CHAPTER 2

MEASURING AND REPORTING FINANCIAL POSITION

LEARNING OBJECTIVES

When you have completed your study of this chapter, you should be able to:

LO 1 Explain the nature and purpose of the statement of financial position (balance sheet) and its component parts

LO 2 Explain the accounting equation, and use it to build up a statement of financial position at the end of a period

LO 3 Classify assets and claims

LO 4 Apply the different possible formats for the statement of financial position

LO 5 Identify the main factors that influence the content and values in a statement of financial position

LO 6 Explain the main ways in which the statement of financial position can be useful for users of accounting information

LO 7 Identify the main deficiencies or limitations in the statement of financial position.

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THE NEXT FIVE CHAPTERS ESSENTIALLY DEAL with the area known as financial accounting. In this chapter we examine the first of the major financial reports—that which is concerned with establishing financial position. The statement of financial position, traditionally labelled the 'balance sheet', represents the assets of an entity and the claims against those assets at a given point in time. The interests in, or claims against, the assets are divided into external (liability) and internal (owners') interests. We will see how the statement is made up and how the report is prepared. We will also consider the basis on which accounts are included, measured and reported. Finally, its usefulness in decision-making will be considered and possible deficiencies highlighted.

In order to enable us to focus primarily on the nature of the accounting process in this chapter and in Chapter 3, we will concentrate on relatively simple business structures, mainly sole proprietorships and partnerships, although the same principles apply to limited companies. However, given the size, complexity and range of regulatory issues that confront larger companies, we have deliberately left detailed company accounting to Chapters 4 and 5.

NATURE AND PURPOSE OF THE STATEMENT OF FINANCIAL POSITION

LO 1

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

The purpose of the statement of financial position is to set out the financial position of a business at a particular point in time. It is also referred to as a 'balance sheet'. Both terms have been used in recent years. However, the current recommendation is that the term 'statement of financial position' be used. This statement represents a summary of information provided in the accounts, and is effectively a listing of the balances in all of the detailed accounts—this is where the term 'balance sheet' comes from. The statement of financial position sets out the assets of the business on the one hand, and the claims against it on the other. Before looking at the statement in more detail, we need to be clear what these terms mean.

Assets

asset
A present economic resource controlled by the entity as a result of past events.

An **asset**, for accounting purposes, is essentially a resource controlled by the entity as a result of past events. To qualify as an asset for inclusion in the statement of financial position, however, a resource must possess the following characteristics:

- ***It must be a present economic resource.*** This type of resource confers a right that gives the potential to receive economic benefits in the future. The right is usually acquired through legal ownership or through a contractual agreement (e.g. leasing equipment). This right must entitle the business to receive economic benefits that are not equally available to others. To illustrate this point let us consider the right to use what economists refer to as 'public goods', such as the road system, GPS satellites or official statistics. Although these resources may provide economic benefits to the business, others can receive the same benefits at no greater cost. The right to benefit from public goods is not, therefore, an economic resource of the business.

  Potential benefits flowing from an economic resource can take various forms depending on how the resource is used. Examples include: cash generated by using the resource to produce goods or services; cash received from the proceeds of its sale; the value received when it is exchanged for another economic resource; the value received when it is used to satisfy debts incurred by the business; or cash generated from renting or leasing it.

  Note that an economic resource need only have the potential to generate benefits. These benefits need not be certain or even likely. Where, however, there is a very low probability that economic benefits will flow, the information is unlikely to be relevant to users. The resource may not, therefore, be included as an asset in the statement of financial position. Thus, an obsolete piece of equipment that can be sold for scrap would still be considered an asset, whereas an obsolete piece of equipment that could not be sold for scrap would not be regarded as an asset.
- ***The economic resource must be under the control of the business.*** The business must have the right to decide how the resource will be used and be entitled to any benefits that flow. Again, control is usually acquired through legal ownership or through contractual agreement (e.g. leasing equipment).
- ***The transaction, or other event, establishing control must have occurred in the past.*** This means that the business will already exercise control over the resource. Thus, if a business agrees to purchase a piece of machinery at some future date, this does not make the item one of its assets at this point in time.
- ***The economic resource must be capable of measurement in monetary terms.*** Unless the resource can be measured in monetary terms with a reasonable degree of certainty, it will not be recognised as an asset on the statement of financial position. For example, customer loyalty may be valuable to the business but impossible to quantify. Similarly, the title of a magazine (e.g. *New Idea* or *Wheels*) that was created by its publisher. While it may be extremely valuable

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to the publishing business, its value cannot be measured with reasonable certainty. It will not, therefore, appear as an asset in the statement of financial position. This is because any valuation produced is likely to have little relevance to user needs.

Note that all of the characteristics identified must exist if a resource is to qualify for recognition. This will strictly limit the resources that are regarded as an asset for inclusion in the statement of financial position. Once included, an asset will continue to be recognised until the economic benefits are exhausted or the business disposes of it.

