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Financial Management – Assets And Liabilities (Definitions, Recognition Criteria And Bases Of Measurement)

Manpreet Kaur[1]

Abstract

There are various definitions of Assets and Liabilities in vogue. The variation is mainly due to treatment of depreciation, use of asset in different situations, accounting principles and practices followed. in different countries. Of late, under the arrangement of WTO compliance and consequent upon global cooperation, accounting principles and audit standards are being redefined for better understanding of corporate financial statements that form the bases for taking various kinds of decisions in the financial and investment world. Initiatives have been taken, mor in the offing, to arrive at consensus about uniformity of approach to recognition, treatment, valuation and accounting principles and practices in the financial community and business world.

Key words: Assets, liabilities, depreciation, financial statements, international accounting and audit standards, research and development.

1.RESEARCH SCHOLAR, PTU, JALANDHAR

Introduction

Globalisation process is believed to be about ushering in free trade that will ensure close business relations among nations through membership of monitoring and compliance body – WTO – and thus bringing countries closer in economic relationships. But the concept does not end here. It is a continuous process just as life on the 'Earth Planet' is always in a flux, ever changing, thanks to natural phenomena and the research results in science and technology. All codes, rules, guidelines, procedures and practices about accounting and auditing are going to become global and thus uniform, comparable and enabling dependency in socio-economic and business normative relationships. All countries have to move to become integral part of this process and be also integral part of the world family with humane dealings and full of human values in relationships for ensuring happy and prosperous life to each individual in all societies. Accounting practices and audit standards will be different from their current definitions. Time is to come sooner than later.

Objectives of the study:

It was an humble attempt:

(i) to describe, discuss and analyse Assets and Liabilities, as classified in the annual financial statements; and
(ii) to reach own conclusion about definitions, recognition criteria and measurement bases of Assets and Liabilities.

Approach adopted: The approach adopted in this study was to accessing material on the Internet, study of articles in International Journals on the subject and recourse to relevant text books and reference books.

Review of current literature:

Asset as it stands presently defined: The author is research student. His opinion is that goods, in the control of an entity or goods forming the property of a business enterprise including the commitments owing to it by other entities in money terms are its assets. In other words, briefly stated, anything usable as asset that enables a business enterprise to get economic benefit in future is truly an asset. Finney & Miller define Assets as: "Assets are future economic benefits, the rights of which are owned or controlled by an organization or individual"

The characteristic of assets as per the above definition is that resources of an entity must yield economic benefit to qualify as assets; their value must be measurable and verifiable too.

According to Khan (2007, 3.28), "Asset is a valuable resource owned by a firm acquired at measurable money cost". The definition is too brief.

Bruce (2003, pp. 42-46), in his article "Asset Management: Providing solutions in Difficult Times", quoted Grantham, "If an asset class is below its valuation level, it will outperform over the longer term and, if above, it will underperform".

Schuman (2005, pp. 566-579), in his article, "Asset Life Cycle Management: towards improving physical asset performance in the Process Industry", gave findings as: "Operational reliability and systems engineering are the means to achieve optimum value from physical assets over a facilities life time".

Arbidane (2012, NA) says, in his article on Education about control over Assets that "Increasingly important in the control system acquires an objective need time to identify problems and determine most current options for managing the assets".

Existing Definition of Liability

IABS Framework, Paragraph 49 states liability as "A liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits"

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FASB Framework, CON. 6, Paragraph 35,states liability as "Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events"

Finney & Miller define "Liabilities are debts; these are amounts owed to creditors"

Deegan (2011, p.64) Essential characteristic of liability is that the entity has present obligation, which is duty or responsibility to act or perform in a certain way. Obligations may be legally enforceable as a consequence of a binding contract or statutory requirement"

Khan (2007, 3.30) says that liabilities are "Liabilities are the claims of outsiders against the firm". It is too simplistic a definition to lend itself to analysis and interpretation.

Characteristics of liability: it is created by past transaction or other event, must be paid off in future in the form of economic benefits to other entities, and there must exit some other obligation in the present.

