CHAPTER 3

Balance Sheet

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

3.1 identify the nature and purpose of the balance sheet

3.2 master the important concepts and recognition about asset, liability and equity

3.3 describe the disclosure about asset, liability and equity on the balance sheet

3.4 discuss the measurement of various assets and liabilities on the balance sheet

3.5 understand the accounting policy choices, estimates and judgements on financial statements

3.6 discuss the limitations of the balance sheet.

The focus of this chapter is the financial statement that depicts the financial position of an entity at a point in time: the balance sheet (or the statement of financial position). The balance sheet lists an entity's assets, liabilities and equity at a particular point in time. Simplistically, the assets can be thought of as items that the entity owns, the liabilities and equity representing the external and internal claims on those items respectively. The purpose of this chapter is to examine in more detail the nature and purpose of the balance sheet. It will explore the definition, recognition, measurement, classification and disclosure criteria applied to assets, liabilities and equity reported on the balance sheet. The presentation of the balance sheet and potential limitations associated with using financial numbers on the balance sheet will also be discussed.

3.1 Nature and purpose of the balance sheet

There are major four financial statements in a entity. They are balance sheet (also referred to as statement of financial position), statement of profit or loss (also known as income statement and included as part of a statement of comprehensive income), statement of changes in equity, and statement of cash flows. In this chapter we will pay attention to the balance sheet.

Financial reporting obligations

Before learning the balance sheet, a broader discussion of the reporting obligations of entities is necessary. The previous chapter introduced the business Appreciation Basketball Coaching (ABC). What financial statements does ABC have to prepare? How does this differ from the financial statements that a listed company has to prepare? What are the rules and regulations that govern the preparation of financial statements prepared by entities?

Entities that are structured as companies (incorporated entities) generally have a legal obligation to prepare financial statements. These entities must prepare financial statements with a relevant regulatory body. For example, a listed company has legal obligation to prepare and lodge financial statements. Similarly, legislative obligations exist for some public sector entities, such as hospitals and schools, to prepare financial statements to discharge their accountability to the public.

For other entities, such as partnerships and sole traders, it is not legally required to prepare financial statements as the businesses are not separate legal entities from their owners. A business such as ABC is not required to prepare financial statements. However, for taxation purposes, records of the operations of the business are required so that the owner can fulfill his taxation obligations. Further, if the owner(s) wanted to sell the business as a going concern, potential purchasers would wish to view financial statements. A lender to the business may also demand financial statements to assess the entity's ability to service debt obligations, when providing new, or renewing existing, financing facilities. Financial statements should also assist the owner to assess the financial position and performance of the business.

General purpose and special purpose financial statements

Entities required to prepare financial statements may have to prepare general purpose financial statements or special purpose financial statements. What is the difference between general purpose financial statements and special purpose financial statements? Statements that are purported to be general purpose financial statements must be prepared in accordance with generally accepted accounting principles (GAAP), whereas special purpose financial statements can be prepared without adhering to GAAP. GAAP is a set of rules and practices that guide financial reporting.

As the conceptual framework (paragraph OB6) states: general purpose financial reports do not and cannot provide all the information that existing and potential investors, lenders and others creditors need. Those users need to consider pertinent information from other sources, for example, general economic conditions and expectations, political events and political climate, and industry and company outlooks.

Special purpose financial statements can be contrast with general purpose financial statements, which are provided to meet the information demands of particular users and which are not required to comply with accounting standards. In this textbook we considered general purpose financial statements.

A country's GAAP is usually specified in accounting standards. Accounting standards detail specific recognition, measurement, presentation and disclosure requirements applicable to various types of transactions. Historically, accounting standards varied by country. For example, China issued Chinese accounting standards that were different from the accounting standards issued in the United States, Japan, Germany and Australia. As markets have become increasingly borderless, considerable progress has occurred in developing a set of acceptable international accounting standards — International Financial Reporting Standards (IFRS). IFRS particularly focus on for-profit entities and are issued by the International Accounting Standards Board (IASB). Most countries, more than 120 jurisdictions have adopted or converged their domestic standards with IFRS. Countries adopting IFRS include Australia, South Africa and all European Union countries. Countries substantially converging their domestic standards with IFRS include China and India. Notable countries that have not adopted or substantially converged their standards to IFRS are the United States and Japan.

A set of public sector accounting standards — International Public Sector Accounting Standards (IPSAS) — issued by the International Public Sector Accounting Standards Board, are also available for jurisdictions to adopt. Are there different versions of IFRS to use when preparing general purpose financial statements? The IASB has issued IFRS as well as IFRS for Small and Medium-sized Entities (IFRS for SMEs). IFRS for SMEs simplifies some of the recognition and measurement rules, omits topics not relevant to SMEs and reduces disclosure requirements. The use of IFRS or IFRS for SMEs when preparing general purpose financial statements depends on whether an entity has public accountability.