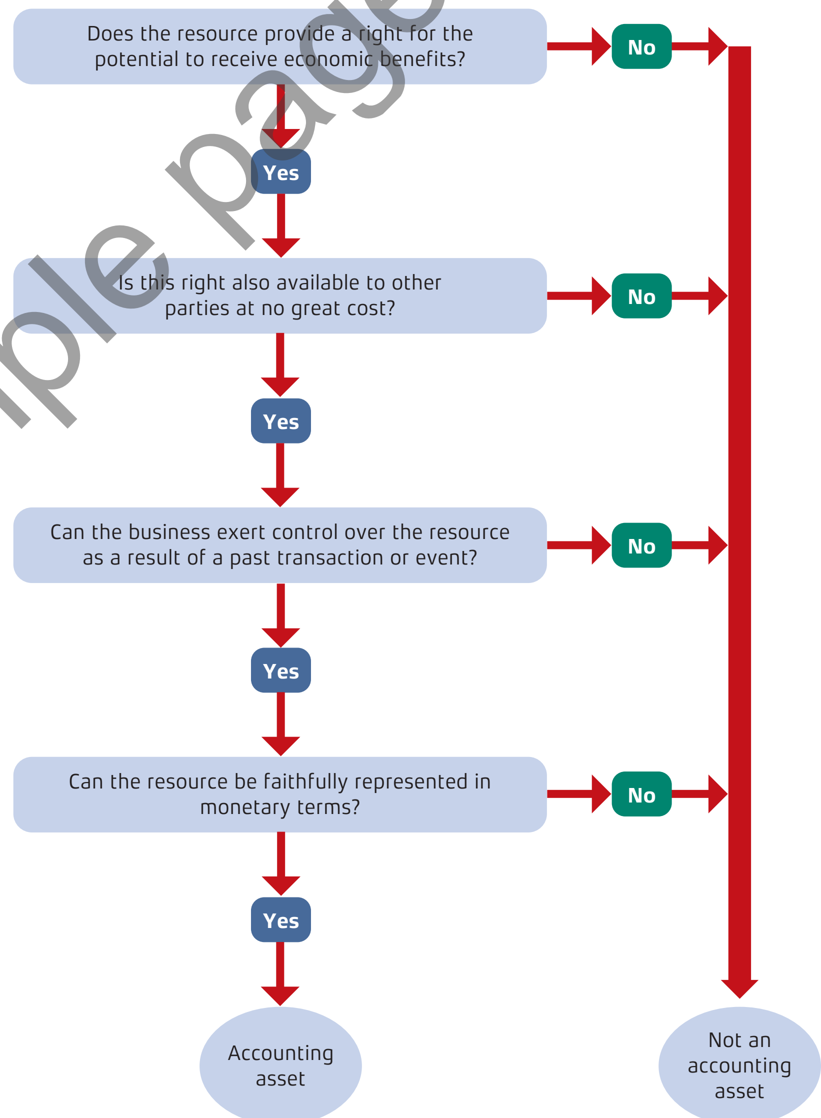
Figure 2.1 summarises the above discussion in the form of a decision chart.

We can see that these conditions will strictly limit the kind of items that may be referred to as 'assets' in the statement of financial position. Certainly not all resources exploited by a business will be assets of the business for accounting purposes. Some, like the roads system or the magazine title *Wheels*, may well be assets in a broader sense, but not for accounting purposes. Once an asset has been acquired by a business, it will continue to be considered an asset until the benefits are exhausted or the business disposes of it in some way.

FIGURE 2.1

Decision chart for identifying an accounting asset

An item must possess each of the characteristics identified to be regarded as an asset that should appear on a conventional statement of financial position.



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tangible assets
Those assets that have a physical substance (e.g. plant and machinery, motor vehicles).

intangible assets
Assets that, while providing exapected future benefits, have no physical substance (e.g. copyrights, patents).

claim
An obligation on the part of the business to provide cash or some other economic resource to an outside party.

liabilities
A present obligation to transfer an economic resource as a result of past events.

owners' equity
The residual interest in the assets of the entity after deducting all its liabilities.

equity/capital
The share of the business that represents the owners' interests.

provisions
An estimated liability for which there is greater uncertainty regarding the amount or the timing of the amount than for a normal liability.

contingent liability
A potential liability that might arise by the occurrence of one or more uncertain future events. It will become a liability contingent on that event happening.

Examples of items that often appear as assets in a business statement of financial position include: freehold premises; machinery and equipment; fixtures and fittings; patents and trademarks; accounts receivable; investments; cash; and inventories.

Note that an asset does not have to be a physical item—it may also be a non-physical right to certain benefits. Assets that have a real, physical substance are referred to as **tangible assets** (e.g. inventory, plant and equipment). Assets that have no physical substance but still represent potential benefits are referred to as **intangible assets** (e.g. copyright, trademark, patent, franchise, goodwill). Leases now need to be shown as an asset, other than for short-term operating leases, with a corresponding liability being shown.

Claims against the assets

The other side of the statement of financial position includes any **claim** against the assets of an entity, or simply the different interests in those assets. There are essentially two types of claims: external claims, known as **liabilities**; and internal, or ownership, claims, labelled equity, **owners' equity** or **capital**.

Liabilities

Liabilities represent the claims of individuals and organisations, apart from those of the owner(s). They involve a present obligation to transfer economic resources (usually cash) as a result of past transactions or events. Liabilities normally arise when individuals, or organisations, supply goods and services, or lend money, to the business. Examples include accounts payable (creditors), bank overdrafts, personal loans, mortgages and provisions (estimates) for warranty, long-service leave, holiday pay and taxation. In order to be recognised as a liability, the same kinds of recognition criteria that apply to assets also apply, which means it must meet the definition and result in relevant and faithfully represented information.

Most liabilities represent legal claims by external parties against the entity for satisfaction in cash (e.g. bills or accounts payable) or for the provision of goods and services (e.g. subscriptions received in advance). Another type of liability is generally classified as provisions. **Provisions** are estimated liabilities, for which there is rather less certainty regarding the amount or timing. Provisions typically include income tax, long-service leave, warranties, etc.

In certain instances, the situation arises in which a potential liability exists that might arise on the occurrence of a particular event. This is known as a **contingent liability**. It will become a liability contingent on that event happening. This situation does not satisfy the definition of a liability, so will not be included in the statement of financial position. For limited companies, such contingent liabilities will normally be included in the annual report as a note.

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ACTIVITY 2.1

Indicate which of the following items could appear as an asset or a liability on the statement of financial position of business A. Explain your reasoning in each case.

(a) $1,000 owing to business A by a customer who will never be able to pay.
(b) The purchase of a licence from business B giving business A the right to produce a product designed by business B. Production of this new product is expected to increase profits over the period in which business A holds the licence.
(c) The hiring by business A of a new marketing director who is confidently expected to increase profits by at least 30% over the next three years.
(d) The purchase by business A of a machine that will save $10,000 per annum. It is currently being used by business A, but it has been acquired on credit and is not yet paid for.
(e) $2,000 owing to business B for the satisfactory supply of goods during the past month.
(f) Magazine subscriptions worth $27,400 have been received in advance by business A.
(g) Business A has guaranteed a manager's personal loan of $100,000. The manager has maintained the account in good order and $79,000 is currently owing.
(h) There is a legal claim against business A for negligence over faulty workmanship. It is likely that they will settle out of court for $50,000.