BASES OF ASSET RECOGNITION

Assets: Deegan(2011,p.65) treats the subject and says that the issue of various provisions has been in AASB Framework that when a provision involves a present obligation and satisfies the rest of the definition, it is a liability even if the amount has to be estimated. In view of this, I opine that an asset is recognized in the financial statement as certain (not probable) to give economic benefits; will increase inflow or reduce outflow. It should not turn out to be 'non-performing' asset. Its inherent quality is that it possesses cost or other value; value must be reliably measurable. In other words, supporting this opinion, Assets are certain, acquired for deriving or enhancing economic benefits, they should be kept healthy. Assets – visible or invisible - increase inflows or reduce outflows in the future but their use must begin in the present. Again, each asset should continue to give performance in terms of economic benefits. I suggest that an asset may be reduced in value when realizable value falls short of the depreciated value. Fair value will be computed in the same manner for all categories of assets.

Liabilities: Deegan (2011, p.65) deals the recognition part of liabilities and says that recognition criteria for liabilities are consistent with recognition criteria for assets. As if supporting this contention, paragraph 91 of AASB Framework states: "A liability is recognized in the balance sheet when it is probable that an outflow of resources embodying economic benefits will result from settlement of a present obligation and

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the amount at which the settlement will take place can be measured reliably". Paragraph 91 of AASB Framework also mentions that commitments under contracts that are equally unproportionately underperformed (for example, liabilities for inventory ordered but not yet reached) are generally not recognized as liabilities in the financial report. However, such obligations may meet the definition of liabilities and, provided the recognition criteria are met in the particular circumstances, may qualify for recognition of liabilities entails recognition of related expenses or assets.

I have found that liabilities are also in the nature of provisions, contingent liabilities, unforeseen expense, etc. - both tangible and intangible. Liability is present obligation or contractual obligation or commitment made by an entity for gaining economic benefit in the future; the liability is extinguished in the future only. I also find that current liabilities are met within the operation cycle; the accounting period end-stock is evaluated at cost or market/realizable value, whichever is lower. Long-term liabilities are met either by periodical repayments as per contract with interest or in lump-sum. Asset-Liability matching takes care of all liabilities, recognized at face value if no penal provision contained in contract has become applicable or operative.

Measurement bases for Assets and Liabilities

The usual equation is: Assets = Liabilities + Equity

This is the algebraic formula for accounting equation followed everywhere.. To a layman, the accounting equation presents the most convenient and the easy picture to judge the financial position of a business because for a common man, business is just a sum of what it has (Assets) and what it has to pay off (Liabilities). We can say that Assets and Liabilities are akin to two sides of the same coin. Both are interrelated, interdependent and the importance of either cannot be undermined.

Historically, the terms - assets & liabilities - were used in wider sense in accounting .The scope and usage of these words was limited. But due to technological changes, these terms underwent frequent changes .With passing time, the rationality and transparency of these terms has increased. The biggest change came with the implementation of IFRS. Changing business environment due to technological advances and application of IT as well as globalization process seeking to integrate national economies into global economy are set to lead to more transparency, comparability and fuller disclosure in financial statements , as IFRS also seeks to initiate, and that will change the definitions too of Assets and Liabilities. India too is moving towards fair value accounting practices i.e. assets and liabilities should be shown at current value or fair value as at the Balance Sheet date instead of historical cost concept, followed earlier.

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It is relevant to make reference to Australia which is one of the most advanced countries and is seen keen to switch over to globally recognized accounting standard. Australia has adopted IASB standards and its Framework. Financial Statements are expected to result in fair presentation in the financial statements. Within the AASB Framework, prudence is expected to be exercised to observe degree of caution for exercising judgments required for working estimates under uncertainty conditions for fair presentation of value of assets and liabilities in the financial statements.

