LEARNING GOAL 3

Define and Identify the Two Claims on Assets

Overview

Introduction

In the previous learning goal, you learned how to identify business assets. In this learning goal, you will learn who gets to claim these assets and why . . . and it is not always just the owner!

Rules for Claims on Assets

- There is always at *least* one kind of claim on business assets—the owner's.
- There are never more than two possible claims—the owner's and the creditors'.

"Equity" Means a Claim

Equity, as used in business, means the legal right to claim the value of assets. Another way of expressing the same idea is to say that equity means a legal claim on the business wealth.

In Learning Goal 3, you will find:

The Owner's Claim and the Creditors' Claims

The Owner's Claim and the Creditors' Claims

Owner's Equity and Creditors' Equity Defined

Two Possible Kinds of Equity

There are two kinds of legal claims on assets:

- The owner's equity
- The creditors' equity

Definition of Owner's Equity

Owner's equity is the owner's legal claim on the value of business assets. This is the most basic claim on the assets. There is always an owner's equity for every business.

Other terms used for owner's equity are ***net worth*** and ***net assets***.

Example of Owner's Equity

Ramos Enterprises has a $10,000 value of various kinds of assets, consisting of cash, accounts receivable, supplies, equipment, and so on. Andy Ramos (the owner) has the legal right to claim the entire $10,000 value of the business assets for himself if there are no business debts to pay.

Definition of Creditors' Equity (Liability)

Creditors' equity is a legal claim on the value of business assets by a creditor. This kind of claim is usually called a ***liability***. Liability simply means a debt of the business.

Examples of Liabilities

- An unpaid bank loan (the bank is the creditor)
- Amounts owing to suppliers (for items purchased on credit)
- Wages owing to employees (who are creditors until they are paid)
- An unpaid telephone bill (the telephone company is the creditor)

What Is the Amount of a Liability?

The amount of a liability is the unpaid value of the resources provided. When a business fully pays a creditor, the liability disappears.

Owner's Equity and Creditors' Equity Defined, *continued*

Examples: Not Liabilities

- A company purchases various items of office supplies and pays cash. The seller is fully paid, so no liability exists.
- A contract is signed for $5,000 of accounting services to be received next month. No resources (services) have yet been provided, so no liability exists.
- Totally defective supplies are received from a seller. No acceptable resources (supplies) have yet been provided, so there is no liability to the seller.

Check Your Understanding

Write the completed sentences on a separate piece of paper.

.... is the owner's claim on the value of the business assets. Other terms that mean the same are .... and .... The word .... is used to describe the total creditors' equity claim on assets. If a business purchased $900 of supplies and paid $500 to the seller, a liability of $ .... would exist. The creditors' claims have (higher/lower) .... priority than the owner's claim.

Answers

Owner's equity is the owner's claim on the value of the business assets. Other terms that mean the same are net worth and net assets. The word liabilities is used to describe the total creditors' equity claim on assets. If a business purchased $900 of supplies and paid $500 to the seller, a liability of $400 would exist. The creditors' claims have higher priority than the owner's claim.

Why the Two Claims Exist

Overview of the Two Claims

Directly or indirectly, the owner and the creditors provide all the resources to a company, both assets and services.

- *The owner* invests his/her own assets into a business. The owner also invests services—time and energy—and by doing this creates a business operation that adds value and obtains wealth from customers.
- *Creditors* directly supply both assets and services to a business.

Why Owner's Equity Exists

The owner's equity claim exists because the business belongs to the owner.

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Why the Two Claims Exist, *continued*

Why Creditors' Equity Exists

The creditors' equity (liabilities) exists because the creditors provided goods and services resources to the business that the business has not yet paid for.

When . . .	and . . .	then . . .
resources are provided by someone other than the owner	the resources are not immediately paid for,	a liability is created (creditor's equity).

Claims Are Usually on the Total Assets

The liability claims and owner's equity claim are normally against the entire dollar value of all assets, up to the amount of the claim, and not against the value of any specific asset.

