

## 2 The balance sheet

The objectives of this chapter are to:

- explain the nature and purpose of the ‘entity’ concept;
- define the major components of a balance sheet;
- identify and explain the ‘accounting equation’;
- outline the relationship between ‘assets’ and ‘sources of finance’ as disclosed in the balance sheet;
- explain the impact of individual transactions on ‘net assets’ and ‘owner’s capital’ contained in the balance sheet;
- demonstrate the impact of profit on assets and on the owner’s capital;
- show how assets and sources of finance are presented in the balance sheet, distinguishing between ‘fixed assets’ and ‘current assets’ on the one hand and ‘capital’, ‘current liabilities’ and ‘non-current liabilities’ on the other;
- outline different possible ways of valuing assets; and
- explain why historical cost is widely used for reporting purposes.

### THE ENTITY CONCEPT

In Chapter 1 we saw that there are three main forms of trading organization (clubs and societies do not usually trade) within the private sector of the economy – the sole trader, the partnership and the limited company. There are two important differences between sole traders and partnerships (sometimes referred to as ‘firms’) on the one hand and limited companies on the other:

- 1 *The relationship between ownership and management.* In the case of firms, the owner or owners run the business, whereas in the case of the limited company there may well be a significant separation between the ownership and managerial functions. This is particularly likely in the case of the public limited company, where the bulk of the finance is provided by the general public.
- 2 *The owner’s liability for business debts.* Sole traders and partners normally have unlimited liability for the debts of their firm, whereas the shareholders of limited companies are not required to contribute beyond the amount originally paid for shares issued by the company.

The latter distinction is significant when a business runs into financial difficulties. In the case of firms, the creditors claim first against the business assets; if these are insufficient to satisfy the amounts due, the creditors can then claim against the owner’s personal wealth. In an extreme situation, the owner of a bankrupt firm could be forced to sell his or her home and all other personal belongings to meet

demands from the firm's creditors. (It is to avoid this outcome that a person in business sometimes transfers the ownership of personal assets to his or her partner.) This contrasts with the relative position of investors and creditors of a limited company, where any deficiency of business assets compared with liabilities at the date of liquidation is borne by the creditors.

Company law, therefore, regards a limited company as a separate legal entity. The creditor contracts with the company and can claim only against its assets. No such legal distinction is recognized where the business is carried on by a sole trader or by partners. The position in accountancy, however, is quite different. It is always assumed, for accounting purposes, that the business entity has an existence separate and distinct from its owners, managers or any other individuals with whom it comes into contact during the course of its trading activities. The assumption of a separate existence, usually referred to as the *entity concept*, requires a careful distinction to be drawn between business affairs and personal transactions. One of the reasons for requiring this distinction to be made is that it facilitates performance assessment. A sole trader forms a business in the hope that it will earn him or her a satisfactory profit and, to discover whether this objective has been achieved, profit must be calculated only on the basis of business transactions.

#### Illustration 2.1

On 1 January 20X1 Mr Old was made redundant and received £30,000 in compensation. He used the cash as follows:

- (a) Purchased a sports car £19,500.
- (b) Arranged the redecoration of his house £1,000.
- (c) Paid off his personal overdraft £3,500.
- (d) Decided to form a business called Old Ventures and, as a first step, opened a business bank account and paid in £6,000.

To comply with the entity concept it is necessary to distinguish between Mr Old's personal transactions and the business transactions of Old Ventures. An examination of the above information shows (a), (b) and (c) to be personal transactions and (d) to be a business transaction.

Joe runs a plumbing business. Indicate which of the following transactions relate to his business and which are personal transactions.

#### ACTIVITY 2.1

- (a) Joe won £10,000 on the National Lottery and decided to invest it in the business.
- (b) His sister's washing machine broke down and he fixed it for her as a favour.
- (c) She recommended him to a friend who then asked him to plumb in her dishwasher. He charged her £40.
- (d) Joe bought a van for the business costing £8,000.
- (e) He also bought a family car which he will sometimes use in the business.

*The solutions to all 'Activities' are at the end of each chapter.*

Readers should now attempt Question 2.1 at the end of the chapter. In all cases readers should work through the question and only then compare their answer with the solution provided in the Appendix at the end of the book. (Only the odd-numbered solutions are given in the Appendix – as are solutions 6.2, 6.4 and 6.6; all other even-numbered solutions are to be found in the Solutions Manual located at: [www.sagepub.co.uk/resources/marriott.htm](http://www.sagepub.co.uk/resources/marriott.htm).)

## CLASSIFICATION OF ASSETS AND SOURCES OF FINANCE

The balance sheet can be described as a 'position' statement that shows the financial position of a business at a particular point in time. It consists of assets, liabilities and capital.

### Assets

Business assets may be defined as resources owned by an entity that have the potential for providing it with future economic benefits in the sense that they help to generate future cash inflows or reduce future cash outflows. The fact that a business asset exists, however, does not necessarily mean that it will be reported in the balance sheet. For this to be done, the asset must satisfy the further requirement that the benefit it provides can be measured or quantified, in money terms, with a reasonable degree of precision. This is referred to as the *money measurement* concept. For example, stock-in-trade is reported as a business asset because it is owned by the firm, it has an identifiable monetary value (its cost) and it is expected to produce an at least equivalent cash benefit to the firm when it is sold. Expenditure incurred on training staff, on the other hand, presents a more difficult problem. While it is possible to identify the amount of the expenditure, it is not possible to forecast with a high degree of certainty whether the firm will benefit from the expenditure. Employees may be poorly motivated and fail to improve their competence as the result of attending training courses. In addition, they may leave the firm and take their new expertise elsewhere. Due to this uncertainty concerning the likely extent of any future benefit, such expenditure is not reported as a business asset but is instead written off against profit as an expense as it is incurred.