Recognition of Assets

Recognition of an item as asset, liability, revenue, expense or the like is the process of formally recording or incorporating it in the accounts and financial statements of an entity. An asset is recognized in the financial statement on the clear understanding rather condition that it is certain (not only probable) that economic benefits will materialize in future activities. It is inherent property of the asset that it must possess cost or other value and that value must be reliably measurable.

Assets are acquired for getting economic benefit no sooner than they are purchased, not only in future; and benefit should be continuous, not one time shot. Initially, however, cost incurred and other overheads will make up the value of an asset. Subsequently, each asset should continue to give performance in terms of economic benefits. Asset may have to be reduced in value when realizable value falls short of depreciated and market value. Fair value will be computed in the same manner for biological assets.

Recognition of Liabilities: Liabilities are in the nature of provisions, contingent liabilities, unforeseen obsolescence, contingent assets, etc. – both tangible and intangible. Thus liability is nothing but present obligation or contractual obligation or commitment undertaken by an entity in the interest of gaining economic benefit in the present and continuing into the future and to redeem the liability in the future. While on meeting the obligation under the liability to extinguish it, there will be outflow of funds or goods or rendering of service equivalent, as committed earlier and there is thereby expected economic benefit in the present and future.

Current liabilities are met within the operation cycle. Long-term liabilities are met either in instalment with interest (Equated Monthly Instalments) or in lump-sum as contacted.

Measurement of Assets and Liabilities

Despite application of depreciation, using suitable/appropriate models for working out fair price, the assets sometimes may not be evaluated precisely correctly. It may be

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due to change in technology that those assets and liabilities may not be fully used for generating economic benefits; they may just be abandoned as outmoded. Assets have to be measured in terms of fair value; it implies that depreciated value or market value (realizable value) has to be taken into account (depreciation is the process whereby cost is allocated, not an evaluation process). Assets have to be reported at fair value with full transparency and complete disclosure.

Moreover, liabilities are based on contract or commitment and these remain unchanged in money value if all conditions are met by suppliers or creditors or bankers and the entity. These are reported in the financial statements at face value in normal circumstances.

Analysis

Assets: I find that the existing IASB and FASB definitions suffer from some shortcomings and have been made and kept static whereas technology has advanced tremendously ahead whereby dynamism is called for. These definitions anchored to IASB, FASB and AASB need to be changed. The working definition of Asset should be like this: "An asset is a resource controlled by a business entity for present and future economic benefits in continuity, having stability in its capability to yield economic benefits".

The assets are the most fundamental realities for use in the economic world; these are more like phenomena. The financial reporting seeks to portray the assets as all results spring forth with asset-utilization.. We can not keep the definition of an asset so vague as to allow others to interpret as they please. Financial reporting will then be at risk of being undermined.

The IASB and FASB definitions of asset, together with explanations of how the proposed new definition seeks to mitigate these shortcomings - "expectation" in case of the IASB definition and "probability" in case of FASB definition do not make future benefits certain; there is uncertainty. Definition should be robust.

IASB and FASB have defined assets indicating future benefits from them with 'likelihood' or 'expectation'. The Boards included these words with the intent of indicating that the item in question need not be certain.

With a view to avoid this continued misinterpretation on the basis of 'likelihood' and 'probability' in the definitions given by the two boards in their Frameworks, the

working definition does not admit of any dependence upon an assessment of likelihood. The economic benefits focus on identifying a future flow of economic benefits for the existence of an asset. It is not thought to be the right kind of focus as asset must first exist in the present.

The working definition replaces 'future economic benefits' with 'present economic resources' that exist as reality. The use of 'economic resources' rather than getting 'economic benefits' in the working definition indicates that the item is in the category of 'stock', rather than a flow. Stocks are used in the present; and so, the item must first exist in the present. Further, I opine that some scholars place undue emphasis on identifying the past transaction or event that produced an asset.

Regarding 'control', an entity should have the ability to use the asset for getting future economic benefits. The term 'control' can otherwise mean different things at different dates.

As far as the contractual promises are concerned, it presents a complex situation when to treat contractual promises as assets and when not. Who will decide as to which features of Assets might tell precisely the distinction between those promises that are assets and those that are not assets.