Entities with public accountability must prepare general purpose financial statements using IFRS. Public accountability is applicable to entities with securities, debt or equity that are traded in a public market, or entities that hold assets in a fiduciary capacity as their main business activity. For example, a listed company is subject to public accountability. IFRS for SMEs are available for use by small and medium-size entities that are not subject to public accountability but do publish general purpose financial statements.

Nature and purpose of the balance sheet

A primary objective of a for-profit entity is the generation of profits and a strong financial performance. To generate profits, or to provide services, entities need to invest in productive assets. Assets are items controlled by an entity that provide the entity with future economic benefits. Value creation can also occur if the assets in which an entity invests appreciate in value. Decisions concerning the acquisition and sale of assets are referred to as investing decisions.

The acquisition of assets requires financing, which may be provided by external parties (e.g. lenders) and/or internal parties (e.g. the owners). The external claims on the entity's assets are termed liabilities. The internal claims on the entity's assets are referred to as equity. The mix of debt and equity financing an entity chooses reflects its financing decisions.

The balance sheet is a financial statement that details the entity's assets, liabilities and equity as at a particular point in time — the end of the reporting period. A balance sheet can be prepared more frequently than on an annual basis — indeed, it can be prepared as at any date. However, common practice is to prepare the balance sheet semi-annually or annually as at the end of the reporting period.

Recall from chapter 2 that the accounting equation specifies that the entity's assets equal the sum of the entity's liabilities and equity. The duality system of recording business transactions means that the business transactions have a dual effect on the accounting equation such that the equation remains in balance after the recording of each transaction. This is why a balance sheet, prepared as at any point in time, will always balance.

An example of a balance sheet for ABC is reproduced as example 3.1. The assets of the business as at 30 September 2017 are $87 770. The external claims on the assets at this date, the liabilities, are $51 400 and the equity, the internal claim on the entity's assets, is $36 370. Thus, the assets ($87 770) equal the liabilities ($51 400) plus the equity ($36 370). Net asset refers to the assets less the liabilities. As assets less liabilities equal to equity, net asset equals equity. For ABC, the net assets are $36 370, representing the assets of $87 770 less the liabilities of $51 400.

Analysing a balance sheet enables users to make a preliminary assessment as to the financial position of the entity. For example, ABC commenced the business with an investment of $20 000. As at 30 September 2017, Jack has invested in some office furniture and equipment only. ABC has $71 270 cash in the bank and is unlikely to face liquidity issues in the short term. As the business grows, the investment and finance decisions will be reflected on the balance sheet. For example, if ABC purchases ball machines and uses cash to finance the acquisitions, the cash balance will reduce and ball machines will appear as assets of ABC. Alternatively, if ABC purchases a mini bus to transport junior players and it is financed by a loan, assets of ABC will increase and liabilities will increase. By reviewing the balance sheet, a user may make a preliminary assessment of the economic condition of the entity by identifying the types of assets in which the entity invests and the entity's use of liabilities relative to equity to finance the assets, by appreciating the types and terms of liabilities used to finance the assets and the sources of equity used to fund assets, and by assessing the entity's financial solvency.

EXAMPLE 3.1

A balance sheet

Appreciation Basketball Coaching (ABC) Balance sheet as at 30 September 2017		
Assets		
Current assets	$71 270	
Cash	6 800	$78 070
Accounts receivable		
Non-current assets		
Office furniture	3 200	
Office equipment	6 500	9 700
Total assets		$87 770
Liabilities		
Current liabilities		1 400
Accounts payable		1 400
Non-current liabilities		
Bank loan		50 000
Total liabilities		51 400
Net assets		$36 370
Owner's equity		
Capital — N Cash		20 000
Profit		16 370
Total equity		$36 370

3.2 The definition and recognition of asset, liability and equity

The financial conceptual frameworks address matters such as the objective of financial statements, the assumptions underlying financial statements and the qualitative characteristics of financial statements, define the elements of financial statements (assets, liabilities, equity, income and expenses) and identify the recognition criteria to be applied to the elements. They also guide the development of accounting standards. As is the case with the globalisation of accounting standards, conceptual frameworks are also converging. The IASB issued an exposure draft in May 2015 and in this chapter will be on the proposed revised definitions.

Asset definition

The asset definition in the revised Conceptual Framework is "*an asset is a present economic resource controlled by the entity as a result of past events*" where an economic resource is a right that has the potential to produce economic benefits. The essential characteristics for an asset are:

1. a present economic resource
2. the resource must be controlled by the entity
3. the resource must be as a result of a past event.

