

FAC1502

STUDY UNIT 2

THE FINANCIAL POSITION



Financial Accounting I:

**Financial Accounting
Concepts, Principles and
Procedures**

The financial position

Learning outcome

You should be able to describe the primary purpose of accounting and the double-entry system. You should also be able to calculate the financial position of an entity and the elements of the basic accounting equation.

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KEY CONCEPTS	
• Accounting entity • Accounting equation • Financial position • Asset • Liability • Equity • Double-entry system • Net worth	

2.1 Introduction

The primary purpose of accounting (section 1.2.3) is to give information (section 1.2.4) on the **financial position** (section 4.7) and the **financial result** (section 4.15.1) of an entity. This study unit deals with the key elements of the financial position (section 1.15.2.5) of an entity.

2.2 Accounting entity

Every entity for which **separate financial records are kept** is an accounting entity (section 1.7). It is extremely important to see a business as a separate entity from its owners because transactions entered into by an entity have to be dealt with from the point of view of the entity for which accounting records are kept.

2.3 The financial period

The financial statements of any business entity, regardless of whether it operates as a company, a close corporation, a partnership or a sole trader, consist of at least a statement of financial position, which provides information about the financial position of the business **at the end of a specified period (monthly, every three months, every six months or every twelve months)**. The heading of the statement of financial position identifies the date at which it is reporting, for example:

XYZ Traders

Statement of financial position **as at** 30 September 20.2

If the financial period is one year, the period will be from 1 October 20.1 until 30 September 20.2 and the statement of financial position will be as at the last day of the financial year. Therefore, the statement of financial position reports on the **assets**, the **liabilities** and the **equity** of the entity **for only one day**. (section 3.2.7)

2.4 Financial position

The financial position of an entity is described in terms of **assets**, **liabilities** and **equity** at a **given time**, which are reflected in a statement of financial position. The statement of financial position is essentially an accounting report on the financial position of the entity. The statement of financial position communicates relevant financial information to the owners, creditors/trade payables and other interested parties.

A simplified example of a statement of financial position according to the basic accounting equation is as follows:

BUSINESS TRADERS

STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20.9

	R
ASSETS	
Tools and equipment	88 800
Bank	8 200
	97 000
EQUITY AND LIABILITIES	
Capital	40 000
Creditor/Trade payables	7 000
Long-term loan	50 000
	97 000



COMMENT

This example of a statement of financial position (balance sheet) is in a basic form. We will deal with statements of financial position (balance sheets) in more detail later.

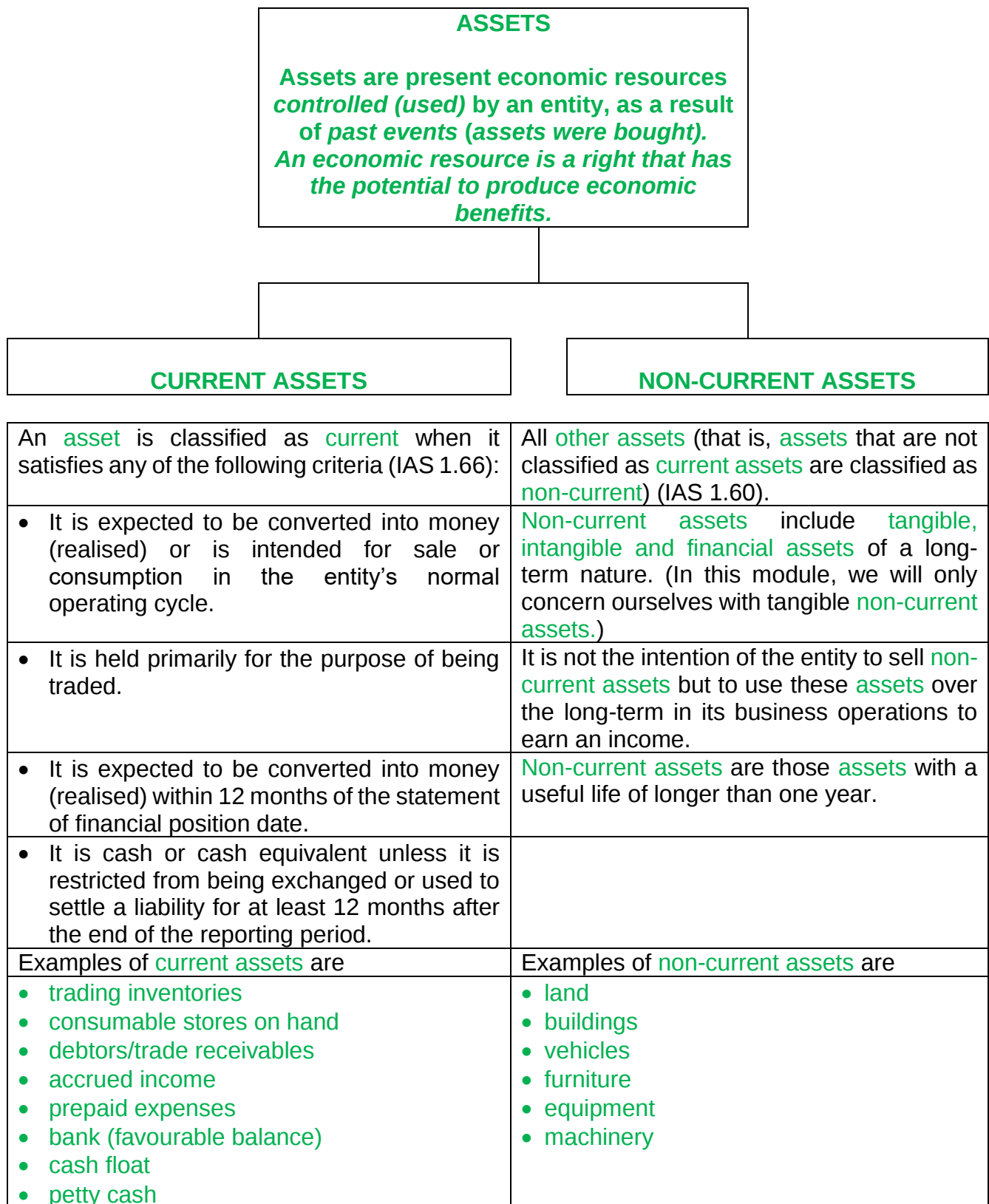
2.5 The elements of financial statements

