2.3 ▶ Claims against the Assets

In the previous section, you saw that a business lists the assets it owns on the left side of a balance sheet. Who is entitled to these assets? The answer is shown on the right side of the balance sheet. That is, both the creditors and the owner have a claim on the assets.

L OE

Why do the creditors and owner have a claim on the assets? Part of the answer is that they have either provided the funds used to acquire the assets, or they have provided the assets themselves.

Figure 2.8 below shows the balance sheet of Pacioli Designs, owned by Grace Cho. It shows clearly all the business assets that can be claimed and who has a right to claim them.

Pacioli Designs			
Balance Sheet			
December 31, 20–			
Assets		*Liabilities*	
Cash	$ 1618 00	Bank Loan	$ 9000 00
Accounts Receivable		Accounts Payable	
– J. Tenney	1350 00	– CMYK Supplies	1905 15
– V. Weiss	1850 50	– Golden Art Store	2299 90
Supplies	1750 50	– Premium Printing	1750 95
Furniture	4702 00	Total Liabilities	$14956 00
Equipment	16000 00		
Automobile	21850 00	*Owner's Equity*	
		Grace Cho, Capital	34165 00
Total Assets	$49121 00	Total Liabilities and Equity	$49121 00

Claims of the creditors

Assets available to be claimed

Claim of the owner

Creditors (Borrowed)

Owner(s) (Invested)

Figure 2.8

The balance sheet of Pacioli Designs showing its assets and the claims against those assets

As shown on the left side of the balance sheet, the business assets are \$49 121.00. The right side of the balance sheet shows that these assets, or the funds to obtain them, were provided by the bank, \$9000; the other creditors, \$1905.15, \$2299.90, and \$1750.95; and by Grace Cho herself, \$34 165.00.

The total amount of assets is subject to claims from two sources: the creditors and the owner. Thinking about assets and the claims against them will help you understand why the fundamental accounting equation is written as A = L + OE.

$$\underbrace{\$49\,121.00}_{\text{Assets}} = \underbrace{\$9000 + \$1905.15 + \$2229.90 + \$1750.95}_{\text{Creditors' claims against the assets}} + \underbrace{\$34\,165.00}_{\text{Owner's claim against the assets}}$$

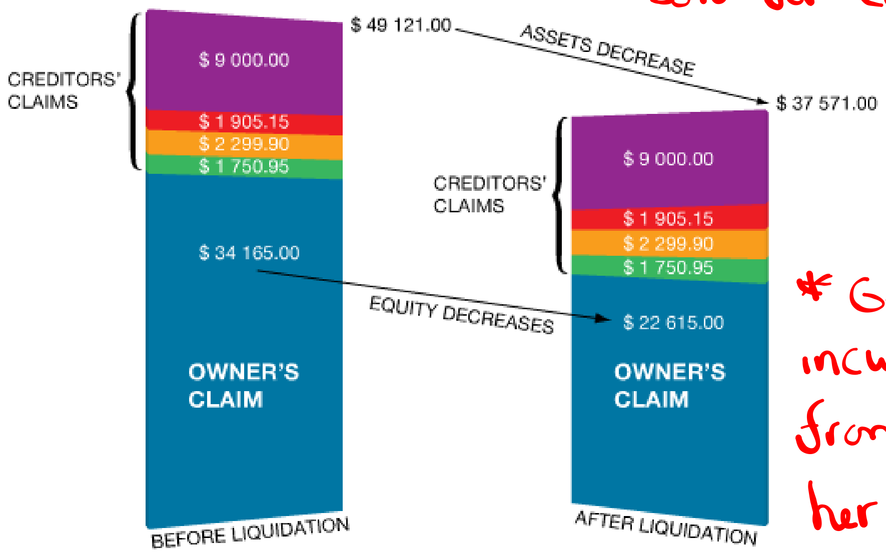
Creditors' Claims First

If a business is closed down, who takes possession of the assets? They still belong to the owner and to the creditors. The claims of the creditors will be settled first, followed by the claim of the owner. This means that the owner has to accept any losses that might occur from selling off any assets. On the other hand, the owner benefits from any profits that might occur. The owner always gets what is left after the claims of the creditors have been paid.

Selling the assets of a business for cash is called liquidation.