Assets reported in the balance sheet are divided into two categories:

- 1 *Current assets.* These are defined as short-term assets that are held for resale, conversion into cash or are cash itself. There are three main types of current assets: stock-in-trade, trade debtors and cash. A temporary investment of funds in the shares of, say, a quoted company or government securities should also be classified as a current asset. A characteristic of current assets is that the balances are constantly changing as the result of business operations.
  - (a) Stock-in-trade represents the value of items purchased for resale that are still in stock at the year end. They are regarded as a current asset because there is a high chance of the items being converted into cash within the next 12 months.

- (b) Debtors represent the amount of money owed to the business and can be sub-divided into trade debtors and others. The former category relates to customers who have bought goods on credit terms and represents the amount of money still outstanding from them at the year end. Other debtors could include dividends receivable from investments in the shares of other companies.
  - (c) Cash is the amount of funds readily usable by the business and can either be in the form of cash or a balance in the business bank account.
- 2 *Fixed assets.* These are assets a firm purchases and retains to help carry on the business. It is not intended to sell fixed assets in the ordinary course of business and it is expected that the bulk of their value will be used up as the result of contributing to trading activities. Examples of fixed assets are premises, plant, machinery, furniture and motor vehicles. A characteristic of fixed assets is that they usually remain in the business for long periods of time and will only be sold or scrapped when they are of no further use.

It is important to realize that it is possible to classify an asset as current or fixed only by examining the reason why it was purchased: was it purchased for resale or retention? Assets purchased for resale by one company may be purchased by another for retention. For example, a garage purchases motor vehicles for resale, while a manufacturing concern acquires them as fixed assets to be used by sales representatives.

Assets are reported in the balance sheet in the order of increasing liquidity: the list starts with the items least likely to be turned into cash and ends with the items expected to be converted into cash in the near future. Cash will therefore appear at the bottom of the list as it is the most liquid, and stock will be listed at the top because it is the least liquid.

### Sources of finance

The finance of a business can be obtained from three sources: capital, current liabilities and long-term liabilities.

- 1 *Capital.* This is the amount of money invested in the business by the owner(s). The amount can increase through further investment of funds by the owner(s) or by the business making a profit and can decrease when money is withdrawn from the business for personal use or where a business loss is suffered. Capital is regarded as a permanent source of finance since it is only repayable in full when the business ceases. Until such time the amount is regarded as a liability of the business as the amount is owed to the owner.
- 2 *Current liabilities.* These liabilities are defined as amounts repayable within 12 months of the balance sheet date. Typical examples include bank overdrafts and creditors. Any loans repayable within the following year are also listed under current liabilities.

Creditors can be divided into trade and other creditors. Trade creditors represent the amount owing to suppliers of stock items that have been purchased on credit terms. Other creditors could include amounts outstanding for miscellaneous services.

- 3 *Long-term liabilities.* These represent the amounts payable after more than 12 months. They include such items as bank loans and mortgages.

Sources of finance are arranged in order of permanence, with the most permanent sources at the top and amounts repayable (or potentially repayable) in the near future at the bottom of the appropriate section of the balance sheet. Most sources of finance are easily classified into one or other of the three categories, but certain items cause a little more difficulty. For example, the terms of a bank loan may provide for an advance of £100,000 repayable by five equal annual instalments of £20,000. In these circumstances the liability must be divided into two parts, with the next instalment repayable shown as a current liability and the balance reported as a long-term liability. Therefore, at the end of the first year, £20,000 is reported as a current liability and £80,000 as a long-term liability.

Accounting is a device for communicating relevant financial information to interested parties and as such it is important that the information reported should be not only technically accurate but also presented in an orderly fashion so that it can be readily understood by owners, managers and others who wish to assess progress. The balance sheet is drafted so as to help to achieve this objective. It is divided into five sections and, for each of these, an appropriate description is given and subheading provided. (A balance sheet presented in the horizontal format is given in Figure 2.1.)

Users of accounting statements are therefore able to see, at a glance, the amount of finance provided by the owners, the volume of long-term loans and the quantity of short-term finance. The statement also shows how the total finance has been allocated between fixed and current assets. If a firm is to be financially stable, it is normally important for long-term investments in fixed assets to be

|                       | £       | £              |                            | £            | £              |
|-----------------------|---------|----------------|----------------------------|--------------|----------------|
| <b>Assets</b>         |         |                | <b>Sources of finance</b>  |              |                |
| <i>Fixed assets</i>   |         |                | Capital                    |              | 179,000        |
| Land and buildings    |         | 75,000         | <i>Non-current</i>         |              |                |
| Plant and machinery   |         | 49,000         | <i>Liabilities</i>         |              |                |
| Motor vehicles        |         | 21,500         | Loan                       |              | 50,000         |
|                       |         | <u>145,500</u> | <i>Current liabilities</i> |              |                |
| <i>Current assets</i> |         |                | Bank overdraft             | 36,700       |                |
| Stock-in-trade        | 145,700 |                | Trade creditors            | 170,000      |                |
| Trade debtors         | 143,700 |                | Expense creditor           | <u>1,900</u> |                |
| Investments           | 2,600   |                |                            |              |                |
| Cash in hand          |         | 292,100        |                            |              |                |
|                       |         | <u>437,600</u> |                            |              |                |
|                       |         |                |                            |              | <u>208,600</u> |
|                       |         |                |                            |              | <u>437,600</u> |

FIGURE 2.1 Balance sheet of Nut and Bolt Engineering at 31 December 20X1

financed substantially by the owners and for current assets to be sufficient to meet current liabilities falling due over the next 12 months. A well-prepared balance sheet enables these and other forms of financial analysis, examined in Chapters 11 and 12, to be efficiently carried out.