Owners' equity (OE, or simply 'equity')

This represents 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 of its liabilities'. Some find it hard to understand how the owner can make a claim against the business, particularly when we consider a sole proprietor-type business like Paul's from Chapter 1, where the owner is, in effect, the business. However, for accounting purposes, a clear distinction is made between the business (whatever its size) and the owner(s). The business is viewed as being quite separate from the owner, irrespective of whether the business has a separate legal identity or not. This means that when financial reports are prepared, they are prepared for the business rather than the owner(s). From this perspective, therefore, any funds the owner contributes to help finance the business are regarded as a claim against the business in its statement of financial position.

The equity section of the statement of financial position is broadly the same irrespective of the type of business concerned. We shall see in Chapter 4 that with limited companies the total equity figure must be analysed according to how each part of it first arose. For example, companies must make a distinction between the part of it that arose from retained earnings (or profits) and the part that arose from the owners putting in cash to start up the business, usually by buying shares in the company.

Once a claim from the owners or outsiders has been incurred by a business, it will remain as an obligation until it is settled.

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CONCEPT CHECK 1

The statement of financial position:

- **A** Is prepared at a particular point in time
- **B** Is also referred to as a balanced sheet
- **C** Consists of assets, reliabilities and equity
- **D** All of the above are true
- **E** None of the above is true.

CONCEPT CHECK 2

Which of the following is a main characteristic of an asset?

- **A** Confirmed future economic benefit
- **B** Exists from a future transaction or event
- **C** The business has an exclusive right to control the economic resource
- **D** Cannot be reliably measured in monetary terms
- **E** All of the above are key asset characteristics.

CONCEPT CHECK 3

A potential liability exists that might arise on the occurrence of a particular event is known as:

- **A** A provision
- **B** A creditor
- **C** A contingent liability
- **D** A debt
- **E** All of the above.

LO 2

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

THE ACCOUNTING EQUATION

Now that the meanings of the terms 'assets', 'liabilities' and 'owners' equity' have been established, we can go on to discuss the relationship between them. It is quite simple and straightforward: if a business wishes to acquire assets it will have to raise the necessary funds from somewhere. It may raise the funds from the owner(s) or from other outside parties, or from both. The relationship is demonstrated by the new business outlined in Example 2.1.

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EXAMPLE 2.1

Jerry and Co. deposits $20,000 in a bank account on 1 March to commence business. Let us assume that the cash of (i) $6,000 is supplied by the owner, and (ii) $14,000 is supplied by the bank, an outside party. The effect of this transaction is to increase the assets on the left-hand side of the accounting equation, specifically cash at bank by $20,000. Raising the funds (capital) this way will give rise to a claim on the business by both (i) the owner (capital), and (ii) the bank, an outside party (liability) of $14,000. There is an equal increase of $20,000 on the right-hand side of the accounting equation. The equation relates only to the business entity. Jerry and Co.'s owners' personal assets and debts are not part of the business, and therefore are excluded from the equation because of the business entity equation.

If a statement of financial position of Jerry and Co. is prepared following the above transactions, the assets and claims of the business will appear as follows:

JERRY AND CO.
Statement of financial position
as at 1 March

Assets	$	Claims	$
Cash at bank	20,000	Owners' equity	6,000
		Liability—loan	14,000
Total assets	20,000	Total liabilities and owners' equity	20,000

We have chosen a two-sided, traditional-style statement for our example. This is primarily because this links easily with the formal recording process, which will be outlined in Accounting and You, later in the chapter (page 57). At a later stage, we will discuss other formats that are in more common use for published reports.

We can see from the statement that has been prepared that the total claims are the same as the total assets. Thus:

$$\text{Assets} = \text{Owners' equity} + \text{Liabilities}$$

The equation shown above—often referred to as the 'accounting equation'—will always hold true. Whatever changes may occur to the business's assets or the claims against it, compensating changes elsewhere will ensure that the statement of financial position always 'balances' (i.e. both sides agree).

For example, consider some further possible transactions for Jerry and Co. Assume that, after the $20,000 had been deposited in the bank, the following transactions took place:

2 March	Purchased a motor vehicle for $5,000 paying by cheque.
3 March	Purchased inventory (stock-in-trade, goods to be sold) on one month's credit for $3,000. (This means that the inventories were bought on 3 March, but payment will not be made until 3 April.)
4 March	Repaid $2,000 of the loan from the outside party.
6 March	Owner introduced another $4,000 into the business bank account.

A statement of financial position may be drawn up after each day in which transactions have taken place. In this way, the effect of each transaction on the assets and the claims against them can be seen. The statement of financial position as at 2 March will be as follows:

JERRY AND CO.
Statement of financial position
as at 2 March

Assets	$	Claims	$
Cash at bank (20,000 – 5,000)	15,000	Owners' equity	6,000
Motor vehicle	5,000	Liabilities—loan	14,000
Total assets	20,000	Total liabilities and owners' equity	20,000

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As you can see, the effect of purchasing a motor vehicle is to decrease the balance at the bank by $5,000 and to introduce a new asset—a motor vehicle—onto the statement. The motor vehicle is recorded initially at its cost of $5,000. The total assets of $20,000 are still equal to the liabilities of $14,000 plus equity of $6,000. The total assets remain unchanged; only the 'mix' of assets has changed. The claims against the business remain the same, as there has been no change in the funding arrangements for the business.

The statement of financial position as at 3 March, following the purchase of inventory, will be as follows:

JERRY AND CO.
Statement of financial position
as at 3 March

Assets	$	Claims	$
Cash at bank	15,000	Owners' equity	6,000
Motor vehicle	5,000	Liabilities—loan	14,000
Inventory	3,000	Liabilities—accounts payable	3,000
Total assets	23,000	Total liabilities and owners' equity	23,000

The effect of purchasing inventory has been to introduce another new asset (inventory) to the statement of financial position. In addition, the fact that the goods have not yet been paid for means that the claims against the business have been increased by the $3,000 owed to the supplier, which is referred to as 'accounts payable' on the statement of financial position. Accounts payable is also known as 'payables' or 'creditors'. Jerry and Co.'s equity in the business remains unchanged at $6,000, because the assets and liabilities increased by equal amounts of $3,000 with the purchase of inventory. The accounting equation is still in balance, with $23,000 in total assets and $23,000 of liabilities and equity.