Present economic resource

An economic resource is a right that has the potential to produce economic benefits. The rights can be established by contract or legislation, or arise from a constructive obligation of another party. In principle, each of an entity's rights is a separate asset. However, for accounting purposes, related rights tend to be treated as a single asset. For example, the following rights may arise from legal ownership of a property: the right to use the property and the right to sell the property.

For the economic resource to have the potential to produce economic benefits, it is only necessary that the economic resource already exists and that there is at least one circumstance in which it will produce economic benefits. There is no requirement that it be certain, or even probable, that the resource will produce economic benefits. The provision of benefits can take the form of having goods and services desired by customers available for sale. It can also take the form of being able to satisfy human wants.

Control

An entity must control the item for that item to be considered an asset and recognised on the balance sheet. Legal ownership is synonymous with control; however, legal ownership is not a necessary prerequisite for control. The concept of control refers to the capacity of the entity to benefit from the asset in the pursuit of its objectives, and to deny or regulate the access of others to the benefit.

To illustrate this concept, consider an entity that arranges to lease an asset required for its manufacturing process. The lessee (the entity) pays the lessor (the owner of the asset) a monthly rental. The lease contract specifies that the lease can be cancelled by the lessor with one month's notice. In this scenario, the entity is able to use the asset but it does not have control of the asset, given that the lessor can cancel the contract. It is the lessor who controls access to the asset. What if the contract was non-cancellable and the lessee had the right to purchase the asset at the end of the lease contract at a predetermined price? In this situation, it is most likely that the lessee controls the asset even in the absence of legal ownership. Other examples of assets where control is present in the absence of legal ownership include licences and management rights.

Past event

Another criterion necessary for an item to be defined as an asset is the existence of a past event that has resulted in the entity controlling the asset. Most assets are generated as a result of an exchange transaction, non-reciprocal transfers or discoveries. Consider an office building that is to be used as a rental property. The first two asset definition criteria are satisfied, as the building creates future economic benefits in the form of rental income, and the entity owns the building. If the building is purchased, an exchange transaction has occurred and the requirement that there be a past event is satisfied. If the building is bequeathed to the entity, a non-reciprocal transfer (a past event) is also deemed to have occurred. If the entity is in the process of finding a suitable property and has enlisted the services of a commercial real estate agent to assist in the task, the past event criterion is not satisfied as no exchange has occurred yet. The building is not considered an asset until this exchange has occurred.

Liability definition

The liability definition in the revised Conceptual Framework is "*a present obligation of the entity to transfer an economic resource as a result of past events*". The essential characteristics of a liability are:

1. a present obligation
2. to transfer an economic resource
3. a result of past events.

Present obligation

An essential element of the liability definition is a present obligation to another entity, even if the entity cannot be identified. A legal contractual obligation clearly creates a present obligation; however, the "obligation" for accounting definition purposes is more far-reaching than a legal obligation — it extends to the entity having no practical ability to avoid the transfer. The obligation can arise as a result of a duty to do what is fair, just and right; or it can arise if a particular set of facts creates valid expectations in other parties that the entity will satisfy the obligation.

If an entity has no realistic alternative to settling the obligation, the obligation would be deemed a present obligation. For example, if an entity has entered into a binding non-cancellable contractual arrangement to purchase equipment from a manufacturer and subsequently cancels the order, a liability will exist. The contract creates a legal obligation for the entity, and the entity will need to honour that obligation in the form of damages for breach of contract.

Transfer an economic resource

An entity's obligation to transfer an economic resource must have the potential to require the entity to transfer an economic resource to another party. Transferring economic resources is associated with adverse financial consequences for the entity. For example, accounts payable involve future sacrifices of economic benefits because the entity must remit cash to the supplier in the future. Similarly, a bank loan is a liability, as the entity must transfer an economic resource in the form of cash payments for interest and loan repayments to service the loan. The transfer does not necessarily have to be a cash sacrifice. For example, the requirement to transfer goods constitutes the transfer of an economic resource.

Past event

Another essential element for a liability is the existence of a past event. The event resulting in the future sacrifice of economic benefits must have occurred. Consider an entity that has contracted a company to undertake a major overhaul of its machinery. Until the overhaul is performed (the past event), there is no present obligation for the entity to pay the contractor and so the liability definition is not satisfied.

One of the contentious issues in financial reporting has been how lease financing should be addressed in financial reporting. If an entity leases assets, should the leased assets be recorded as assets and the future lease obligations as liabilities? The reporting of leased assets is covered by an accounting standard. Currently, the accounting treatment depends on the contractual terms of the lease and whether the substantial risks and benefits associated with the assets transfer from the lessor to the lessee. If they do, the leased assets are recorded as assets and must be amortised. Correspondingly, the lease obligations are recorded as liabilities. If the substantial risks and benefits associated with the assets remain with the lessor, lease financing has no balance sheet implications. The lease payment is recorded as an expense in the statement of profit or loss. This is why lease financing is referred to as "off balance sheet financing".