## THE ACCOUNTING EQUATION

As we have already discussed, the business is regarded as an accounting entity separate from its owner(s). As such all business transactions must be recorded twice: first, to show the effect of the transaction on the assets belonging to the business; and second, to show the effect of the transaction on the owner(s) and other providers of finance of the business. The result is that assets will always be equal to capital plus liabilities:

$$\text{Assets} = \text{Capital} + \text{Liabilities}$$

In other words, what the business owns is equal to what the business owes.

Applying this rule to transaction (d) in Illustration 2.1, we find that its effect is as follows:

Effect on business assets:            Assets increase from zero to £6,000 as the result of the injection of cash.  
 Effect on providers of finance:    The business now has capital of £6,000 that is owed to Mr Old.

The financial effect of this transaction may be presented in a balance sheet in the following manner:

**Illustration 2.2**  
 Old Ventures  
 Balance Sheet as at 1 January 20X1

| <b>Assets</b> | <b>£</b> | <b>Sources of finance</b> | <b>£</b> |
|---------------|----------|---------------------------|----------|
| Cash at bank  | 6,000    | Capital: Mr Old           | 6,000    |

The left-hand side of the balance sheet shows that the assets belonging to the business consist of cash amounting to £6,000. The right-hand side of the balance sheet shows that Mr Old is owed £6,000. Put another way, the right-hand side shows that Mr Old has made an investment of £6,000 in the business.

We may therefore describe the balance sheet as a financial statement that shows on the one side the assets belonging to the business and on the other the way in which those assets have been financed.

Two obvious differences should be noted between the above balance sheet and that given for Marks and Spencer plc in Figure 1.2:

- 1 The balance sheet of Marks and Spencer plc contains much more information. This is because it has been in business for many years, and the balance sheet reports the accumulated financial effect of literally millions of transactions undertaken between the date of formation and 31 March 1999. Old Ventures, by way of contrast, has only just been formed and has undertaken only one transaction.
- 2 The balance sheet of Marks and Spencer plc is presented in vertical format with the assets listed *above* the sources of finance. The balance sheet of Old Ventures is presented in horizontal format with assets on the left and sources of finance on the right. Either presentation is perfectly legal but it is the vertical format that is widely adopted today. (We shall convert to the vertical layout later.)

## RAISING FURTHER FINANCE

Before a business commences operations, sufficient finance should be raised to support the planned level of activity. Too many businesses begin their lives with insufficient cash resources and most of them fail before they get off the ground. At best, the early years of a firm's life are marked by a continuous shortage of cash and much of management's time is taken up coping with cash flow problems rather than being directed towards the development of profitable trading activities.

Mr Old has made a personal investment of £6,000 in Old Ventures (see Illustration 2.2), and we will assume that he has estimated that a total initial investment of £10,000 is required to finance the planned level of business operations. He is £4,000 short and is likely to explore a number of avenues in the endeavour to obtain this sum and to place the business on a sound financial footing. One possibility is to borrow from family, friends or the bank; another is to seek government aid; and a third might involve acquiring some of the business assets on hire purchase. We will assume that Mr Old convinces his bank manager that there are good prospects for Old Ventures and on 2 January the bank lends his business £4,000. The effect of the transaction is as follows:

|                                 |   |
|---------------------------------|---|
| Effect on business assets:      | Cash increases by £4,000.                               |
| Effect on providers of finance: | Indebtedness to the bank increases from zero to £4,000. |

The equality between assets and sources of finance is retained with the increase in business assets financed by the bank loan. There are now, however, two different types of finance. The amount advanced by Mr Old, his capital, is a permanent investment that will not usually be withdrawn until the business is wound up, whereas the amount advanced by the bank is a liability that must be repaid in due course. The balance sheet below now shows that the business owns assets worth £10,000 and that these assets have been financed by capital (from Mr Old) and a

### Illustration 2.3

The revised balance sheet is as follows:

| Old Ventures<br>Balance Sheet as at 2 January 20X1 |               |                           |               |
|--|---------------|---------------------------|---------------|
| <b>Assets</b>                                      | <b>£</b>      | <b>Sources of finance</b> | <b>£</b>      |
| Cash at bank                                       | 10,000        | Capital: Mr Old           | 6,000         |
|  |               | Long-term liabilities:    |               |
|  |               | Bank loan                 | <u>4,000</u>  |
|  | <u>10,000</u> |                           | <u>10,000</u> |

bank loan. So, in accordance with the accounting equation, assets equal capital plus liabilities:

$$A = C + L$$

Readers should test their understanding of this relationship by working through Question 2.2 at the end of this chapter.

## THE INVESTMENT DECISION

It is the job of management to employ profitably the resources that have been placed at its disposal, and to carry out this function many decisions have to be made. These result in a continuous flow of cash and other assets into, through and out of the business. Accounting statements, among which the balance sheet is one of the most important, are prepared at regular intervals to enable management to monitor the results of their decisions and to gauge the extent to which they are achieving the objective of profit maximization. In the case of Old Ventures, Mr Old, when performing his managerial role, must decide how to employ the cash available to the business, i.e. he must make an investment decision. Mr Old decides to go into business as an antiques dealer and purchases on 10 January 20X1 a small warehouse for £7,000 cash. On the same day he acquired various relics, second-hand goods and memorabilia (together called his stock-in-trade) for £2,500 cash. The effect of these transactions is as follows:

Effect on business assets: Premises increase by £7,000.  
 Stock-in-trade increases by £2,500.  
 Cash at bank reduces by £9,500.