ACTIVITY 2.2

Try drawing up a statement of financial position for Jerry and Co. as at 4 March and as at 6 March.

Example 2.1 illustrates the point made earlier that the accounting equation (owners' equity + liabilities = assets) will always hold true because the equation is based on the fact that if a business wishes to acquire assets it must raise funds equal to the cost of those assets. These funds must be provided by the owners (owners' equity) or other outside parties (liabilities), or both. Hence, the total cost of assets acquired should always equal the total owners' equity (capital) plus liabilities.

It is worth pointing out that a business would not draw up a statement of financial position after each day of transactions, as shown in Example 2.1. Such an approach is likely to be impractical given even a relatively small number of transactions each day. A statement of financial position for a business is usually prepared at the end of a defined reporting period. Determining the length of the reporting period involves weighing up the costs of producing the information against its perceived benefits for decision-making purposes. In practice, the reporting period varies between businesses, and could be monthly, quarterly, half-yearly or annually. For external reporting purposes, an annual reporting cycle is the norm (although certain large companies report more frequently than this). However, for internal reporting purposes, many businesses produce monthly financial reports.

The effect of trading operations on the statement of financial position

In Example 2.1, we dealt with the effect on the statement of financial position of a number of different types of transactions that a business might undertake. These transactions covered the purchase of assets for cash and on credit, the repayment of a loan, and the injection of owners' equity. However, one form of transaction—namely, trading (an asset is sold for a price that is different from the cost to acquire or manufacture that asset)—has not yet been considered. To deal with the effect of trading transactions on the statement of financial position, let us return to Example 2.1.

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EXAMPLE 2.1 *CONTINUED*

We will use the statement of financial position drawn up for Jerry and Co. as at 6 March in the solution to Activity 2.2 (page 53). The statement of financial position was as follows:

JERRY AND CO.
Statement of financial position
as at 6 March

Assets	$	Claims	$
Cash at bank	17,000	Owners' equity	10,000
Motor vehicle	5,000	Liabilities—loan	12,000
Inventory	3,000	Liabilities—accounts payable	3,000
Total assets	25,000	Total liabilities and owners' equity	25,000

Let us assume that, on 7 March, the business managed to sell all of its inventory for $5,000 and received a cheque immediately from the customer for this amount. The statement of financial position on 7 March, after this transaction has taken place, will be as follows:

JERRY AND CO.
Statement of financial position
as at 7 March

Assets	$	Claims	$
Cash at bank (17,000 + 5,000)	22,000	Owners' equity	12,000
Motor vehicles	5,000	[10,000 + (5,000 − 3,000)]	
Inventory (3,000 − 3,000)	–	Liabilities—loan	12,000
		Liabilities—accounts payable	3,000
Total assets	27,000	Total liabilities and owners' equity	27,000

We can see that the inventory of $3,000 has now disappeared from the statement of financial position, but the cash at bank has increased by the selling price of the inventory, that is $5,000. The net effect has, therefore, been to increase assets by $2,000 (i.e. $5,000 – $3,000). This increase represents the net increase in wealth (profit) which has arisen from trading. Also note that the owners' equity in the business has increased by $2,000 in line with the increase in assets. This increase in owners' equity reflects the fact that increases in wealth as a result of trading or other operations will be to the benefit of the owner and will increase his or her stake in the business.

It is appropriate to consider just what the effect would have been on the statement of financial position if the inventory had been sold on 7 March for $1,000 rather than $5,000. The statement of financial position on 7 March would be as follows:

JERRY AND CO.
Statement of financial position
as at 7 March

Assets	$	Claims	$
Cash at bank	18,000	Owners' equity [10,000 + (1,000 – 3,000)]	8,000
Motor vehicle	5,000	Liabilities—loan	12,000
		Liabilities—accounts payable	3,000
Total assets	23,000	Total liabilities and owners' equity	23,000

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As we can see, the inventory of $3,000 will disappear from the statement of financial position, but the cash at bank will rise by only $1,000. This will mean a net reduction in assets of $2,000. This reduction will be reflected in a reduction in the equity of the owner(s).

We can see that any decrease in wealth (loss) arising from trading or other transactions will lead to a reduction in the owners' stake in the business. If the business wished to maintain the level of assets as at 6 March, it would have to obtain further funds from the owner(s) or outside parties, or both.

What we have just seen means that—assuming that the owner(s) makes no injections or withdrawals of equity during the period—the accounting equation can be extended as follows:

Assets at the end of the period = Owners' equity at the beginning +
Profit (or – Loss) + Liabilities at the end of the period

Any funds introduced by the owner(s), or withdrawn by the owner(s) for living expenses or other reasons, will further extend the accounting equation as follows:

Assets at the end of the period = Owners' equity at the beginning +
Profit (or – Loss) ± Other owners' equity changes + Liabilities at the end of the period

These additions and withdrawals are typically shown separately on the statement of financial position, as is the profit figure for the period. Thus, if we assume that the above business sold the

inventory for $5,000, as in the earlier example, and further assume that the owner withdrew $1,500 of the profit, the owners' equity would appear as follows on the statement of financial position:

Owners' equity	$
Opening balance	10,000
Add profit	2,000
	12,000
Less drawings	1,500
Closing balance	10,500

Jerry and Co.'s closing equity balance is $10,500, consisting of the $10,000 the owner invested to start the business plus $2,000 profit, representing the excess of income of $5,000 over expenses of $3,000 for the period, less the $1,500 drawings. If the drawings were in cash, then the balance of cash would decrease by $1,500 in the statement of financial position.

It is highly unlikely that a statement of financial position will be required on a daily basis, but rather at the end of a specified period, typically at the end of a month or a year. The same approach could theoretically be used to build up a statement of financial position at the end of a period. Self-assessment Question 2.1 requires you to try to do this.

An alternative to the system of pluses and minuses is a worksheet approach. Table 2.1 provides an illustration of how a worksheet can achieve the same result. It uses the content of Example 2.1. It should be noted that the drawings figure is effectively a negative figure in the owners' equity section of the statement of financial position.