Exception: Sometimes a creditor's claim may be "secured" by a particular asset. This means that a creditor has the right to seize and sell a particular asset to pay a debt, if the debt is not paid on time. The particular asset is said to be ***security*** for the debt.

TIP

A supplier of goods or services is sometimes called a ***vendor***. "Vendor" means the same as "seller."

Compare the Claims

The Most Important Difference

Owner's equity claim and the liability claim are different in several ways, which are listed for you in the comparison table on page 52. However, the *most important difference* is that they do not have the same priority for payment.

Liabilities Have First Priority

Liabilities have first priority over owner's equity. This means that if a business does not have enough assets to pay both the creditors and the owner, then the creditors must be paid first.

If all liabilities are fully paid, any remaining asset value can be claimed by the owner.

Compare the Claims, *continued*

Examples of Liability Priority

- Tishomingo Enterprises has a $10,000 bank loan coming due this week. The owner must make sure there is sufficient asset value to pay the loan before considering how much asset value might be available for himself.
- Wilmington Company has $90,000 of assets and $50,000 of liabilities. The company decides to cease operations and go out of business. Therefore, all company debts are now due and payable. The owner must wait and make sure that all the debts are fully paid before he can claim any of the asset value for himself.

Owner's Equity Is Residual

Whenever there are liabilities, the owner's equity is the amount of asset value that would be left over if all the liabilities were fully paid. Therefore, the owner's equity is always a residual amount. The formula is:

Assets – Liabilities = Owner's Equity

Example of Owner's Equity Residual

The accounting records of Georgetown Company show $52,000 of total assets and $35,000 of various liabilities. To calculate the amount of the owner's equity, calculate the value of assets that would be left over if the business were to pay off all its liabilities: $52,000 – $35,000 = $17,000 owner's equity.

TIP

Sometimes when a business is liquidated (sold), the assets will sell for more or less than what is shown in the accounting records. That will make the liquidating owner's equity be more or less than what was recorded.

continued ►

"It says: 'There are no more than two kinds of claims on assets.'"

Compare the Claims, *continued*

Liabilities Compared to Owner's Equity

This table compares the three important characteristics of liabilities and owner's equity.

Compare . . .	Liabilities . . .	Owner's Equity . . .
priority of payment	always have first priority	is second priority
when it must be paid	▪ the day a debt becomes due, according to its terms, or ▪ when the business terminates	has no requirement to be paid at a particular time—it is a residual
intended risk	none, because the creditor expects to be fully paid	resources that are invested can be lost

TIP

Sometimes the word "liability" is confused with the word "expense." We discuss expenses in Learning Goal 6. "Liability" only means a debt.

Check Your Understanding

Write the completed sentences on a separate piece of paper. The answers are below.

There are two kinds of claims on the assets of a business. The owner's claim is called · · · · · · · · · · · · · · · · and the creditor claims are called · · · · · · · ·. Directly or indirectly, the owner and the creditors together provide all the · · · · · · · · to a company, both assets and services.

The (owner's equity/liabilities) · · · · · · · · always has (have) legal priority for payment. Claims are usually against (total assets/a particular asset) · · · · · · · ·.

Answers

There are two kinds of claims on the assets of a business. The owner's claim is called owner's equity and the creditor claims are called liabilities. Directly or indirectly, the owner and the creditors together provide all the resources to a company, both assets and services.

The liabilities always have legal priority for payment. Claims are usually against total assets.

Management of a Business Changes the Owner's Equity

Good Management

Regardless of whether an owner manages a business or employs other people to manage it, management can be good or bad. Good management will cause the business assets to grow because the managers will operate the business so it will create and sell more value than the value of resources it uses up. When assets increase this way, owner's equity also increases.

Bad Management

Bad management will cause the business to use up more resource value than the value that is created and sold. This will cause assets to decrease as more resources flow out than come in. When assets decrease this way, owner's equity decreases.