Effect on providers of finance: Zero.

Illustration 2.4 sets out the revised financial position of Old Ventures on 10 January. No additional sources of finance have been raised and the right-hand side of the balance sheet remains unchanged. The effect of the investment decision is merely to cause a reallocation of resources between business assets.

Before Old Ventures is ready to commence trading, Mr Old must make sure that his display of antiques is sufficiently extensive to attract customers into his warehouse. Let us assume that a further consignment of furniture, costing £2,000, is



**Illustration 2.4**  
 Old Ventures  
 Balance Sheet as at 10 January 20X1

| <b>Assets</b>   | <b>£</b> | <b>Sources of finance</b> | <b>£</b> |
|-----------------|----------|---------------------------|----------|
| Fixed assets:   |          | Capital: Mr Old           | 6,000    |
| Premises        | 7,000    | Long-term liabilities:    |          |
| Current assets: |          | Bank loan                 | 4,000    |
| Stock*          | 2,500    |                           |          |
| Cash at bank    | 500      |                           |          |
|                 | 10,000   |                           | 10,000   |

\* This is the commonly used abbreviation for stock-in-trade.

required for this purpose. The above balance sheet shows that the company has insufficient cash available for this purpose and an additional source of finance must be obtained. In practice, very few businesses operate entirely on a cash basis. Instead, a proportion – often a high proportion – of purchases and sales are made on credit, i.e. a period of time elapses between the dates on which goods are supplied and paid for. Normally businesses take the maximum period of credit allowed because, during this time, stock is financed by suppliers rather than by the firm itself. The period of credit allowed by suppliers varies a great deal, but 30 days is most common.

Old Ventures takes delivery of furniture costing £2,000 on 11 January 20X1. The supplier allows 30 days' credit. The effect of the transaction is as follows:

Effect on business assets:           Stock increases by £2,000.

Effect on providers of finance:   Trade creditors increase by £2,000.

The balance sheet below shows that the firm now owns assets totalling £12,000 made up of premises, stock and cash at bank. The finance has been obtained from three sources: ownership, the bank and suppliers who are described as trade creditors for balance sheet purposes. The investment made by the owners is normally permanent, while the loan is likely to be the subject of a formal agreement that covers such matters as the repayment date and the rate of interest payable. Trade creditors expect to be repaid in accordance with the normal practice of the

**Illustration 2.5**  
 Old Ventures  
 Balance Sheet as at 11 January 20X1

| <b>Assets</b>   | <b>£</b> | <b>Sources of finance</b> | <b>£</b> |
|-----------------|----------|---------------------------|----------|
| Fixed assets:   |          | Capital: Mr Old           | 6,000    |
| Premises        | 7,000    | Long-term liabilities:    |          |
| Current assets: |          | Bank loan                 | 4,000    |
| Stock           | 4,500    | Current liabilities:      |          |
| Cash at bank    | 500      | Trade creditors           | 2,000    |
|                 | 12,000   |                           | 12,000   |



Effect on business assets:      Stock decreases by £1,500  
    Trade debtors increase by £2,500.  
 Effect on providers of finance:    Capital increases by £1,000.

**Illustration 2.7**  
 Old Ventures  
 Balance Sheet as at 15 January 20X1

| <b>Assets</b>   | <b>£</b> | <b>Sources of finance</b> | <b>£</b> |
|-----------------|----------|---------------------------|----------|
| Fixed assets:   |          | Capital: Mr Old           | 6,000    |
| Premises        | 7,000    | Add: Profit               | 1,500    |
|                 |          |                           | 7,500    |
| Current assets: |          | Long-term liabilities:    |          |
| Stock           | 2,500    | Bank loan                 | 4,000    |
| Trade debtors   | 2,500    |                           |          |
| Cash at bank    | 1,500    | Current liabilities:      |          |
|                 |          | Trade creditors           | 2,000    |
|                 | 13,500   |                           | 13,500   |

It should be noticed that profit is recognized despite the fact that the price paid by the customer has not yet been received in cash. This brings us to a second assumption made by accountants when preparing accounting statements, namely, the *realization concept* (considered further in Chapter 4). This concept assumes that profit is earned or realized when the sale takes place, and the justification for this treatment is that Old Ventures now possesses a more valuable asset, since the £2,500 is a legally enforceable debt.

The trading cycle is completed by Old Ventures collecting £2,500 from Rustic Relics on 31 January 20X1 and paying £2,000 to its supplier on 8 February 20X1, 30 days after the goods were supplied.

The effects of these transactions are as follows:

Effect on business assets:      Trade debtors decrease by £2,500.  
    Cash increases by £2,500.  
    Cash decreases by £2,000.  
 Effect on providers of finance:    Trade creditors decrease by £2,000.