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SELF-ASSESSMENT QUESTION 2.1

The statement of financial position of a business at the start of a week is as follows:

STATEMENT OF FINANCIAL POSITION
as at 7 February 2020

Assets	$	Claims	$
Accounts receivable	33,000	Accounts payable	23,000
Inventory	28,000	Bank overdraft	43,000
Furniture and fittings	63,000	Capital (Equity)	203,000
Freehold premises	145,000		
	269,000		269,000

During the next week the following transactions took place:

1. Sold inventory for $11,000 cash. This inventory had cost $8,000.
2. Sold inventory for $23,000 on credit. This inventory had cost $17,000.
3. Received cash from accounts receivable totalling $18,000.
4. The owners of the business contributed $100,000 of their own money, which was placed in a business bank account.
5. The owners contributed a second-hand motor vehicle at the start of the business, valued at $10,000 to be used in the business. **No cash** is involved in this transaction.
6. Bought inventory on credit for $14,000.
7. Paid accounts payable of $13,000.
8. Paid wages of $2,000.

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

TABLE 2.1 Accounting equation and effects of transactions using a worksheet

	Assets		=	Liabilities	+	Owners' equity		
	Cash	Inventory	Motor vehicle	Accounts payable	Loan	Owners' contribution	Retained profit	Drawings
1 March	20,000				14,000	6,000		
2 March	−5,000		+5,000					
3 March		+3,000		+3,000				
4 March	−2,000				−2,000			
6 March	+4,000					+4,000		
7 March	+5,000	−3,000					+2,000	
and	−1,500		–					+1,500
	20,500	–	5,000	3,000	12,000	10,000*	2,000*	1,500*

*Owners' equity account balance $10,500 (i.e. 10,000 + 2,000 − 1,500).

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ACCOUNTING AND YOU

DOUBLE-ENTRY BOOK-KEEPING

In Chapter 1 we indicated that in this book we will not be focusing on the collection of accounting information or the actual preparation of financial reports. We have, for purposes of illustration and understanding, explained the nature of the accounting equation by use of a system of pluses and minuses. In practice, accounting systems are based on a system of recording known as double-entry book-keeping. Most systems are now computerised, but are essentially still based on double-entry book-keeping principles.

With double-entry book-keeping every item that requires recording is effectively done via a system of individual accounts. Every item in the statement of financial position has its own account, in which entries are made.

Historically, these accounts were typically held in a book known as a 'ledger'; hence, the commonly used reference to 'ledger accounts'. The form of a ledger account is essentially T-shaped; hence, the alternative name of 'T accounts'. An example is set out below. This represents the recording in the cash account of Jerry and Co. up to 4 March.

Debit side		Name of account (Cash)			Credit side
Date	**Detail**	**Amount ($)**	**Date**	**Detail**	**Amount ($)**
1 March	Equity/capital	6,000	2 March	Vehicle	5,000
1 March	Loan	14,000	4 March	Loan	2,000
			4 March	Balance c/f	13,000
		20,000			20,000
4 March	Balance b/f	13,000			

Basically, for assets, entries made on the debit side increase the amount in an asset account, while a credit represents a reduction in the particular asset account. The date enables events to be tracked. The detail represents the other account that needs to be entered, given the dual aspect convention.

For liability accounts, the increases are recorded on the credit side and the decreases on the debit side. When it comes to ledger accounts, this leads to the dual-aspect convention becoming 'for every debit there must be a credit'; hence, double-entry book-keeping. This means that the double entry to the first debit entry in the cash account for 1 March would be a credit to an account set up to keep track of the owners' equity, shown as follows.

Debit side		Equity/Capital account			Credit side
Date	Detail	Amount ($)	Date	Detail	Amount ($)
			1 March	Cash	6,000

Periodically, and certainly when a statement of financial position is needed, it will be necessary to summarise the position of every account, which leads to a balancing of individual accounts. This is shown in the 'Cash' account used above. Note that 'c/f' stands for 'carried forward', and 'b/f' stands for 'brought forward'. All that has happened in this case is that the two sides have been totalled (clearly $20,000 on the debit side and $7,000 on the credit side), which means that there is $13,000 left.

This approach means that during a period all changes in the assets, liabilities and equities are recorded, and at the end of the period balanced, which should leave the balance sheet equation in balance.

At this stage, the important point for you to recognise is that the statement of financial position is simply a summary of the account balances that are maintained in the individual ledger accounts; hence, the title of 'balance sheet', which is the traditional title for the statement of financial position.

So why might it be useful for you to know this? Several reasons spring to mind.

- Many experienced business people still use (or refer to) the traditional terminology. Knowing the double-entry system will enable you to have a more productive dialogue with your accountant or chief financial officer.
- There are examples where figures are represented using debits and credits (e.g. bank statements). For example, you may find a credit balance on your bank account. What does this mean? It seems to be contrary to what is said above. In fact, the bank statement sent to the customer is prepared from the bank's viewpoint. If you have cash in the bank, the bank would show this as a liability (credit) in its accounts. In the customer's own ledger accounts, cash in hand would be shown as a debit.
- In practice, of course, manual ledger systems are rare, with most systems using computerised systems such as MYOB. Many of these still use traditional terminology, and a broad understanding of the systems might be useful. For example, many computer systems still refer to the 'sales ledger' or 'debtors ledger', which is simply the place where detailed individual records relating to customers are kept.

The situation gets a bit more complicated when we consider the income statement, but the principles remain valid.

Sample pages

CONCEPT CHECK 4

Which of the following statements is false?

- **A** Debits and credits are the accountant's method of pluses and minuses.
- **B** A debit to an asset account is an increase to the account.
- **C** A credit to a liability account will increase the account balance.
- **D** A debit to an equity account will increase the account balance.
- **E** None of the above. All are true.

CONCEPT CHECK 5

Which of the following is NOT a possible representation of the accounting equation?

- **A** Owners' equity + Liabilities = Assets
- **B** Assets = Liabilities + Owners' equity

C Assets – Liabilities = Owners' equity

D Assets – Owners' equity = Liabilities

E All of the above are valid representations of the accounting equation.