Suppose that Grace Cho closed down Pacioli Designs, collected the accounts receivable, and then sold the supplies, furniture, equipment, and automobile. Further assume that she did not sell her assets for the values listed on the balance sheet shown in Figure 2.8. In fact, after liquidation, the business was left with total assets of $37 571 in cash. This represents a decrease or loss of $11 550 (from $49 121 to $37 571).

sold for cash



* Grace Cho incurs the loss from liquidating her assets

Figure 2.9

The change in claims after the assets of Pacioli Designs are liquidated

From the graphs in Figure 2.9, you can see that the claims of the creditors (the liabilities) do not change. The drop in the value of assets simply means that the owner has less to claim (equity). This loss can be shown using the assets equation.

-11550 -11550

$$\underbrace{\$37\,571}_{\text{Assets}} = \underbrace{\$9000 + \$1905.15 + \$2299.90 + \$1750.95}_{\text{Creditors' claims against the assets}} + \underbrace{\$22\,615.00}_{\text{Owner's claim against the assets}}$$

Easy Rent-Alls Balance Sheet September 30, 20–					
Assets			*Liabilities*		
Cash	$ 6750	20	Accounts Payable		
Accounts Receivable			– Arrow Supply	$ 3950	40
– W. Boa	2231	50	– Best Repairs	6250	00
– T. Burns	4350	00	Bank Loan	35000	00
Supplies	2965	10	Mortgage Payable	95200	00
Land	148000	00	Total Liabilities	$140400	40
Buildings	134000	00			
Rental Equipment	75364	70	*Owner's Equity*		
			J. Salas, Capital	233261	10
Total Assets	$373661	50	Total Liabilities and Equity	$373661	50

Creditors

Suppose Easy Rent-Alls has to close. When liquidating their assets they are able to get $315000.00. (373 661.50 - 315 000.00 = $ 58 661.50)

a) Who gets paid first?

Creditors

b) Show what happens to the owners capital amount.

- Pre-Liquidation:

  Assets = Liabilities + Owner's Equity

  373 661.50   140 400.40   233 261.10

- Post-Liquidation:

  Assets = Liabilities + Owner's Equity

  315 000.00   140 400.40   174 599.60

c) What would happen if the company only had $130000.00 in cash after liquidation?

The creditors could take the owner to court.

Homework

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Section 2.3

Review Questions 1-5

Exercises 1-2

SECTION 2.3 REVIEW QUESTIONS (page 32)

1. *Two reasons why creditors have claims against the assets of a business are that they provided funds to acquire the assets (a banker) or they provided the assets themselves (a supplier).*
2. *You can quickly find out who has a claim against the assets of a business by looking at the right side of a balance sheet.*
3. *The creditors have first claim against the assets of a business.*
4. *The owner benefits from gains made in closing down a business.*
5. *The owner suffers primarily from losses incurred in closing down a business.*

SECTION 2.3 EXERCISES (page 32)

Exercise 1, p. 32

A.

Cash Value of Assets		Liabilities	
Bank	$ 900	Bank Loan	$ 18 000
Accounts Receivable	1 050	Accounts Payable	3 740
Supplies	500	Mortgage Payable	80 000
Property	180 000	Liquidator's Charges	1 500
Equipment	2 000		$103 240
Boats	20 350	$204 800 – $103 240 = $101 560	
	$204 800	Mr. Litz will receive $101 560 in cash.	

B. *An operating business is generally a profitable business and usually fetches a higher selling price than from simply selling off the assets and paying off the liabilities of a business that has been closed down.*

SECTION 2.3 EXERCISES (continued)
Exercise 2, p. 32

A.

CARLA'S INTERIOR DESIGN
BALANCE SHEET
JULY 31, 20–

Assets						Liabilities					
Cash	$11	9	0	0	–	Bank Loan	$ 9	5	0	0	–
Automobile	17	5	0	0	–	Accounts Payable	1	2	5	0	–
						Total Liabilities	$10	7	5	0	–
						Owner's Equity					
						Carla Mann, Capital	18	6	5	0	–
Total Assets	$29	4	0	0	–	Total Liabilities and Equity	$29	4	0	0	–

B. *To dispose of the remaining assets and close the business, Carla could use the business's cash to pay off the creditors. She could then pay herself by taking the balance of the cash and the automobile.*

Accounting Standards

2.4

In performing their work, accountants throughout the world follow sets of rules or standards. Historically, the Canadian Institute of Chartered Accountants (CICA) has established the standards for Canadian accountants. These standards are made available in the *CICA Handbook*, a publication that is updated regularly so that it reflects current accounting opinions and decisions. The most significant sections of the handbook contained the **Canadian Generally Accepted Accounting Principles (Canadian GAAP)**. Some GAAPs were formal regulations and others described what has become common practice over the years.