Every entity implements a financial accounting system according to the minimum financial accounting standards and practices when it draws up financial statements that are used in making economic decisions. Financial statements (section 1.15.2.4) reflect the financial effects of transactions. These effects are grouped into broad classes according to their economic characteristics, namely, **assets**, **equity**, **liabilities**, **income** and **expenses**. **Assets**, **equity**, **liabilities**, **income** and **expenses** are called the elements of financial statements.

The elements directly related to the measurement of financial position at a given time in the statement of financial position are **assets**, **liabilities** and **equity**.

2.5.1 Assets

Let's have a look at the difference between **non-current assets** and **current assets**.



An **asset** is recognised as an element of an entity's financial statements when

- it is probable that economic benefits will flow to the entity
- the cost or the valuation of the **asset** can be measured reliably. (Koppeschaar et al 2017:21)

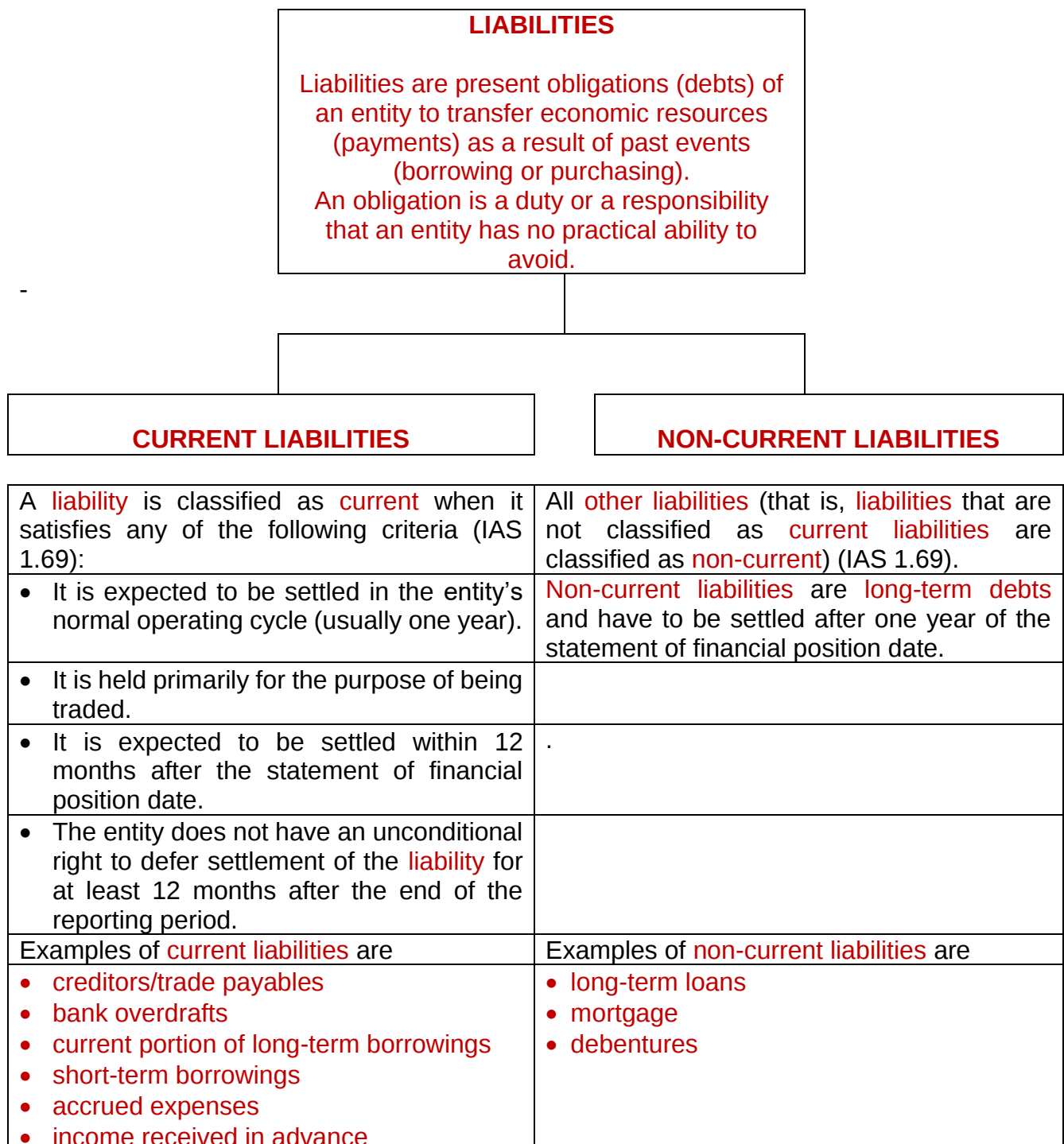
The following examples of how assets may be employed by an entity are given in paragraph 4.10 of the Conceptual Framework:

Assets may be

- used singly or in combination with other assets in the production of goods or services to be sold by the entity
- exchanged for other assets
- used to settle a liability
- distributed to the owners of the entity

2.5.2 Liabilities

Let's have a look at the difference between current liabilities and non-current liabilities.



A **liability** is recognised as an element of an entity's financial statements when

- it is probable that economic benefits will flow from the entity when **an obligation** is settled
- the amount of the benefit to be given up can be measured reliably. (IAS 37, "Provisions, Contingent Liabilities and Contingent Assets")

The settlement of obligations can take place in a number of ways, for instance, through