**Illustration 2.8**  
 Old Ventures  
 Balance Sheet as at 8 February 20X1

| <b>Assets</b>   | <b>£</b> | <b>Sources of finance</b> | <b>£</b> |
|-----------------|----------|---------------------------|----------|
| Fixed assets:   |          | Capital: Mr Old           | 6,000    |
| Premises        | 7,000    | Add: Profit               | 1,500    |
|                 |          |                           | 7,500    |
| Current assets: |          | Long-term liabilities:    |          |
| Stock           | 2,500    | Bank loan                 | 4,000    |
| Cash at bank    | 2,000    |                           |          |
|                 | 11,500   |                           | 11,500   |

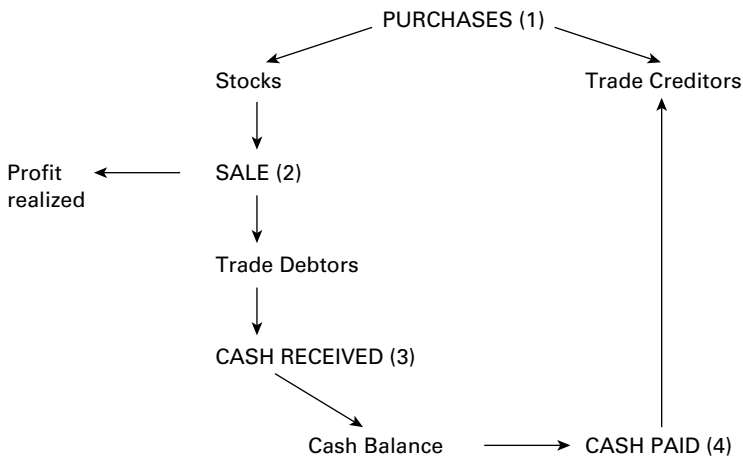


FIGURE 2.2 The trading cycle

Readers should now work through Question 2.4 at the end of this chapter.

### THE TRADING CYCLE

The single trading cycle for Old Ventures, examined above, is now complete, and can be expressed in the form of a diagram as in Figure 2.2. The cycle consists of the following four stages:

- Stage 1* The purchase of goods on credit that gives rise to balance sheet entries for trade creditors and stock.
- Stage 2* The sale of stock on credit results in a profit being realized or a loss incurred. At this stage some of the stock is replaced by trade debtors in the balance sheet.
- Stage 3* The collection of trade debts. This produces a change in the composition of the firm's assets, from debtors to cash.
- Stage 4* The payment of the amounts due to suppliers. This causes a reduction in cash and the removal of trade creditors from the balance sheet.

A comparison of the position before and after completion of the trading cycle (Illustrations 2.4 and 2.8) shows just two differences: cash has risen by £1,500 and the owner's capital investment has increased by the same amount to reflect profit earned.

The trading cycle examined above is obviously a simplified version of what happens in practice. A business does not complete one cycle before commencing another but is involved in a continuous series of overlapping business transactions. The purchases cycle consists of ordering goods, receiving them into stock

as an asset and paying for them by means of a cash outflow, while the sales cycle consists of making a sale, parting with the stocks sold as an asset outflow and collecting the money due from the customer to produce a cash inflow. Therefore even before one creditor is paid another is created and debtors are turned over in a similar manner. It is the responsibility of management to ensure that all these flows are adequately controlled and recorded. Thus no payment should be made without ensuring that the related goods or services have in fact been received, and no goods should be allowed to leave the firm except in exchange for cash or by the creation of a debt. In the latter case there must be adequate follow-up procedures to ensure that the cash is subsequently collected.

A simplified version of the trading cycle occurs when purchases and/or sales are made for cash. There are just two stages: stage 1, the purchase of goods, involves the exchange of cash for stock, stage 2, the sale of goods, involves the exchange of stock for cash of a greater or lesser value, with the amount of the difference recorded as a profit or a loss.

## REPORTING CHANGES IN OWNER'S CAPITAL

The capital section of the balance sheet records the indebtedness of the business to its owner. This indebtedness is initially created by the owner(s) advancing money to the business, but the amount changes over time – for example, a profit increases the indebtedness whereas a loss reduces the value of the owner's capital investment. The capital section also reports all other transactions between the business and its owner – for instance, it reports any additional capital investment made by the owner during the life of the business, and also the regular withdrawals of cash and goods made for personal use. The manner in which these matters are reported is shown in Illustration 2.9.

### Illustration 2.9

At the end of both February and March Mr Old withdrew £1,500 in cash for personal use. During March he sold the remainder of his stock (which cost £2,500) for £5,000 cash. In April he transferred his car into the business at a value of £2,000.

#### Old Ventures Balance Sheet as at 30 April 20X1

| <i>Assets</i>   | £             | <i>Sources of finance</i> | £              | £             |
|-----------------|---------------|---------------------------|----------------|---------------|
| Fixed assets:   |               | Capital: Mr Old           |                | 6,000         |
| Premises        | 7,000         | Add: Additional capital   |                | <u>2,000</u>  |
| Vehicle         | <u>2,000</u>  |                           |                | 8,000         |
|                 | 9,000         |                           |                |               |
| Current assets: |               | Add: Profit               | 4,000          |               |
| Cash at bank    | 4,000         | Less: Drawings            | <u>(3,000)</u> | <u>1,000</u>  |
|                 |               | (1,500 × 2)               |                | 9,000         |
|                 |               | Long term liabilities:    |                |               |
|                 |               | Bank loan                 |                | <u>4,000</u>  |
|                 | <u>13,000</u> |                           |                | <u>13,000</u> |

C. Newman started in business on 1 January 20X1 and paid £2,000 into his business bank account. On 30 June he transferred to the business his car valued at £1,400. Each week he withdrew £60 from the business in cash. The accounts prepared for 20X1 showed that his business had earned a profit of £4,100 during the year.

**ACTIVITY 2.2**

Prepare the Capital section *only* of the balance sheet, taking into account the above transactions.