Originally, CICA committees were created to oversee Canadian accounting practice. Eventually these committees combined to form one separate governing body called the **Accounting Standards Board (AcSB)**. The board makes its decisions independently after consulting with many organizations and like-minded boards, including the **International Accounting Standards Board (IASB)**.

In 2006, the AcSB announced a process to replace the Canadian GAAP with the **International Financial Reporting Standards (IFRS)**, which are set by the IASB. The move to these international standards will help Canadian businesses communicate globally. The number of countries that have adopted or permitted IFRS is well over 100 with more joining this globalization trend.

The start date for moving to IFRS was January 1, 2011. This requirement was for public companies only. Public companies are those listed on stock exchanges.

Private businesses are not listed on stock exchanges. To help these organizations make the transition to global standards, the AcSB developed a separate set of guidelines called the **Accounting Standards for Private Enterprises (ASPE)**.

As of January 1, 2011, private businesses may choose IFRS or ASPE to govern their accounting practices. Since ASPE was developed from traditional Canadian standards, its guidelines force fewer changes in accounting procedures than the guidelines in IFRS. Therefore, most private enterprises will initially adopt ASPE, while holding on to the option of using IFRS in the future.

Business Entity Concept

The heading of the balance sheet indicates the name of the business, what the financial statement is, and when it applies. Therefore, the subject matter of this statement is the financial position of Pacioli Designs on December 31, 20–. Even though we see the name of the owner, Grace Cho, on the balance sheet, we know nothing about her financial position. No extra data is given about her personal assets and liabilities. All that is known is that she has a claim on the assets of Pacioli Designs in the amount of $34 165.

The **business entity concept** is a long-standing principle that keeps the accounting for a business organization separate from the personal affairs of its owner, or from any other business or organization.

This means that the owner of the business should not place any personal assets, such as the family home, on the business balance sheet. The balance sheet of the business must reflect the financial position of the business alone. The business entity concept is important in ASPE and IFRS, just as it was in Canadian GAAP.

- Business is a seperate entity from the owner.

The Cost Principle and The Continuing Concern Concept

Other interesting accounting principles can be seen on the Pacioli Designs balance sheet. Look at the value for supplies. Pacioli Designs originally paid $1750.50 for the supplies. The ASPE uphold the traditional **cost principle**, which requires accountants to record the value of assets at their historical cost price. (what you paid for them)

Readers of Pacioli's balance sheet are not concerned about the market value of the supplies because they know their original cost. They assume the business will continue operating and that the supplies will be eventually used. This is known as the **continuing concern concept.** It is also related to the cost principle and balance sheet interpretation.

The continuing concern concept assumes that a business will continue to operate unless it is known that it will not. This assumption frees the reader of a balance sheet from worrying about the market values of assets and whether debts will have to be paid before they are due.

① Assets are listed at their cost value

② The business will continue to run as usual

The Revaluation Model

The revaluation model contained in IFRS allows for modifications to the cost principle. The **revaluation model** outlines an accounting procedure that allows accountants to change the value of particular assets based on market conditions.

For example, suppose the automobile in Figure 2.10 ($21 850) is a custom sports car that was purchased to add to the business's designer image. The market value of the sports car has risen to $30 000. If Grace Cho chooses to use IFRS for Pacioli Designs, she could change the value of the automobile to $30 000, based on the current market conditions.

If Grace chose IFRS and revalued the automobile to $30 000, the total assets of Pacioli Designs would increase by $8150. What else would change by $8150? If you said equity—the owner's claim on assets—then you are applying your understanding of accounting theory to new situations.