- the payment of cash
- the transfer of **other assets**
- the provision of services
- the replacement of one **obligation** with **another**
- the conversion of an **obligation** into **equity** (Conceptual Framework, par 4.16)

2.5.3 Equity

The difference between the value of assets owned by an entity and the **liabilities** it has incurred represents the **net asset value**. If we express this as an equation, then

$$\text{ASSETS} - \text{LIABILITIES} = \text{NET ASSET VALUE}$$

The **net asset value** represents the portion by which the **assets** exceed the **liabilities** and is therefore also called **EQUITY**.

According to these principles the correct statement of financial position for Business Traders is as follows:

BUSINESS TRADERS

STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20.9

	R
ASSETS	
Non-current assets	
Tools and equipment	88 800
Current assets	
Bank	8 200
Total assets	97 000
EQUITY AND LIABILITIES	
Equity	
Capital	40 000
Non-current liability	
Long-term loan	50 000
Current liability	
Creditor/Trade payables	7 000
Total equity and liabilities	97 000

2.6 The basic accounting equation (BAE)

The logical method of recording transactions by way of the accounting equation is used to process transaction data. Transactions may

- affect **assets** and/or **equity** and/or **liabilities**
- generate **income** or give rise to **expenditure**

The accounting equation states that

ASSETS	=	EQUITY	+	LIABILITIES
A	=	E	+	L

OR

EQUITY	=	ASSETS	-	LIABILITIES
E	=	A	-	L

The **equity** of an entity equals **all the assets** in the entity less **all the claims** against those **assets (liabilities)**.

The accounting equation is a mathematical equation that should **always balance**. The financial position of an entity is indicated by this equation.

Since the **accounting equation should always balance**, the **involvement of two accounts is required for each transaction**. The **accounting equation** is, therefore, **based on the double-entry accounting system**.