In the current definition, probability of future economic benefit (result of process) is loudly pronounced. There is apprehension that the assets, existing in the present, may not lie in the control of the entity and it may not be able to use them for getting future economic benefit.

Liability: I suggest that liabilities should mean "present commitments and promises or sacrifices based on past and present events or other economic transactions made in money terms for debts raised or credits availed or contractual obligations undertaken to do something of money value or make sacrifice measurable in money terms, both current and future, including contingencies and unforeseen or sudden expenses, which have to be met on due dates; evaluated at the face value or equivalent of expense in case of maintenance, repairs, overhauls, and intangibles, etc. in conditions of uncertainty which bedevil operating conditions many times".

Liabilities do arise mostly in the past and redeemed in the future. But they can arise in the present also. They occur due to need to support assets and thereby operations. But they can spring a surprise when expenditure is required to be suddenly incurred to tide over an emergency due to faults in plant or delay in receiving supplies and alternative arrangements are to be made. Contingencies do arise sometimes. Impairment of asset as consequence of natural calamity may give rise to liability. Liabilities are met out of inflows in the future, sometimes in the present operating cycle too.

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Conclusion

Suggested Definition of Assets and Liabilities

I am of the opinion that an asset is a resource controlled by the entity. It happens to be in place as a result of the past events and transactions. Besides, future economic benefits are not only expected but also certain to flow to the entity. I also agree that there should be undisputed control of asset with the entity, assets grow as benefits from past events and transactions, and also that the benefits will accrue in the present as well as in the future.

Liability is a present obligation of the entity; it also arises from past events. The settlement of the liability is not only expected but also sure to result in an outflow of resources from the entity, with few exceptions where situations turns suddenly hostile and liability has to be incurred to tide over stringency. The outflows represent economic benefits to other entity (ies).

Criteria for Recognition of Assets: An asset is asset that assures the entity that economic benefits will (inflows) result from its employment in future activities. It exists in the present and starts giving benefits from the present normally, extending into the future. Generating benefit should be certain, continuous, not one time shot.

Criteria for Recognition of Liabilities: Liabilities arise due to commitment to give economic benefit to other entities for matching benefits derived by the entity which creates liabilities. Liabilities are thus promises, contractual obligations, and customary business practices, and include provisions, contingencies, unforeseen obsolescence, and huge expenditure for overhauling plant, maintenance and other unpredictable expenses and requirements.

Liability is thus nothing but present obligation or contractual obligation or business commitment undertaken by an entity in the interest of gaining economic benefit in the present and the future, and to redeem the liability in the future, as agreed. On meeting the obligation under the liability to extinguish it, there will be outflow of funds or goods or rendering of service equivalent in money value; there is definite/certain economic benefit in the present and future thereby.

Measurement of Assets and Liabilities

Valuation is in fact the process of measuring assets on the basis of their past, present or future characteristics; measurement may be for individual item or class of assets.

Fair value of assets appears to be the reasoned measurement for reporting in the financial statement. Situation may force this measurement when cost minus depreciation of an asset is more than its realizable value.

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Initially, however, purchase price (cost) will constitute value of an asset. Subsequently, each asset should continue to give economic benefits. Asset may have to be reduced in value when realizable value falls short of the depreciated value. Fair value will be computed in the same manner for biological and other kinds of assets.

I find that, despite application of depreciation, using suitable/appropriate models for working out fair price, the assets sometimes may not be measured for their economic benefits precisely correctly. Measurement is decidedly a broader concept that valuation; many types of attributes are involved in measurement. We can not avoid measurement in terms of fair value; it implies that depreciated value or realizable value has to be taken into account. Corporate Governance demands that Assets are reported at their fair value with full transparency and complete disclosure.

Liabilities are based on contracts or commitments and these remain unchanged in money value if all conditions are met by suppliers or creditors or bankers and the entity and conditions to be followed turn into impossibility of performance. These are reported in the financial statements at face value in normal circumstances.

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