REFLECTION 2.1

Your friend Lucas, a young entrepreneur, heard you were enrolled into an accounting course. He has some questions about what value the balance sheet has. He is a bit of a gourmet chef, and has plans to open a high-class restaurant. He has managed to lease premises and bought the necessary equipment, funded by a loan from his parents. He plans to do most of the cooking, but is recruiting a small team of employees, all of whom are to be paid a wage. He is trying to think through just what kind of business transactions he needs to plan for. He has asked you for your thoughts on just what these transactions might be. (He is worried about forgetting something and the impact that this might have on the success of the business.) He is particularly concerned about just what his balance sheet might look like after the first six months.

Provide him with some guidance.

Sample pages

THE CLASSIFICATION OF ASSETS AND CLAIMS

The classification of assets

LO 3
Classify assets and claims

To help users of financial information easily locate items of interest on the statement of financial position, it is customary to group assets, liabilities and equities into categories. This is designed to help users, as a haphazard listing of those items could be confusing. Assets are normally categorised as either current or non-current. The distinction between current and non-current assets is as follows.

Current assets are basically assets that are held for the short term. They include cash and other assets that are expected to be consumed or converted to cash, usually within the next 12 months or within the **operating cycle**.

current assets
Assets that are not held on a continuing basis. They include cash and other assets which are expected to be consumed or converted to cash, usually within the next 12 months or within the operating cycle.

operating cycle
Normally represents the time between the acquisition of the assets and their ultimate realisation in cash or cash equivalents.

To be more precise, current assets are assets that meet any of the following conditions:

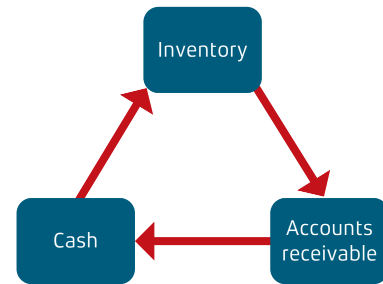
- they are held for sale or consumption during the business's normal operating cycle
- they are expected to be sold within a year after the date of the relevant statement of financial position
- they are held principally for trading, and/or
- they are cash, or near-cash (such as easily marketable, short-term investments).

The operating cycle normally represents the time between the acquisition of the assets (e.g. raw materials or finished goods) and their ultimate realisation in cash or cash equivalents. Current assets are normally held as part of the day-to-day trading activities of the business. The most common current assets are inventory (stock), accounts receivable (trade debtors), prepayments and cash itself: these are all interrelated and circulate in a business, as shown in Figure 2.2. It is worth making the point here that most sales made by most businesses are made on credit. This is to say that the goods pass, or the service is rendered, to the customer at one point but the customer pays later. Retail sales are the only significant exception to this general practice. We can see that cash can be used to purchase inventory, which is then sold on credit. When the customers pay, the business receives an

FIGURE 2.2

The circulating nature of current assets

Inventories may be sold on credit to customers. When the customers pay, the accounts receivable will be converted into cash, which can then be used to purchase more inventories, and so the cycle begins again.



injection of cash. For purely service businesses, the situation is similar, except that inventories are not involved.

non-current assets Assets held with the intention of being used to generate wealth rather than being held for resale. They can be seen as the tools of the business, and are normally held by the business on a continuing basis.

Non-current assets (also known as 'fixed assets') are simply assets that do not meet the definition of current assets. They tend to be held for long-term operations, so they are typically held for generating wealth rather than resale (although they may be sold when the business has no further use for them). They can be seen as the tools of the business. Non-current assets may be either tangible or intangible. Tangible non-current assets are normally categorised under a heading of 'property, plant and equipment'. This rather broad term includes items such as land and buildings, motor vehicles, and fixtures and fittings.

Intangible assets are of increasing importance in today's business environment. The role of data and information, the importance of staff and associated teams, the use of technology in an effective way, and intellectual property all have the potential to impact seriously on the success of a business. It is clear that while commerce has typically attached value to physical assets, and intangibles can be difficult to identify and measure, intangible assets are of major (and growing) importance to businesses. Real World 2.1 provides some discussion of recent articles on this.

The distinction between assets that are continuously circulating within the business (current) and assets used for long-term operations (non-current) may be helpful when trying to assess the

Sample pages

REAL WORLD 2.1

Glittering intangibles

Included under the umbrella of intangibles are 'software code, data, trade secrets, branding, domain names, and ... the skills and knowledge of the workforce'. The empires of Google and Facebook are created 'from and with data', not by generating actual content. Uber owns no vehicles, Alibaba doesn't actually hold stock, and Airbnb has no real estate. 'Not every business asset has to be tangible. Entire business models can be created from and operate through intangibles.'

Source: *Yohan Ramasundra, 'How you tap intangible assets may decide your future growth'*, The Australian Business Review, *13 February 2018.*

'Today the most valuable assets are more likely to be stored in the cloud than in a warehouse.' There has been a shift in Western economies 'from making things to providing information and services'. While hard to define, it has been estimated that intangibles 'accounted for 84% of the value of S & P 500 firms'.

Source: *The Economist, 'Insurers struggle to come to grips with intangible assets'*, The Australian, *27 August 2018.*

CLASS DISCUSSION POINTS

1. Why do you think that shares of companies such as Apple and Microsoft have high values relative to the figures shown in their balance sheets for tangible assets?
2. Explain what you think is meant by the statement 'today the most valuable assets are more likely to be stored in the cloud than in a warehouse'.

appropriateness of the mix of assets held. Most businesses will need a certain amount of both types of asset to operate effectively.

It is important to appreciate that the classification of an asset may vary (i.e. between current and non-current) according to the nature of the business being carried out. This is because the purpose for which a particular type of business holds a certain asset may vary. For example, a motor-vehicle manufacturer normally holds its motor vehicles for resale, and would therefore classify them as inventory. On the other hand, a business that uses motor vehicles for transport would classify them as non-current assets.

Assets should be classified as non-current when they do not satisfy any of the criteria for being classified as current.

The accounting standard relating to the presentation of financial statements also permits assets to be classified using the order of liquidity (i.e. the ability to turn the asset into cash), where appropriate. The vast majority of businesses use the current/non-current basis.