Basic requirements for the accounting equation

- A minimum of two accounts must be used for each transaction.
- The equation must remain in balance after each transaction. In other words, the debit side (**A**) is equal to the credit side (**E + L**).

Consider the following example of transactions that affect **assets** and/or **equity** and/or **liabilities**:

Before the entity starts to do business, the **accounting equation** will look like this:

Debit side	=	Credit side
A	=	E + L
Possessions the entity owns	=	Amounts owed to the owner of the entity + Amounts owed to third parties
What the entity owns	=	What the entity owes
0	=	0

Note that the recording of transactions is done from the point of view of the business entity independent from its owner.

Every entity for which separate financial records are kept is a financial accounting entity. It is extremely important to see the entity as separate from its owner: transactions entered into by

the entity have to be dealt with from the point of view of the entity whose books are being done. Why do we say that the **accounting equation is a fact** and not a rule? To answer this question, you need to know what each concept in the equation means:

- **Assets** are basically all the **resources controlled by an entity** (whether they are owned by the entity or not).
- **Liabilities** are the **debts** of an entity (all the money owed to third parties).
- **Equity** refers to the **wealth of the owner(s)** of an entity (from the business only). It is an indication of how much of the **asset base** actually **belongs to the owner(s)**.

An easy way to remember the accounting equation is to ask:

What would **the owner have left for him-/herself** if he/she closed his/her business today, sold all the **assets** and paid back all the **liabilities**?

Remember, not all **assets** controlled by an entity are **owned** by the entity. If a business entity bought a **vehicle** on **credit**, for example, the vehicle does not belong to the entity until the final instalment is paid. Until then, the **vehicle** actually belongs to the financier, and it will be accompanied by a **liability (debt)** in the accounting records of the entity. If the owner decides to close the business, **the money owed** on this **vehicle** will still be due. In simple language, the accounting equation therefore states a fact.

Equity (wealth) equals all the valuables (assets) in a business less all the claims against those assets (liabilities).

Before you will be able to use the accounting equation, you have to learn about the **double-entry principle that drives the accounting process**.

2.7 The double-entry system

Bookkeeping is the part of financial accounting that is concerned with the recording of transactions. The transactions are recorded in an account.

An account consists of a left-hand side and a right-hand side and is presented in a “T” format. The left-hand side is referred to as the debit side and the right-hand side is referred to as the credit side. The name of the “T”-account is written across the centre at the beginning of the account.

This can be illustrated as follows:

Dr (debit side)	 Account	(credit side) Cr
Left-hand side (LHS)		Right-hand side (RHS)

For each **asset**, **liability**, **equity**, **expense** and **income** there will be a **“T”-account** in the accounting records of an entity. All these “T”-accounts together are called the **general ledger**.

The double-entry principle provides a logical method of recording transactions. When the double-entry system is used, **the monetary (money) value of each transaction** must be entered on the **debit side of one ledger account as well as on the credit side of another ledger account**. The entry in one ledger account refers to the corresponding entry in the **other ledger account**.

As the entries in the two ledger accounts have been entered on opposite sides, the use of the

double-entry system allows for **cross references**. Each transaction is entered in two separate accounts on opposite sides, and it is therefore possible to check and control the arithmetical and accounting accuracy of the work. **If each transaction is recorded so that the debit and credit entries are equal, the same sum of all the debits to the account must equal the sum of all the credits.** This can be explained by way of the accounting equation.

The double-entry system is based on the fact that every transaction affects two or more items in the BAE. In principle, this means that each transaction must be recorded in such a way that the equation remains in balance. The dual effect that each transaction has on the elements of the BAE is the fundamental principle on which all entries in an accounting system are based.

When the double-entry principle is applied, the following rules need to be followed:

Dr (debit side)	Assets	(credit side) Cr
+		-
Dr (debit side)	Equity, Liabilities	(credit side) Cr
-		+

The above can be summarised as follows:

- **Assets increase** on the (left) **debit side** and **decrease** on the (right) **credit side** of the T-account.
- **Equity increases** on the (right) **credit side** and **decreases** on the (left) **debit side** of the T-account.
- **Liabilities increase** on the (right) **credit side** and **decrease** on the (left) **debit side** of the T-account.

For you as a learner in accounting the reality is that the double-entry rules are not concepts that you can try to understand – you have to learn them!

Refer to section 2.5.3 for an example of a statement of financial position.

EXERCISE

1

Maxi Services's assets amount to **R30 000** and its **liabilities (creditors/trade payables)** amount to **R5 000**.

Calculate the **equity**.