The owner does not normally wait until profit is calculated before making withdrawals. He or she is often dependent on the business for his or her livelihood and profits are withdrawn, for personal use, as they are earned during the year. Where profits exceed drawings, as is the case in Illustration 2.9, the surplus of £1,000 (profit £4,000 minus drawings £3,000) is retained in the business and increases the owner's capital by an equivalent amount. These extra resources may be used to finance an expansion in the level of business operations. Illustration 2.9 also demonstrates the fact that capital may be introduced in the form of assets other than cash. The motor vehicle, transferred to the business by Mr Old, appears as an asset in the balance sheet and is matched by a corresponding increase in the value of his capital investment. Similarly, drawings may be made in a non-cash form (e.g. the family of a farmer is likely to consume some of the farm produce) though this has not happened in the above illustration.

Readers should now work through Question 2.5 at the end of the chapter.

**THE ACCOUNTING EQUATION: A FURTHER ILLUSTRATION**

In the case of Old Ventures we saw that the equality between sources of finance and assets was maintained throughout the trading cycle and, because all assets must be financed in some way, we can be confident that this equality will continue throughout the firm's life. In this context there are five basic categories of business transaction:

- 1 An increase in an asset is matched by a corresponding increase in a source of finance – for example, cash increases as the result of extra capital being invested by the owner.
- 2 An increase in a source of finance is matched by a decrease in a different source of finance – for example, a loan raised from the bank to enable trade creditors to be paid the amount due to them.
- 3 A reduction in an asset is matched by a reduction in a source of finance – for example, cash is used to pay trade creditors.
- 4 An increase in an asset is matched by a reduction in a different asset – for example, a new motor vehicle is purchased for cash.
- 5 A reduction in a source of finance is matched with a reduction in an asset – for example, the owner of a business withdraws cash from the business bank account.

A complication occurs in the case of a transaction involving the sale of goods, since this gives rise to a profit or a loss that must also be recorded. For example, assume that an item of stock which cost £80 is sold on credit for £100. In the balance sheet stock is replaced by debtors, i.e. a category 4 transaction takes place. In addition a category 1 transaction occurs, because the higher value of debtors, £20, gives rise to a profit that must be added to the owner's capital.

**ACTIVITY 2.3** Examine separately the effect of each of the following transactions on the relationship  $A = C + L$  and indicate the category of transaction being used.

- 1 The owner of a business received a legacy of £2,000 and paid it into his business bank account.
- 2 Machinery costing £3,000 is purchased for cash.
- 3 Stock is purchased on credit from ABC & Co. for £800.
- 4 A business computer is purchased for £5,000 financed by a loan from a friend.
- 5 Trade debts amounting to £750 are collected from customers.
- 6 Stock costing £1,000 is sold for £1,400 cash.
- 7 ABC & Co. are paid £220.
- 8 Stock is purchased for £350 cash.
- 9 Goods costing £1,000 are sold on credit to XYZ Ltd for £2,500.
- 10 A filing cabinet is purchased for £60 by increasing an existing bank overdraft.
- 11 The owner of a business withdrew £100 from the business bank account.

You should present your answer in the following form:

| Transaction | Assets =  | Capital + | Liabilities | Category of transaction |
|-------------|-----------|-----------|-------------|-------------------------|
|             | +, - or 0 | +, - or 0 | +, - or 0   |                         |
| Example 1   | + 2,000   | + 2,000   | 0           | 1                       |
| Example 2   | + 3,000   | 0         | 0           | 4                       |
|             | - 3,000   |           |             |                         |

Readers should now work through Question 2.6 at the end of this chapter.

## VALUATION OF ASSETS

The balance sheet contains a list of assets belonging to the company and, for each category, a value is given. For example, a freehold property may be shown in the balance sheet at £50,000. What does this value represent? If a lay person were asked this question, it is quite likely that he or she would say: 'It is what the asset is worth.' This seems reasonable on the face of it, but it leads to further questions, such as: Worth to whom? At what point (i.e. past, current or future) are you valuing the worth? For what purpose (i.e. to retain in the business or to sell in the short term) is the asset being held?

There are four possible methods for valuing assets, although we will see that only one of these normally finds favour with the accountant. The four methods are as follows:

- 1 *Historical cost.* The asset is valued at its original purchase price.
- 2 *Replacement cost.* The asset is valued at the amount it would cost the business to buy at the balance sheet date.
- 3 *Realizable value.* This is the price at which the asset could be sold at the balance sheet date. It differs from replacement cost, as anyone who has ever attempted to sell, say, a second-hand motor vehicle will know.
- 4 *Present value.* This is a little more complicated and is the present value of cash expected to be generated, in the future, as a result of owning a particular asset. The estimated cash flows are discounted, at a rate of interest, to take account of the fact that £1 receivable, say, in one year's time is worth rather less than £1 receivable immediately. In other words, the future stream of income is translated into what it is worth today.

The appropriate method of valuation depends on the purpose for which it is required. If the company is contemplating the acquisition of an asset, purchase price is the most relevant. The replacement cost of an asset is likely to be of interest if the existing asset is worn out. Realizable value is relevant if there is an intention to sell the asset in the near future, while the present value calculation should be made if the asset is to continue in use for some time generating a stream of cash flows stretching into the future.

In general, assets are shown in company accounts at their *historical cost* less, in the case of fixed assets, a reduction to reflect wear and tear (depreciation) that has occurred since the acquisition took place.