ACTIVITY 2.3

(a) The assets of Kunalun and Co., a large metalworking business, are shown below. Classify each of the following accounts as either (i) current or (ii) non-current assets for the preparation of a statement of financial position.

cash at bank	**fixtures and fittings**	**plant and machinery**
motor vehicles	**freehold factory premises**	
computer equipment	**stock of work-in-progress (i.e. partly completed goods)**	
short-term investments	**office equipment**	

(b) Can you identify which sort of businesses may prefer to use the liquidity basis rather than the current/non-current basis for classifying assets?

Sample pages

Classifying claims

As we have already seen, claims are normally classified into equity (owners' claim) and liabilities (claims of outsiders). Liabilities are further classified as either current or non-current.

Current liabilities are basically amounts due for settlement in the short term. To be more precise, they are liabilities that meet any of the following conditions:

current liabilities Amounts due for repayment to outside parties within 12 months of the statement of financial position date, or within the operating cycle.

- they are expected to be settled within the business's normal operating cycle
- they exist principally as a result of trading
- they are due to be settled within a year after the date of the relevant statement of financial position, and/or
- there is no right to defer settlement beyond a year after the date of the relevant statement of financial position.

Non-current liabilities represent amounts due that do not meet the definition of current liabilities and so represent longer-term liabilities.

non-current liabilities Those amounts due to other parties which are not liable for repayment within the next 12 months after the statement of financial position date.

Examples of current and non-current liabilities include:

Current	**Non-current**
Accounts payable	Mortgage loan
Bank overdraft	Long-term loans
Bank loan (repayable within 12 months)	
Revenue received in advance (e.g. subscriptions)	

Unlike the case for assets, the purpose for which the liabilities are held is not an issue—only the period for which the liability is outstanding is important. Thus, a long-term liability will turn into a current liability when the settlement date comes within 12 months or one operating cycle of the statement of financial position date. For example, borrowings to be repaid 18 months after the date

of a particular statement of financial position will appear as a non-current liability, but will appear as a current liability in the statement of financial position in the following year.

This classification of liabilities between current and non-current helps to highlight those financial obligations that must shortly be met. Users can compare the amount of current liabilities with the amount of current assets (i.e. the assets that are cash or will turn into cash within the normal operating cycle). This comparison should indicate whether a business can cover its maturing obligations.

The classification of liabilities between current and non-current should also help to indicate how long-term finance is raised. If a business relies on long-term borrowings to finance the business, the financial risks associated with the business will increase. This is because these borrowings will bring a commitment to make periodic interest payments and capital repayments. The business may be forced to stop trading if this commitment is not fulfilled. Thus, when raising long-term finance, a business must try to strike the right balance between non-current liabilities and owners' equity. We shall consider this issue in more detail in Chapter 14.

The classification of owners' equity

Owners' equity is typically represented in a single account in sole proprietorships (owners' capital). Typically, the end-of-period balance sheet of a sole proprietorship will simply show the opening capital plus profit less any drawings, giving the end-of-year capital.

However, for most businesses it is useful, or required (as in the case of companies), to provide three separate categories:

1. ***Owners' equity contributed***—initial funds contributed plus any specific increases.
2. ***Retained profit (retained earnings)***—profits made less any amounts drawn out by the owners. In the case of partnerships, the profits and drawings are typically collected and shown in a separate current account for each partner. In the case of companies, withdrawals take the form of dividends. Retained earnings shown reflect the cumulative figure after including earnings and dividends.
3. ***Other reserves***—profits that result from other events; for example, if an asset is revalued to a higher value, there will be a corresponding increase in the equity, and this increase is usually put in a revaluation reserve. This area will be dealt with a little later in the chapter, and further expanded in Chapters 4 and 5.

It is now common for categories 2 and 3 to be combined:

1. owners' equity
2. reserves:
   a. retained profits
   b. other reserves.

Table 2.2 shows how equity typically appears for the three types of business structure.

Sample pages

TABLE 2.2 Presentations of equity in balance sheets, by type of enterprise

	SOLE PROPRIETORSHIP	PARTNERSHIP	COMPANY
Contributed capital	Opening capital	Capital accounts Partner A Partner B (etc.)	Capital contributed Share capital
Retained earnings	Profit less drawings = closing capital	Current accounts Partner A Partner B (etc.)	Retained earnings
Other reserves	Seldom found other than revaluation reserve	A number are possible, with revaluation being probably the most common	A variety, to be discussed in detail in later chapters

CONCEPT CHECK 6

Which of the following is NOT a current asset?

- A Cash
- B Equipment
- C Inventory
- D Accounts receivable
- E Debtors.

CONCEPT CHECK 7

Which of the following statements is true?

- A Non-current assets must be tangible.
- B Non-current assets are generally held for sale to customers.
- C Current liabilities are amounts due for settlement within a year or two.
- D Revenue received in advance can be either a current or a non-current liability.
- E Accounts payable are generally classified as a non-current liability.

Sample pages

CONCEPT CHECK 8

Which of the following is NOT a component of owners' equity?

- A Share capital
- B Retained earnings
- C Contributed capital
- D Revaluation reserve
- E None of the above. All are components of owners' equity.

FORMATS FOR STATEMENTS OF FINANCIAL POSITION

LO 4
Apply the different possible formats for the statement of financial position

Now that the classification of assets, liabilities and owners' equity has been completed, it is time to consider the format of the statement of financial position. Although there is an almost infinite number of ways of presenting the same information, there are, in practice, two basic choices.

FIGURE 2.3

The horizontal layout

The equation for the horizontal form of statement of financial position layout.

Horizontal format

So far in the chapter we have used the traditional horizontal format (also referred to as the 'T account format') based on the ledger accounting system outlined earlier in Accounting and You (page 57). Figure 2.3 provides an overview of this perspective.

The style we adopted with Jerry and Co. in Example 2.1 is in line with this approach. A more comprehensive example of this style is shown in Example 2.2.

