-down value of service contracts so it will only include figures relating to a player's rights purchased. The value of a Gareth Bale or Christian Ronaldo may be quite different to that shown in the accounts. This potential sales value is important and may well be a really critical part of decision making, but just what the value is will not be known until the player is sold. Just ask what you think Lionel Messi is worth on the transfer market (of people who know their soccer) and see just what kind of difference responses you get.

L05 Identify the main factors that influence the content and values in a statement of financial position

- 2.19** Two of the impairment examples given in Real World 2.3 relate to the energy industry. Substantial reductions in oil and gas prices worldwide necessitated these impairments. Why do you think that the original valuations were made? Should they have been made more conservatively?

Solution: Typically, valuations are based on cost or some other estimate that reflects expected future earnings. These latter valuations inevitably involve judgement. At the time of the investment, we presume that the estimates seemed reasonable. In the light of changed circumstances, and with the benefit of hindsight, the judgements now looked optimistic. That does not make them wrong for the time when the valuations were derived. The change in oil and gas prices would have been extremely difficult to foresee. As soon as changes could reasonably have been anticipated then the assets need to be amortised, but it is unreasonable to expect impairment to proceed prior to this. Indeed, to do so would have been excessively conservative.

L05 Identify the main factors that influence the content and values in a statement of financial position

- 2.20** How would you assess the fair value of a piece of property that you owned? How accurate could you be? How could you convince anyone else that your estimate was reasonable?

Solution: You would probably get a couple of real estate agents to provide you with an estimated valuation. They are used to dealing with arm's-length transactions and would be able to provide a figure which could be accepted as reasonable. If you tried to do this yourself you may well be too optimistic and your valuation would be coloured by wishful thinking. It is highly unlikely that your estimate would be the same as that of other individuals. Evidence such as historical details of recent transactions, provision of figure by experts and provided in writing, would help convince people that your estimates were reasonable.

L05 Identify the main factors that influence the content and values in a statement of financial position

- 2.21** Suppose that you inherited from a rich relative an allowance of \$50,000 a year, starting tomorrow, when your age is 60 (there are fewer years to use in the calculation than if we assumed that you were 20). Could this (or similar cash flow patterns) be seen as an asset?

What is the allowance worth today as a lump sum? Bear in mind that there is a huge market where retirees can trade a lump sum for an annuity (a regular amount received over a future period). What other factors need to be considered?

Solution: The capitalised value of an income stream can be seen as an asset. We need to know (or estimate) the annual income (in this case \$50,000), the number of years that we expect to receive it, and what kind of rate of return to assume. We can then do what is known as a discounted cash flow (a kind of compound interest in reverse – dealt with in chapter 14). The period would differ for men and women, given life expectation for women is about 3-4 years longer than for men. The discount rate to be used needs to be determined.

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

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.

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

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.

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

AE2.2

Solution:

(a)

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

(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		EQUITY	
Cash at bank	\$19,500	Contributed capital	\$20,000
Accounts receivable	<u>2,000</u>	Plus profit	<u>1,500</u>
Total current assets	<u>21,500</u>		<u>\$21,500</u>
TOTAL ASSETS	<u>\$21,500</u>	TOTAL EQUITY	<u>\$21,500</u>

(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		<u>\$45,500</u>
TOTAL ASSETS		<u>\$45,500</u>
LIABILITIES		
Current liabilities		
Accounts payable	\$4,000	
Non-current liabilities		
Bank loan	<u>\$20,000</u>	
TOTAL LIABILITIES		<u>\$24,000</u>
EQUITY		
Contributed capital		\$20,000
Plus profit		<u>1,500</u>
TOTAL EQUITY		<u>\$21,500</u>
TOTAL LIABILITIES + EQUITY		<u>\$45,500</u>

(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	<u>25,000</u>
Total current assets	\$143,000
Non-current assets	
Motor vehicles	<u>\$40,000</u>
TOTAL ASSETS	<u>\$183,000</u>

LIABILITIES

Current liabilities	
Accounts payable	\$4,500
Revenue received in advance	<u>15,000</u>
Total current liabilities	<u>\$19,500</u>
Non-current liabilities	
Bank loan	\$20,000
Car dealership debt	<u>30,000</u>
Total non-current liabilities	<u>\$50,000</u>
TOTAL LIABILITIES	<u>\$69,500</u>

EQUITY

Contributed capital	20,000
Plus profit to date	<u>93,500</u>
TOTAL EQUITY	<u>\$113,500</u>
TOTAL LIABILITIES + EQUITY	1. <u>\$183,000</u>

(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	<u>15,000</u>
Office supplies	5,000	Total current liabilities	<u>\$19,500</u>
Accounts receivable	<u>25,000</u>	Non-current liabilities	
Total current assets	<u>\$134,000</u>	Bank loan	\$20,000
Non-current assets		Car dealership debt	<u>30,000</u>
Motor vehicles	<u>\$40,000</u>	Total non-current liabilities	<u>\$50,000</u>
Total non-current assets	<u>\$40,000</u>	TOTAL LIABILITIES	\$69,500
		EQUITY	
		Contributed capital	20,000
		Plus profit to date	<u>84,500</u>
		TOTAL EQUITY	<u>\$104,500</u>
TOTAL ASSETS	<u>\$174,000</u>	TOTAL LIABILITIES + EQUITY	<u>\$174,000</u>