At first glance this is a little surprising. The analysis in the preceding paragraph shows that although historical cost is of interest at the date of the initial purchase, it is the other valuation methods, particularly market price and present value, that are likely to be more relevant when a balance sheet is prepared at some subsequent date. Why is historical cost so popular? Perhaps the main reason is that this figure is readily available. Most assets are purchased on credit and are entered in the books at their historical cost so as to provide a record of the amount to be paid to the supplier at some future date. Once the figure is in the books it is simply convenient to use it for the purpose of preparing the balance sheet. Many people believe that this is not a sufficient justification for continuing to use historical cost. For example, it seems quite ridiculous to report a building in the balance sheet at £27,000 – the price paid ten years ago – if the building could today be sold for, say, £127,000. But this is what is done. This limitation should be borne in mind when assessing the usefulness of information appearing in accounts. The alternatives to historic cost, however, can be used and we shall look at these later.



**ACTIVITY 2.4** Lexington owns a fleet of cars that are rented to customers. One of the cars was purchased a couple of years ago for £7,000. The company has discovered that it could purchase a car in similar condition, today, for £5,000 from the local distributor. Cars no longer needed by Lexington are usually sold to employees. It is estimated that the car costing £7,000 would now sell for £3,800.

The company's intention is to retain the vehicle as part of its fleet for one year. It will be rented to a single customer for an annual rental of £2,000, payable in arrears. The car will then be immediately sold for £3,000. Assume the rental arises at the end of the year and that future cash flows have to be discounted at 10 per cent in order to convert them into an equivalent present value.

**Required** Valuations of the car on the following bases:

- (a) historical cost;
- (b) replacement cost;
- (c) realizable value; and
- (d) present value.

**QUESTIONS** 2.1 Indicate which of the following transactions relate to Clive's business as a newsagent and which are his personal transactions:

- 1 £50 win on Premium Bonds owned by Clive.
- 2 £100 paid for the following advertisement on a hoarding at the local football ground: 'Clive's for all the up-to-date news'.
- 3 Payment to the newspaper wholesaler, £1,260.
- 4 Sale of unsold newspapers to a local fish-and-chip shop.
- 5 Purchase of a new car for family use, although it will be used each morning to collect papers from suppliers.

2.2 John decides to start up in business on 1 April 20X1, and pays £4,000 from his private bank account into a newly opened business bank account. On 2 April 20X1 John's father loans the firm £600 to help with the new venture, and this amount is paid immediately into the business bank account. On 4 April the firm borrows £150 from John's friend, Peter. This amount is kept in the form of 'ready cash' to meet small business expenses.

**Required** Balance sheets for John's business after the transactions on:

- (a) 1 April; (b) 2 April; (c) 4 April.
- 2.3 Roger starts up in business on 1 September 20X0 with a capital of £1,200 which he pays into his business bank account on that day. The bank agrees to provide him with a business overdraft facility of £1,500 for the first three months. The following business transactions take place:

- 2 Sept A machine is bought, on three months' credit, from Plant Suppliers Ltd for £750. £1,000 is borrowed from the Endridge Local Authority, which is keen to encourage this type of enterprise.
- 3 Sept £1,820 is paid for a second-hand machine. Stock is purchased, for £420 cash.
- 4 Sept Stock is purchased, on credit, for £215.

Balance sheets for Roger's business following the transactions on:

**Required**

- (a) 1 September; (b) 2 September; (c) 3 September; (d) 4 September.

**2.4** The following balance sheet was prepared for Jeff's business at 1 October 20X0. The firm has an overdraft facility of £700.

Jeff  
Balance Sheet as at 1 October, 20X0

|                        | £     |                            | £     |
|------------------------|-------|----------------------------|-------|
| <b>Fixed assets:</b>   |       |                            |       |
| Machinery              | 2,200 | Capital                    | 5,300 |
| <b>Current assets:</b> |       | <b>Current liabilities</b> |       |
| Stocks                 | 2,870 | Trade creditors            | 690   |
| Trade debtors          | 800   |                            |       |
| Cash at bank           | 120   |                            |       |
|                        | 5,990 |                            | 5,990 |

Jeff enters into the following transactions:

- 2 October Sells goods that cost £120 for £200 cash. Sells goods that cost £240 for £315 on credit.
- 3 October Collects £150 from customers. Purchases stock for £190 on credit.
- 4 October Pays trade creditors £75. Purchases a machine for £600 cash.

Balance sheets for Jeff's business following the transactions on: (a) 2 October; (b) 3 October; (c) 4 October.

**Required**

**2.5** (a) Prepare the balance sheet of Daley from the following list of assets and liabilities at 31 December 20X1:

|                   | £     |
|-------------------|-------|
| Cash              | 1,750 |
| Stock             | 5,250 |
| Owed by customers | 3,340 |
| Owed to suppliers | 2,890 |
| Business premises | 9,000 |
| Loan from Weakly  | 3,000 |

Remember, Assets = Capital + Liabilities.

- (b) Prepare the balance sheet of Daley's business at the end of each of the first seven days of January, taking account of the following transactions:

January 20X2

- 1 Purchased, on credit, a typewriter for office use, £500.
- 2 Received £190 from a customer.
- 3 Paid a supplier £670.
- 4 Purchased stock, on credit, £260.
- 5 Sold goods that had cost £350 for £530 cash.
- 6 Repaid Weekly £1,000 of the balance due to him (ignore interest).
- 7 Withdrew stock costing £100 for private use.

