

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

**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

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

- (a) Do you agree with this statement?
- (b) Provide examples to support your position.

**Solution:** The words 'costs' and 'expenses' are often interchanged. However, in an

accounting context the term 'cost' represents an exchange equivalent (cash; other assets; liabilities assumed) for the acquisition of a good or service (e.g. the cost of equipment; the cost of advertising, the cost of insurance, the cost of depreciation etc.). The term 'expense' on the other hand represents the using up of economic benefits.

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

Therefore, we should conclude that 'all costs become expenses'.

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

**LO3** Classify assets and claims

- 2.13** Distinguish between a 'legal entity' and an 'accounting entity' in relation to different business types.

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

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

## Discussion questions – Challenging

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

- (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

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

- liquidity
- asset mix
- financial structure (solvency).

(a) What do these terms mean?

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

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

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

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

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

## Application exercises – Easy

### AE2.1

#### **Solution:**

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

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

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

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

**AE2.2****Solution:**

(a)

Martin Russel Consulting	
Statement of Financial Position	
as at 15 November	
<b>ASSETS</b>	
Current assets	
Cash at bank	\$16,500
Accounts receivable	<u>5,000</u>
Total current assets	<u>\$21,500</u>
<b>TOTAL ASSETS</b>	<u><b>\$21,500</b></u>
<b>LIABILITIES</b>	
<b>TOTAL LIABILITIES</b>	\$ -
<b>EQUITY</b>	
Contributed capital	\$20,000
Plus profit	<u>1,500</u>
<b>TOTAL EQUITY</b>	<u><b>\$21,500</b></u>
<b>TOTAL LIABILITIES and EQUITY</b>	<u><b>\$21,500</b></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			
<b>ASSETS</b>		<b>TOTAL LIABILITIES</b>	
Current assets		EQUITY	
Cash at bank	\$19,500	Contributed capital	\$20,000
Accounts receivable	2,000	Plus profit	<u>1,500</u>
Total current assets	<u>21,500</u>		<u>\$21,500</u>
<b>TOTAL ASSETS</b>	<u><b>\$21,500</b></u>	<b>TOTAL EQUITY</b>	<u><b>\$21,500</b></u>

(cont'd...)



(c)

<b>Martin Russel Consulting</b>		
<b>Statement of Financial Position</b>		
<b>as at 30 November</b>		
<b>ASSETS</b>		
Current assets		
Cash at bank		\$39,500
Supplies		4,000
Accounts receivable		2,000
Total current assets		<u>\$45,500</u>
<b>TOTAL ASSETS</b>		<u><b>\$45,500</b></u>
<b>LIABILITIES</b>		
Current liabilities		
Accounts payable	\$4,000	
Non-current liabilities		
Bank loan	<u>\$20,000</u>	
<b>TOTAL LIABILITIES</b>		<b>\$24,000</b>
<b>EQUITY</b>		
Contributed capital		\$20,000
Plus profit		<u>1,500</u>
<b>TOTAL EQUITY</b>		<u><b>\$21,500</b></u>
<b>TOTAL LIABILITIES + EQUITY</b>		<u><b>\$45,500</b></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>
<b>TOTAL ASSETS</b>	<b><u>\$183,000</u></b>

**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>
<b>TOTAL LIABILITIES</b>	<b><u>\$69,500</u></b>

**EQUITY**

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

(cont'd...)