Equity definition

The remaining element of the balance sheet to discuss is equity. Equity is defined in the Conceptual Framework as "*the residual interest in the assets of the entity after deducting all its liabilities*". The revised Conceptual Framework does not propose to alter this definition.

The definition means that equity cannot be determined without reference to assets and liabilities. The definition is such that the entity's assets less liabilities (that is, net assets) at a particular point in time equal its equity. The equity balance represents the owner's (or owners') claims on the assets of the entity. Equity is a difficult concept to define independently of assets and liabilities.

Equity section of a balance sheet contains many different items. For example, one item within the equity section of the balance sheet is contributions made by the owner(s). The term given to the funds contributed by owner(s) is share capital for a company, or contributed capital for a partnership or sole trader. Retained earnings, also referred to as "unappropriated earnings" or "undistributed profits", are another equity item. Retained earnings are the cumulative profits made by an entity since it commenced operation that have been retained in the entity for reinvestment rather than distributed to the owner(s).

Recognition to assets, liabilities and equity

Only items that meet the definition of an asset, a liability or equity can be recognised in the balance sheet. The term recognition refers to recording items in the financial statements with a monetary value assigned to them. Therefore, "asset recognition" or "liability recognition" means that the asset or liability is recorded and appears on the face of the balance sheet with its amount included in totals in the relevant statement.

Central to the recognition principle is that items can be measured in monetary terms. This is referred to as the monetary concept. As money is the language used to quantify items recognised in the financial statements, if items cannot be assigned a monetary value, then they cannot appear on the balance sheet. It is recognition that links the elements in financial statements — assets, liabilities, equity, income and expenses — and hence the financial statements.

There are no definitive rules to assist the decision of whether an item should be recognised. The recognition decision requires judgment. The factors to consider when making a recognition decision are as follows.

- **Uncertainty**: if it is uncertain whether an asset exists, or is separable from goodwill, or whether a liability exists. For example, customer relationships are not contractual and therefore uncertainty exists as to whether these are assets or whether they are separable from the business as a whole.
- **Probability**: if an asset or a liability exists, but there is only a low probability that an inflow or outflow of economic benefits will result. For example, an entity is being sued for a claimed act of wrong doing but the probability of having to pay damages is assessed as low.
- **Measurement uncertainty**: if a measurement of an asset or a liability can be obtained, but the level of measurement uncertainty is high, impacting the relevance of the information. For example, the economic benefits are derived from business reputation that the reasonableness of the estimation is questionable.

If due to uncertainty or unreliable measurement an asset or liability is not recognised, an entity always has the option to disclose information concerning the asset or liability in the notes to the accounts supporting the financial statements. The term "contingent" is often used to describe such assets or liabilities. For example, an entity may be embroiled in a court case, resulting in a contingency being disclosed in the entity's notes to the accounts.

REAL WORLD

Apple's contingent liabilities

In its 2014 statements, Apple identified contingent liabilities relating to unfavourable results of legal proceedings, such as being found to have infringed intellectual property rights. Technology companies, including many of Apple's competitors, often enter into litigation, alleging patent infringement or other violations of intellectual property rights. Also, patent holding companies seek to monetise patents they have purchased or otherwise obtained. As Apple has grown, the intellectual property rights claims against it have increased, and may continue to increase. In particular, the company's cellular enabled products compete with those of mobile communication and media device companies that hold significant patent portfolios, and the number of patent claims against Apple has significantly increased. The company is vigorously defending infringement actions in a number of US jurisdictions and before the US International Trade Commission, as well as internationally in various countries. The plaintiffs in these actions frequently seek injunctions and substantial damages.

Source: *Apple* 2014, *annual report*, *p.* 262.

3.3 Disclosure of elements on the balance sheet

The presentation and disclosure of financial information is designed to communicate information to users in an effective and efficient manner, which enhances the qualitative characteristics of relevance, faithful representativeness, understandability, and comparability.

The balance sheet details recognised assets, liabilities and equity as at a particular date. Relevant information is also conveyed through disclosures accompanying the financial statements. Accounting standards exist that prescribe the presentation and disclosure requirements for financial statements. In this section, we will explore some of the key presentation and disclosure requirements applicable to the balance sheet.

Small entities with no public accountability, such as ABC, are not required to comply with accounting standards. This means that they are unconstrained in the preparation of their financial statements. A small business operation such as ABC would not have raised equity or debt capital from the public and would not have investors and shareholders who depend on