- 2.6 Prepare balance sheets to determine the amount missing from each of the following columns of balances at 31 December 20X1:

|                       | <b>A</b> | <b>B</b> | <b>C</b> | <b>D</b> | <b>E</b> | <b>F</b> |
|-----------------------|----------|----------|----------|----------|----------|----------|
|                       | <b>£</b> | <b>£</b> | <b>£</b> | <b>£</b> | <b>£</b> | <b>£</b> |
| Capital at 1 Jan 20X1 | 2,500    | 2,000    | 3,000    | 4,000    | 3,800    | ?        |
| Profit for 20X1       | 1,000    | 3,200    | ?        | 5,700    | 2,300    | 7,000    |
| Drawings during 20X1  | 800      | 3,000    | 1,000    | 4,900    | ?        | 4,500    |
| Current liabilities   | 750      | ?        | 600      | 1,300    | 1,700    | 2,100    |
| Fixed assets          | 1,800    | 1,750    | 2,800    | ?        | 3,700    | 8,500    |
| Current assets        | ?        | 850      | 1,200    | 1,900    | 1,600    | 3,500    |

- 2.7 Review your understanding of the following concepts and terms discussed in this chapter by writing a short explanation of each of them:

- 1 Accountancy
- 2 Entity concept
- 3 Balance sheet
- 4 Realization concept
- 5 Trade credit
- 6 Trading cycle and credit transactions
- 7  $A = C + L$
- 8 Owner's capital
- 9 Money measurement concept
- 10 Fixed assets
- 11 Current assets
- 12 Current liabilities
- 13 Gross assets
- 14 Historic cost

**2.8** For a fish-and-chip shop, indicate which of the following items are current liabilities, which are current assets and which are fixed assets:

- 1 Microwave oven
- 2 2,000 kilos of King Edward potatoes
- 3 Cash register
- 4 Amount owing to the Fat Fishy Company Ltd
- 5 Capital investment of Mr V. Greasy, owner
- 6 Mrs Greasy's pearl necklace and gold wrist-watch
- 7 250 mackerel
- 8 Loan from V. Greasy's father, repayable in two years' time
- 9 Last instalment due, in one month's time, on the microwave oven acquired on hire purchase
- 10 Shop rented from a property company

For items not classified as current liabilities or current assets or fixed assets, describe how they would be reported in the balance sheet, if at all.

**2.9** The following list of balances relate to the business of C. Forest at 31 December 20X2:

|  | £      |
|--|--------|
| Plant and machinery                    | 26,500 |
| Stock                                  | 14,200 |
| Loan repayable June 20X3               | 2,500  |
| Capital of C. Forest at 1 January 20X2 | 52,380 |
| Trade creditors                        | 10,600 |
| Trade debtors                          | 14,100 |
| Cash-in-hand                           | 270    |
| Bank overdraft                         | 3,940  |
| Profit for 20X2                        | 12,600 |
| Owner's drawings during 20X2           | 10,950 |
| Loan repayable 20X9                    | 9,000  |
| Premises                               | 25,000 |

The balance sheet of C. Forest's business at 31 December 20X2 presented in good style.

**Required**

## SOLUTIONS TO ACTIVITIES

Business transactions: (a), (c) and (d).

Personal transactions: (b) and (e).

*Solution to  
Activity 2.1*

Solution to  
Activity 2.2

|                          | £       | £     |
|--------------------------|---------|-------|
| <b>Financed by:</b>      |         |       |
| Capital (2,000 + 1,400)  |         | 3,400 |
| Add: Profit              | 4,100   |       |
| Less: Drawings (60 × 52) | (3,120) |       |
|                          |         | 980   |
|                          |         | 4,380 |

Solution to  
Activity 2.3

| Transaction | Assets  | = | Capital | + | Liabilities | Category of transaction |
|-------------|---------|---|---------|---|-------------|-------------------------|
| 1           | + 2,000 |   | + 2,000 |   | 0           | 1                       |
| 2           | + 3,000 |   | 0       |   | 0           | 4                       |
|             | - 3,000 |   |         |   |             |                         |
| 3           | + 800   |   | 0       |   | + 800       | 1                       |
| 4           | + 5,000 |   | 0       |   | + 5,000     | 1                       |
| 5           | - 750   |   | 0       |   | 0           | 4                       |
|             | + 750   |   |         |   |             |                         |
| 6           | - 1,000 |   | + 400   |   | 0           | 4 and 1                 |
|             | + 1,400 |   |         |   |             |                         |
| 7           | - 220   |   | 0       |   | - 220       | 3                       |
| 8           | + 350   |   | 0       |   | 0           | 4                       |
|             | - 350   |   |         |   |             |                         |
| 9           | - 1,000 |   | + 1,500 |   | 0           | 4 and 1                 |
|             | + 2,500 |   |         |   |             |                         |
| 10          | + 60    |   | 0       |   | + 60        | 1                       |
| 11          | - 100   |   | - 100   |   | 0           | 5                       |

Solution to  
Activity 2.4

|   |       |
|---|-------|
| (a) Historical cost = £7,000, less deduction for wear and tear or depreciation suffered since the date of purchase. |       |
| (b) Replacement cost = £5,000   |       |
| (c) Realizable value = £3,800   |       |
| (d) Present value =   |       |
| Rental income at the end of year 1 (2,000 × 1/1.1*)   | 1,818 |
| Sale proceeds at the end of year 1 (3,000 × 1/1.1)  | 2,727 |
|   | 4,545 |

\*The effect of this fraction is to discount the future cash flows to an equivalent present value using an interest rate of 10 per cent. Looked at another way, £4,545 invested at 10 per cent for one year increases to £5,000 (£4,545 × 1.1), which is the cash expected to be received if the asset is retained for use within the business.