(e)

<b>Martin Russel Consulting</b> <b>Statement of Financial Position</b> <b>as at 31 January</b>			
<b>ASSETS</b>		<b>LIABILITIES</b>	
<b>Current assets</b>		<b>Current liabilities</b>	
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>	<b>Non-current liabilities</b>	
Total current assets	<u>\$134,000</u>	Bank loan	\$20,000
<b>Non-current assets</b>		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
		<b>EQUITY</b>	
		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>

**AE2.3****Solution:**

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

**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
1	Up		Up
2	Up	Up	
3	Up	Up	
4	Up		Up
5	Up/Down		
6	Down		Down
7	Down	Down	
8	Down		Down
9		Up	Down
10	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	<b>9,100</b>
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)	<b>(39,600)</b>	(41,500)	(51,200)
Opening capital	(20,700)	(29,200)	<b>(47,100)</b>	(26,700)
Profit or Loss	(19,600)	(17,900)	(37,400)	9,500
Drawings	<b>6,900</b>	8,700	11,700	7,200

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

#### AE2.6

**Solution:**

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

F	Materiality	Loose tools	Immediately expense the outlay on loose tools as the cost of capitalising and depreciating such assets is excessive, and will provide little useful information.
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**LO5** Identify the main factors that influence the content and values in a statement of financial position

#### AE2.7

#### **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

**AE2.8****Solution:**

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

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

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

**AE2.9****Solution:**

Opening equity		200,000
Plus		
Sales	250,000	
Less cost of sales	(100,000)	
Less expenses	<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

**AE2.10****Solution:**

<b>Statement of financial position as at Year-end</b>			
<b>Current assets</b>		<b>Current liabilities</b>	
Cash at bank	16,000	Payables	32,000
Receivables	42,000		
Inventories	80,000		
<b>Non-current assets</b>		<b>Long-term loan</b>	
Motor van	36,000		100,000
Equipment	126,000		
Fixtures and fittings	26,000		
Property	<u>150,000</u>	<b>Equity</b>	344,000
	<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>		

**L02** Explain the accounting equation, and use it to build up a statement of financial position at the end of a period

**AE 2.11**

**Solution:**

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

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

### AE2.12

#### **Solution:**

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

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

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

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

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

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

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

**AE2.13****Solution:**

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

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

**LO3** Classify assets and claims

**AE2.14****Solution:**

	Beginning	Transactions							Ending
Assets		1	2	3	4	5	6	7	
Cash	3,000		4,000	2,000	(7,000)	10,000	(6,000)	(2,000)	4,000
Accounts Receivable	5,000		(4,000)	6,000					7,000
Inventory	7,000	5,000		(6,000)					6,000
Freehold Premises	60,000								60,000
Furniture & Fittings	18,000						6,000		24,000
	<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

**AE2.15****Solution:**

(a)

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

	\$		\$
Bank	20,000	Capital	20,000

**Statement of financial position as at 2 March 2017**

	\$		\$
Bank	14,000	Capital	20,000
Fixtures and fittings	6,000	Accounts payable	8,000
Inventory	8,000		
	<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	8,000	Loan	5,000
	<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	27,000	Bank	8,200
	<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	29,000	Bank	11,700
	<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	29,000	Bank	10,700
	<u>43,000</u>		<u>43,000</u>

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

	\$	\$
<b>Current assets</b>		
Bank		
Inventory	<u>8,000</u>	8,000
<b>Non-current assets</b>		
Motor car	29,000	
Fixtures and fittings	<u>6,000</u>	
		<u>35,000</u>
		<u>43,000</u>
<b>Current liabilities</b>		
Bank	10,700	
Accounts payable	<u>8,000</u>	
		18,700
<b>Non-current liabilities</b>		
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

### AE2.16

#### **Solution:**

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

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

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

**LO3** Classify assets and claims

**AE2.17****Solution:****Statement of financial position**

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

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

**AE2.18****Solution:**

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

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

Deficiency (Errors or Omissions)	8,000
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**LO2** Explain the accounting equation, and use it to build up a statement of financial position at the end of a period

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

## AE2.19

### **Solution:**

Your report should consider the following relationships.

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

In your report you may raise the following:

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

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

## AE2.20

### **Solution:**

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

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

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



## Case Study

### Usefulness of the statement of financial position

#### **Solution:**

- 1 In broad terms this is true. However, there are a number of examples of assets which are not included, usually because of difficulties in measuring them, notably in the area of human assets or brands. Limitations include:
  - (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.