- Asset values can change based on market conditions

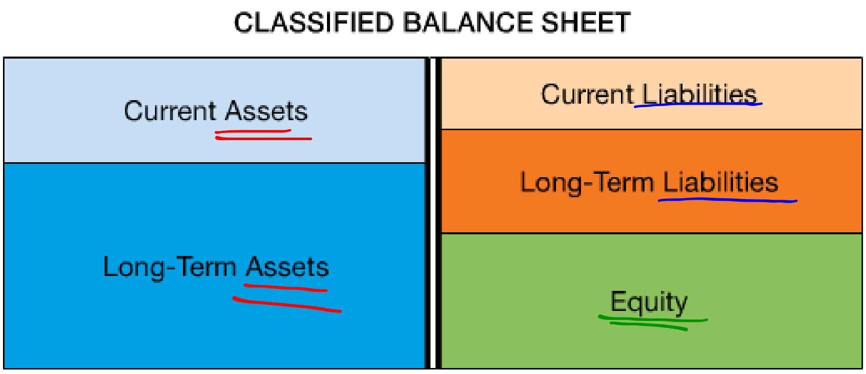


Figure 2.11

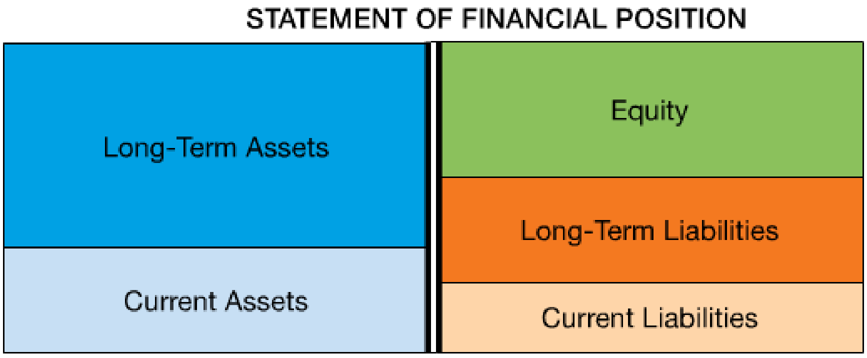
Balance sheet classifications

The pattern shown in Figure 2.11 follows the order of liquidity you learned in Section 2.2. It is also the pattern used by Pacioli Designs in Figure 2.10. New terms are listed below.

1. **Current assets** are cash and assets that will be converted into cash within one year, such as accounts receivable. Current assets also include assets that will be used up within a year, like supplies.
2. **Long-term assets** are items like land, buildings, and equipment (sometimes called property, plant, and equipment). These assets last longer than one year.
3. **Current liabilities** are those that are due within a year, such as accounts payable.
4. **Long-term liabilities** take more than a year to pay off. A mortgage is a common example.

Organizing the balance sheet into classifications helps the reader gain meaning and insight. Current assets are easily compared to the creditor's claims against them (current liabilities). Long-term assets, like a building, are shown with the mortgages against them.

Businesses in many countries using IFRS invert the order as shown in Figure 2.11. A typical structure under IFRS would look similar to Figure 2.12.



The order of both sides of the balance sheet has turned upside down. On the asset side, this inverted order reflects an emphasis on the long-term productive assets of a business, such as property, buildings, and equipment. On the right side, the order stresses the sources of the funds that were used to purchase the assets. The sources of funds begins with the owner(s), followed by the creditors.

Under IFRS, the name of the statement changes from balance sheet to **statement of financial position**.

Presently, most private businesses in Canada choose ASPE rather than IFRS. Therefore, if you see the inverted order in Figure 2.12, you are likely examining the financial position of a public company.

Recall that a private company has the right to choose IFRS. Suppose Grace Cho did just that for Pacioli Designs. The balance sheet you saw in Figure 2.10 might look similar to Figure 2.13.

PACIOLI DESIGNS
STATEMENT OF FINANCIAL POSITION
DECEMBER 31, 20–

Assets			***Equity and Liabilities***		
Long-Term Assets			*Equity*		
Automobile	$21 850.00		Grace Cho, Capital		$34 165.00
Equipment	16 000.00				
Furniture	4 702.00		*Current Liabilities*		
		$42 552.00	Bank Loan	$9 000.00	
Current Assets			Accounts Payable		
Supplies	$ 1 750.50		—CMYK Supplies	1 905.15	
Accounts Receivable			—Golden Art Store	2 299.90	
—J. Tenney	1 350.00		—Premium Printing	1 750.95	
—V. Weiss	1 850.50				14 956.00
Cash	1 618.00				
		6 569.00			
Total Assets		$49 121.00	Total Equity and Liabilities		$49 121.00

Figure 2.13

The statement of financial position for Pacioli Designs under IFRS

Homework

Page 37

Review Questions #1-17

SECTION 2.4 REVIEW QUESTIONS (page 37)