We use the BAE. The amounts that are given are substituted for the appropriate symbol and the unknown symbol is calculated.

A	=	E	+	L
This basic accounting equation will be adjusted so that the equity can be calculated:				
E	=	A	-	L (Creditors/Trade payables)
		R30 000	-	R5 000
R25 000				

EXERCISE**2**

Tom is the owner of Zebra Services, which offers a carpet cleaning service. On 30 November 20.1 Zebra Services owns **equipment** amounting to R100 000. Clients owe R40 000 for services rendered and Zebra Services owes R20 000 to a supplier for parts purchased. Zebra Services also has R10 000 in cash in the bank.

Show the BAE for Zebra Services and determine the **equity**.

*Step 1: Identify the **assets***

Equipment = R100 000
Trade receivables = R 40 000
Bank = R 10 000

*Step 2: Identify the **liabilities***

Trade payables = R20 000

Substitute these amounts into the equation:

A	=	E	+	L
This basic accounting equation will be adjusted so that the equity can be calculated:				
E	=	A	-	L
Equity		Equipment + Trade receivables + Bank	+	Trade payables
		R(100 000 + 40 000 +10 000)	-	R20 000
R130 000				

Zebra Services's financial position can also be presented in the form of a statement of financial position (previously known as balance sheet) as follows:

ZEBRA SERVICES

STATEMENT OF FINANCIAL POSITION AS AT 30 NOVEMBER 20.1

	R
ASSETS	
Equipment	100 000
Trade receivables	40 000
Bank	10 000
	150 000
EQUITY AND LIABILITIES	
Equity	130 000
Trade payables	20 000
	150 000

2.8 Revision exercises and solutions

2.8.1 Revision exercise 1

- (1) Define the concept of an accounting entity.
- (2) Describe the financial position of an entity in terms of the BAE.
- (3) Explain the nature (section 1.15.2.5) of
 - (a) assets
 - (b) equity
 - (c) liabilities
- (4) Name two sources of financing.
- (5) What is meant by the double-entry system?

Solution: Revision exercise 1

- (1) An accounting entity is any entity for which separate financial records are kept.
- (2) $ASSETS = EQUITY + LIABILITIES$
- (3)
 - (a) *Assets* are all the resources controlled by an entity (whether they are owned by the entity or not), that is, the possessions of an entity.
 - (b) *Equity* is the interest that the owner of an entity has in the business and that the entity therefore owes to him/her.
 - (c) *Liabilities* are creditors' interests (trade payables' interest) or interests of parties other than the owners of an entity. Liabilities are therefore the debts of an entity.
- (4) The owner
Creditors/trade payables
- (5) In principle, it means that every transaction has a dual effect on the elements of the BAE and that after every transaction the BAE **must** remain in balance.

2.8.2 Revision exercise 2

Calculate the missing figures using the BAE.

		R
(1)	Bank	= 4 000
	Vehicles	= 5 000
	Equipment	= 7 000
	Capital	= ?

			R
(2)	Capital	=	150 000
	Loan	=	50 000
	Bank	=	?
	Machinery	=	190 000
(3)	Bank	=	5 000
	Trade receivables	=	15 000
	Buildings	=	100 000
	Furniture	=	40 000
	Trade payables	=	50 000
	Capital	=	?
(4)	Capital	=	60 000
	Loan	=	10 000
	Trade payables	=	6 000
	Assets	=	?

Solution: Revision exercise 2

(1)

A	=	E	+	L
This basic accounting equation will be adjusted so that the equity can be calculated:				
E	=	A	-	L
Capital		Bank + Vehicles + Equipment		
		R(4 000 + 5 000 + 7 000) -		R0
R16 000				

(2)

A	=	E	+	L
Machinery + Bank		Capital		Loan
R190 000 + Bank =		R150 000	+	R50 000
Bank = R10 000*				
* R190 000 – R(150 000 + 50 000)				

(3)

A	=	E	+	L
This basic accounting equation will be adjusted so that the equity can be calculated:				
E	=	A	-	L
Capital		Bank + Trade receivables + Buildings + Furniture		Trade payables
		R(5 000 + 15 000 + 100 000 + 40 000) -		R50 000
		R160 000 -		R50 000
R110 000				

(4)

A	=	E	+	L
Assets		Capital		Loan + Trade payables
		R60 000 +		R(10 000 + 6 000)
R76 000				

SELF-ASSESSMENT

Now that you have studied this study unit, can you



- describe the primary purpose of accounting?
- describe an entity?
- describe the financial position of an entity?
- describe the double-entry system?
- calculate the elements of the basic accounting equation?