EXAMPLE 2.2 ***Illustration of horizontal statement of financial position.***

BRIE MANUFACTURING
Statement of financial position
as at 31 December 2021

Current assets	$	$	Current liabilities	$	$
Cash at bank	48,000		Accounts payable	148,000	
Accounts receivable	72,000				
Inventory	92,000		***Non-current liabilities***		
		212,000	Loan	200,000	
			Total liabilities		348,000
Non-current assets			***Owners' equity***		
Motor vehicles	76,000		Opening balance	200,000	
Plant and machinery	120,000		Add profit	56,000	
Property	180,000			256,000	
		376,000	Less drawings	(16,000)	
			Ending balance		240,000
Total assets		588,000	Total liabilities and owners' equity		588,000

Sample pages

Note that within each category of asset (current and non-current), the items are listed with the most liquid (starting with cash) first, going down to the least liquid. This is standard practice, which is followed irrespective of the format used. Liquidity generally relates to cash or closeness to cash. Note also that this approach is not used in all countries. For example, in the United Kingdom the order is typically reversed: the list goes from the least liquid to the most liquid. Overall content is basically the same; only the order changes.

Vertical or narrative format

In recent years, a more common form of layout for the statement of financial position is the 'vertical' or 'narrative' form of layout, which is really based on a rearrangement of the accounting equation.

There are two possible approaches to presenting the vertical format:

- the **entity approach**, and
- the **proprietary approach**.

entity approach An approach to the layout of the statement of financial position which emphasises that the report is focusing on the entity as a whole.

proprietary approach An approach to the layout of the statement of financial position which emphasises that the report is focusing on the proprietors (owners).

The focus of the entity approach is on the entire entity, whereas that of the proprietary approach is on the proprietary interest. The only difference is that the two layouts will be arranged slightly differently, as shown below.

Entity approach	Proprietary approach
Current assets	Current assets
+ Non-current assets	+ Non-current assets
=	
Current liabilities	– Current liabilities
+ Non-current liabilities	– Non-current liabilities
+ Owners' equity	= Owners' equity

It should be clear that the entity approach simply rearranges the horizontal layout in a vertical format. The proprietary approach requires some readjustment, as can be seen in Example 2.3, which shows the information provided in Example 2.2 from a vertical, proprietary perspective.

Sample pages

EXAMPLE 2.3 ***Vertical statement of financial position using proprietary approach***

BRIE MANUFACTURING
Statement of financial position
as at 31 December 2021

	$	$
Current assets		
Cash at bank	48,000	
Accounts receivable	72,000	
Inventory	92,000	
		212,000
Non-current assets		
Motor vehicles	76,000	
Plant and machinery	120,000	
Property	180,000	
		376,000
Total assets		588,000
Less liabilities		
Current liabilities		
Accounts payable	148,000	
Non-current liabilities		
Loan	200,000	
Total liabilities		348,000
Net assets		240,000
Owners' equity		
Opening balance		200,000
Add profit		56,000
		256,000
Less drawings		(16,000)
Total equity		240,000

DISCUSSION QUESTIONS

GENERAL

EASY

2.1	**LO 1**	What are the main characteristics of assets and liabilities from an accounting perspective? Is this consistent with a non-accounting definition?
2.2	**LO 5**	What is the primary measure used for asset valuation on the statement of financial position? What is the source of this measure and the justification for its use?
2.3	**LO 3**	What sort of account is 'retained earnings'?
2.4	**LO 3**	What sort of account would be included in the intangible asset category?

INTERMEDIATE

2.5	**LO 1/5/7**	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?
2.6	**LO 2**	Why is the accounting equation always in balance?
2.7	**LO 3**	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?
2.8	**LO 2**	Why is the statement of financial position also called a 'balance sheet'?
2.9	**LO 4**	Do you think the format of the statement of financial position will affect users' understanding of the statement?
2.10	**LO 2/5**	Why do you think accounting conventions are important?
2.11	**LO 5**	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.
2.12	**LO 6**	What other financial measures besides historical cost might be used for asset valuation?

CHALLENGING

2.13	**LO 1/5**	'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.
2.14	**LO 1/2/5**	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?
2.15	**LO 1/2/5**	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?
2.16	**LO 5/6/7**	'The statement of financial position shows how much a business is worth.' Do you agree with this statement? Discuss.
2.17	**LO 2**	Refer to Accounting and You. Do you consider that knowledge of how 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?

Sample pages

APPLICATION EXERCISES

EASY

2.1a **LO 2** Would the following accounts be classified as assets? If not, how would they be classified?

Account		Yes	No—reason
1	Accounts receivable		
2	Accumulated depreciation		
3	Investments purchased		
4	Advance to employees		
5	Prepaid insurance		
6	Supplies used		
7	Service revenue received in advance		

2.1b **LO 3** Would the following accounts be classified as liabilities? If not, how would they be classified?

Account		Yes	No—reason
1	Accounts payable		
2	Loan taken out		
3	Loan guarantee		
4	Unused bank overdraft		
5	Provision for major maintenance		
6	Provision for warranty		
7	Income tax payable		

2.2 **LO 2** For each of the following transactions identify the effect on the balance sheet equation.

Transaction		*Asset*	*Liability*	*OE*
A	The owner, 'Bill', contributes cash to the business, 'Bills 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 storage shed for the next 6 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			

Sample pages

2.3 LO 2/4 The following is a list of assets and claims of a manufacturing business at a particular point in time:

	$
Bank overdraft	22,000
Freehold land and buildings	245,000
Inventory of raw materials	18,000
Accounts payable	23,000
Plant and machinery	127,000
Loan from National Australia Bank	100,000
Inventory of finished goods	28,000
Delivery vehicles	54,000
Accounts receivable	34,000

a Prepare a statement of financial position in the standard vertical format incorporating these figures.

(*Hint:* There is a missing figure which needs to be deduced and inserted.)

b Discuss the significant features revealed by this financial report.

INTERMEDIATE

2.4 LO 2/3 Complete the table of assets below by classifying each account in terms of being:

- current
- non-current: investments
- non-current: property, plant and equipment
- non-current: intangibles

Account	Classification
Cash at bank	
Patent	
Equipment	
Prepayment	
Land	
Goodwill	
Accounts receivable	
Shares in Telstra	
Accumulated depreciation—equipment	
Inventories	
Leasehold improvements	
Interest prepaid	
Government bonds	

Sample pages