Example Using Equation

Good: Assets ↑ = Liabilities + Owner's Equity ↑

Bad: Assets ↓ = Liabilities + Owner's Equity ↓

QUICK REVIEW

- There are only two possible types of claims on business assets:
  - creditors' claims, which are called liabilities.
  - owner's claim, which is called owner's equity.
- The owner's equity exists because the owner owns the business and provided assets and services to the business. The creditors' claim exists because the creditors provided assets and services which have not been paid for.
- The claims do not have equal rights; the creditor always has priority. This means:
  - Debts must be paid when they are due.
  - Debts have first claim if a business is liquidated.
- Liabilities are normally against the entire total dollar value of the assets.
- The most important cause of change in the owner's equity is the manner in which a business is managed.

VOCABULARY

Equity: a claim on asset value (page 47)

Liability: a debt; a creditor's claim on assets (page 48)

Net assets: a synonym for owner's equity (page 48)

Net worth: a synonym for owner's equity (page 48)

Owner's equity: an owner's claim on assets (page 48)

Security: the particular asset or assets a creditor can claim for nonpayment of a debt (page 50)

Vendor: any seller of goods or services (page 50)

PRACTICE

Learning Goal 3

Solutions are in the disk at the back of the book and at: www.worthyjames.com

Learning Goal 3 is about identifying the claims on assets. Use these questions and problems to practice what you have learned about a business.

Reinforcement Problems

LG 3-1. What creates and changes claims on assets? Claims on the wealth of a business (the assets) result from only two providers of resources.

a. Who are these two providers of resources? What do they provide?

b. Why do they have claims on the wealth of a business?

c. Why isn't the owner's claim equal to the value of whatever assets the owner invested minus the value of whatever the owner has withdrawn?

d. Do the owner's services have a fixed dollar value, like wages of an employee?

LG 3-2. Explain changes in equities.

a. A supplier sells merchandise to a business for $800 on credit. Does the supplier have a claim on the assets? How much?

b. A computer repair service charges a business $500 on credit for repairs made. Does the repair service have a claim on the assets? How much? If the business later pays $100 of the liability, does the claim change?

c. An owner invests $5,000 in his small video store. Does this affect the owner's claim on the assets? By how much?

d. The owner of a video store invests 500 hours of his time managing the store. He thinks his time is worth $30 per hour. Does this affect the owner's claim on assets? By how much?

LG 3-3. On a separate piece of paper, write a short, clear definition of "owner's equity."

LG 3-4. On a separate piece of paper, write a short, clear definition of "liabilities" and give three examples.

PRACTICE Learning Goal 3, continued

Solutions are in the disk at the back of the book and at: www.worthyjames.com

LG 3-5. YOU be the teacher! While I was writing this book, a student made the following suggestion about how to describe the meaning of equities. He said:

> "Why not just say that equities are a claim against assets because the equities are the source of those assets? So, you could look at equities as *simply direct sources of assets and also as claims on assets.* That's all there is to it!"

I appreciated his good suggestion, but why is he not quite complete in his description of equity claims? How do I answer him? (*Hint:* Is there more than one kind of resource that a business has to pay for?)

LG 3-6. Explain the priority of liabilities. "The creditors' liability claims always have priority over the owner's claim." Does this mean that an owner cannot withdraw money from his business until he pays off all the debts first?

LG 3-7. Identify the kind of claim. For each separate item described, indicate if it is a creditors' equity claim or an owner's equity claim. Use a blank sheet of paper to complete the table.

Description of Equity Characteristic	Creditors' Equity	Owner's Equity
a. It always has the first claim on assets.	(Reminder: Use a separate sheet of paper to complete the table.)	
b. It is increased by the owner's hard work and risk-taking.		
c. It is usually called "liabilities."		
d. It is known as a "residual" claim on assets.		
e. They are the debts of the business.		
f. It is increased when the owner invests in his/her business.		
g. It is created when someone other than the owner provides assets or services to the business that are not immediately paid for.		
h. Together they always add up to the total amount of assets.		

Your Questions?

It is *very* important to be aware of what you need to understand better. What do you need to understand better about this learning goal? On a separate piece of paper, write the questions that you want to discuss with your classmates, instructor, or supervisor. Try to be very specific about what is bothering you, such as explanations that you do not fully understand.