

26.2 Some exercises on the significance of balance sheet categories

1.

What, if anything would be the advantage gained by classifying current liabilities as non-current liabilities? (How would it affect the interpretation of the firm's balance sheet?)

Response

Falsely classifying current liabilities as non-current liabilities would make the relevant date of payment appear to be further into the future, and therefore less worrisome for the firm now. The balance sheet would appear to be stronger, and the firm would appear to be more creditworthy – more easily able to borrow or acquire goods or services on credit.

2.

What, if anything would be the advantage gained by classifying current assets as non-current assets?

Response

Because they pass quickly through the firm, current assets are not generally considered suitable as security for long-term loans. Falsely classifying current assets as non-current assets would therefore perhaps enable the firm to raise a long-term loan more easily or at a lower rate of interest.

3.

A firm has the option of borrowing to finance the purchase of a fixed asset, or leasing the fixed asset for a regular annual payment. What presentational difference would the choice make to the balance sheet?

Response

A firm which borrowed to purchase a fixed asset would have to show the asset in the balance sheet (as a non-current asset), and would have to show the liability to repay the loan as a liability in the balance sheet.

A firm which leased the fixed asset for a regular annual payment would be able to show only the annual lease payment as an expense in the P&L Account.

Note: it may be argued that in certain circumstances leasing an asset is *in effect* the same as borrowing to finance the purchase of the asset (as, for example, when the firm leasing the asset is not permitted to return the asset, and is contractually bound to keep making lease payments for a number of years, come what may). In such circumstances, accountants seem to be agreed that the firm leasing the asset *should* in any case show both the asset and the liability to make lease payments in its balance sheet.

4.

State, giving your reasons, how you would finance each of the following (use cash savings, overdraft, short-term loan, long-term loan):

- a) to purchase a stock of goods for immediate resale
- b) to pay for a holiday
- c) to buy a house
- d) to pay for professional training

Response

- a) to purchase a stock of goods for immediate resale**, most firms would favour using cash savings or an overdraft. An overdraft could be repaid as and when the goods were sold – unlike a short-term loan, for which repayment might fall due before the stock was sold, and which might involve penalty clauses for early repayment. It is unlikely in any case that a lender would offer a long-term loan for this purpose.
- b) to pay for a holiday**, a prudent individual would use cash savings. It is rash to incur any avoidable liabilities solely to pay for current consumption.
- c) to buy a house**, most people would favour using a long-term loan. A house is generally an expensive asset which cannot be paid for out of cash savings, and which entails borrowing a sum that cannot quickly be repaid. In addition, a house is a long-lived asset which would deliver benefits over the long term, to match the obligation to make payments under the loan agreement.
- d) to pay for professional training**: in principle, professional training may confer long-term benefits in the form of increased earnings, and therefore could be financed by a long-term loan, like a house. However, it is unlikely that any lender would agree to make a very long-term loan for this purpose, and most professional training is in fact probably financed by short-term loans, or by the cash savings of related parties (parents, etc.).