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

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

AE2.3**Solution:**

	Equation Effects	Examples
(a)	$A \uparrow = L \uparrow$	<ul style="list-style-type: none"> Borrowing Credit purchase of assets
(b)	$A \uparrow = OE \uparrow$	<ul style="list-style-type: none"> Owners' contributions Revenues
(c)	$A \uparrow = A \downarrow$	<ul style="list-style-type: none"> Cash purchase of assets Collect from accounts receivable
(d)	$A \downarrow = L \downarrow$	<ul style="list-style-type: none"> Repay loan Payment to accounts payable
(e)	$A \downarrow = OE \downarrow$	<ul style="list-style-type: none"> Cash expenses Allocation expenses (e.g. depreciation) Asset drawings
(f)	$L \uparrow = OE \downarrow$	<ul style="list-style-type: none"> Accrued expenses Drawings from overdraft
(g)	$L \downarrow = OE \uparrow$	<ul style="list-style-type: none"> 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
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		

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:****Statement of Financial Position as at a particular point in time**

	\$000	\$000
<i>Current assets</i>		
Accounts receivable	34	
Inventory	<u>46</u>	
		80
<i>Non-current assets</i>		
Delivery vans	54	
Plant & machinery	127	
Freehold premises	<u>245</u>	
		<u>426</u>
		<u>506</u>
<i>Current liabilities</i>		
Accounts payable	23	
Bank overdraft	<u>22</u>	
		45
<i>Non-current liabilities</i>		
Loan from NAB		100
<i>Capital (Equity)</i>		<u>361</u>
		<u>506</u>

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

AE 2.7**Solution:****(a) Crafty Engineering Ltd — Statement of Financial Position as at 30 June 2017**

	\$'000	\$'000
Current assets		
Accounts receivable	185	
Inventory	<u>153</u>	338
Non-current assets		
Freehold premises	320	
Machinery and tools	207	
Motor vehicles	<u>38</u>	<u>565</u>
Total assets		<u><u>903</u></u>
Current liabilities		
Bank overdraft	116	
Accounts payable	<u>86</u>	202
Non-current liabilities		
Loan from bank		<u>260</u>
Total liabilities		462
Equity/capital		<u>441</u>
Total liabilities and equity		<u><u>903</u></u>

(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

AE2.8

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

AE2.9

Solution:

	Beginning	Transactions							Ending
		1	2	3	4	5	6	7	
Assets									
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
	<u>93,000</u>								<u>101,000</u>
Liabilities									
Accounts Payable	3,000	5,000			(7,000)				1,000
Bank Loan	30,000							(2,000)	28,000
	<u>33,000</u>								
Capital	60,000			2,000		10,000			72,000
	<u>93,000</u>								<u>101,000</u>

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:**

(a)

Joe Conday**Statement of financial position as at 1 March 2017**

	\$		\$
Bank	<u>20,000</u>	Capital	<u>20,000</u>

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	<u>8,000</u>		
	<u>28,000</u>		<u>28,000</u>

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	<u>8,000</u>	Loan	<u>5,000</u>
	<u>33,000</u>		<u>33,000</u>

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	<u>27,000</u>	Bank	<u>8,200</u>
	<u>41,000</u>		<u>41,000</u>

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	<u>29,000</u>	Bank	<u>11,700</u>
	<u>43,000</u>		<u>43,000</u>

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	<u>29,000</u>	Bank	<u>10,700</u>
	<u>43,000</u>		<u>43,000</u>

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

	\$	\$
Current assets		
Bank		
Inventory	<u>8,000</u>	8,000
Non-current assets		
Motor car	29,000	
Fixtures and fittings	<u>6,000</u>	
		<u>35,000</u>
		<u>43,000</u>
Current liabilities		
Bank	10,700	
Accounts payable	<u>8,000</u>	
		18,700
Non-current liabilities		
Loan		4,000
Capital (owners' equity)		<u>20,300</u>
		<u>43,000</u>

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

AE2.11

Solution:

Opening equity		200,000
Plus		
Sales	250,000	
Less cost of sales	(100,000)	
Less expenses	<u>(50,000)</u>	
Profit		100,000
Less drawings		(25,000)
Plus introduced equity		<u>20,000</u>
Equity at 31 December 2017		<u>295,000</u>

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

AE2.12**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	<u>150,000</u>		
	<u>476,000</u>		<u>476,000</u>
Equity start	240,000		
Injection	50,000		
Profit	<u>110,000</u>		
	400,000		
Less drawings x	<u>= 56,000</u>		
Closing equity	<u>344,000</u>		

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

AE2.13**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

AE2.14**Solution:**

Statement of financial position of _____ as at _____

Current Assets				
• Cash at bank	9,000			
• Inventory	15,000			
• Accounts receivable	6,000			
• Prepayments	<u>1,000</u>	31,00		
		0		
Non-current Assets				
• Land and Buildings	50,000			
• Plant and Machinery	26,000			
• Motor Vehicles	<u>18,000</u>	<u>94,00</u>	<u>125,000</u>	
		0		
Current Liabilities				
• Accounts payable	11,000			
• Bank Overdraft	<u>14,000</u>	25,00		
		0		
Non-current Liabilities				
• Loan	10,000	10,00		
		0		
Equity (Capital)				
• Opening balance	40,000			
• Asset revaluation	20,000			
• Profit	32,000			
• Drawings	<u><10,000></u>	<u>82,00</u>	<u>117,000</u>	
		0		
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

AE2.15**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:

(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 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

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:
 - (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 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.
- 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 (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.
- 9 This depends on the nature of the business. An opportunistic business 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 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.

- 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.