1. *Over the years, the Canadian Institute of Chartered Accountants has established the standards of practice for all Canadian accountants.*
2. *Most of the rules of accounting are found in the CICA Handbook.*
3. *The AcSB stands for Accounting Standards Board.*
4. *IFRS stands for International Financial Reporting Standards. The International Accounting Standards Board (IASB) sets the IFRS.*
5. *Canadian public companies started using IFRS on January 1, 2011.*
6. *ASPE stands for Accounting Standards for Private Enterprises.*
7. *Private businesses may use ASPE. They started using ASPE on January 1, 2011. They use them instead of IFRS because ASPE involve fewer changes for private businesses than adopting IFRS.*
8. *The business entity concept states that the accounting for a business should be kept separate from the accounting for the owner or another business.*
9. *The cost principle states that assets should be valued at their historic cost price.*
10. *The continuing concern concept assumes the company will keep operating and will use all of its short-term assets. This means that assets can be valued at their cost price rather than current market value because the company will use them up and does not need to sell them*
11. *The revaluation model is the IFRS procedure that gives a new perspective on the cost principle. The revaluation model allows accountants to value some assets at market value rather than historical cost price.*
12. *A current asset is an asset that can be converted to cash within a year, such as accounts receivable, or an asset that will be used up within a year, such as supplies.*
13. *A current liability is a liability that is due within a year, such as an account payable.*
14. *Property, plant and equipment are classified as long-term assets because they last longer than one year.*
15. *An example of a long-term liability is a liability that takes more than a year to pay off, such as a mortgage.*
16. *Traditionally, and under the Accounting Standards for Private Enterprises (ASPE), cash is listed first on the balance sheet because it is the most liquid asset. The International Financial Reporting Standards, however, invert the liquidity order of the traditional balance sheet. Long-term assets are listed first; liquid assets, like cash, are listed last.*
17. *Under IFRS, the balance sheet is called the statement of financial position.*

SECTION 2.4 EXERCISES (page 38)

Exercise 1, p. 38

A.

ARNOLD'S LANDSCAPING

BALANCE SHEET

OCTOBER 31, 20–

Assets			*Liabilities*		
Current Assets			*Current Liabilities*		
Cash	*$ 8 200.45*		*Accounts Payable*		
Accounts Receivable			*—Bev's Seed and Supply*	*$1 515.88*	
—P. Cannon	*3 050.–*		*—Peter Power Equipment*	*3 356.–*	
—T. Horvath	*890.30*		*—ToughTurf Supplies*	*950.05*	
Supplies	*850.–*		*Loan Payable*	*6 000.–*	
		$12 990.75			*$11 821.93*
Long-Term Assets			*Long-Term Liabilities*		
Furniture	*$ 512.75*		*Mortgage Payable*		*24 000.–*
Equipment	*42 900.25*				
Truck	*32 160.50*		*Owner's Equity*		
		75 573.50	*A. Vroom, Capital*		*52 742.32*
Total Assets		*$88 564.25*	*Total Liabilities and Equity*		*$88 564.25*

B. *The totals for current assets and current liabilities are very similar ($12 990.75 and $11 821.93). Therefore, Arnold's Landscaping should be able to pay its short-term liabilities with little difficulty. The cost value of the equipment is almost twice as much as the mortgage against it, which is also a healthy sign.*

C.

ARNOLD'S LANDSCAPING
STATEMENT OF FINANCIAL POSITION
DECEMBER 31, 20–

Assets			Equity and Liabilities		
Long-Term Assets			Equity		
Furniture	$ 512 75		A. Vroom, Capital		$52 742 32
Equipment	42 900 25				
Truck	32 160 50		Long-Term Liabilities		
		$75 573 50	Mortgage Payable		24 000 –
Current Assets			Current Liabilities		
Supplies	$ 850 –		Loan Payable	$6 000 00	
Accounts Receivable			Accounts Payable		
—P. Cannon	3 050 –		—Bev's Seed and Supply	1 515 88	
—T. Horvath	890 30		—Peter Power Equipment	3 356 –	
Cash	8 200 45		—ToughTurf Supplies	950 05	
		12 990 75			11 821 93
Total Assets		$88 564 25	Total Equity and Liabilities		$88 564 25

D. *The business has long-term assets of $75 573.50, which is over three times the total of long-term liabilities. The business and the owner provided most of the funds for these important assets, not outside creditors.*