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## Assets and Liabilities

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## ASSETS AND LIABILITIES

*Type of economics:* Monetary and fiscal theory

*Fields of study:* Accounting and monetary theory

*Assets represent things of value that are owned by a household, firm, or government. Liabilities are debts that are owed by a household, firm, or government. Each year, trillions of dollars of assets and liabilities constitute an enormous worldwide capital market that is based on the flows of savings and investments.*

### *Principal terms*

**BALANCE SHEET:** a financial statement that summarizes the assets and liabilities associated with an institution at a given point in time

**CURRENT ASSETS:** any asset that can be converted to cash within a year

**DEPRECIATION:** the decrease in the value of capital because of its wearing out with use or the passage of time

**FINANCIAL ASSETS:** paper claims or IOUs that are held against another household, firm, or government

**LIQUIDITY:** the degree to which an asset can be converted into cash

**REAL ASSETS:** capital or manufactured items, such as equipment and buildings, used in the production of other goods and services

### **Overview**

Anything that is owned by a household, business firm, or government that has economic value is regarded as an asset. Assets can be divided into two general categories—real and financial. Real assets consist of manufactured, physical items such as equipment, manufacturing plants, warehouses, office buildings, and inventories of goods and supplies. The term “capital” is often used interchangeably with real assets. Financial assets are paper claims against another household, firm, or government. IOUs are financial assets to those who own them, as are investments in savings deposits, mutual funds, government securities, bonds, and corporate stocks.

Households, business firms, and governments frequently have to borrow money from others to purchase or acquire assets. Moneys that are owed to someone else are called liabilities. Liabilities are contractually binding debts that must be repaid. One person’s liability is another’s financial asset.

The monetary value of assets and liabilities of a household, firm, or government is calculated at a given point in time. The financial statement that summarizes this information is the balance sheet. Sometimes the balance sheet is called a statement of financial condition, a statement of financial position, or a net worth statement. Net worth is the difference between an institution’s assets and liabilities and is also referred to as owner’s equity.

When the monetary value of assets equals corresponding claims of ownership on those assets by creditors (liabilities) and owners (equity), a balance sheet is considered balanced. Thus, assets equal liabilities plus an owner’s equity. This is another

way of stating that an institution's assets have been purchased with money supplied by either creditors (debt capital) or owners (equity capital). An institution's portfolio is its overall combination of assets and liabilities.

Liquidity, the characteristic of assets that is of concern to portfolio managers, is the ease with which an asset can be converted into money (or cash). Having quick and ready access to cash is especially important to institutions with significant expenses to pay. The most liquid assets include currency and deposits in checking accounts. Accountants normally regard any asset, such as an investment or inventory that can be converted into cash within a year, as a current asset. Economists often refer to financial assets, such as time deposits and money market fund accounts, as near moneys. Near moneys are similar to money in many ways except that they lack liquidity. Assets such as land, buildings, and equipment usually take longer than a year to convert into cash. These assets are fixed assets that remain in use year after year in order to produce or sell other goods and services.

As with assets, there are similar classes of liabilities. Liabilities that fall due and must be paid within one year are considered to be current liabilities. Accounts payable, notes payable, and accrued wages are examples of current liabilities. Liabilities that come due beyond one year into the future are described as long-term liabilities and include such items as mortgages, long-term loans, and bonds.

### Applications

Savings are translated into investments or the accumulation of capital in capital markets. Households, firms, financial intermediaries, and the government are all involved. Financial intermediaries are firms such as commercial banks, savings and loan associations, and credit unions, whose main business is taking deposits and using them to make loans or buy securities. Insurance companies are another type of financial intermediary that use household savings to provide insurance, establish pension funds, and buy stocks or bonds.

Households can invest savings in capital through direct ownership of proprietorships and partnerships, through the direct purchase of stocks or bonds, or indirectly through deposits with financial intermediaries that make this money available to firms by purchasing stocks and bonds. Thus, firms acquire money to invest in capital by selling stocks or bonds to households or financial intermediaries and by taking out loans with financial intermediaries. Governments also sell bonds to finance their operations.

The United States' capital markets are of enormous size. There are trillions of dollars of assets and liabilities that make up the nation's balance sheet. By the late 1980's, the total financial assets for all sectors of the U.S. economy were approximately \$25 trillion. Almost half of these financial assets were owned by households. In addition, total capital assets for all sectors of the economy were approximately \$12 trillion. Not only is the scale of these markets huge, but so is the volume of transactions that takes place in these markets. It is common for 100 million to 200 million shares of stock to be traded each day on the New York Stock Exchange. On what is



often referred to as "Black Monday"—October 19, 1987—more than 600 million shares of stock were traded.

Balance sheet information regarding assets, liabilities, and net worth can also provide insight into the financial performance of an individual institution. Comparing balance sheets from one year to another can help measure changes in an institution that, in turn, may assist in identifying institutional strengths or weaknesses. For example, assume that in the following information taken from the balance sheet of a business firm at the end of two successive years of operation, the first number equals values for the first year and the second number equals values for the second year: cash, \$100,000 and \$50,000; inventories, \$200,000 and \$400,000; buildings and equipment, \$700,000 and \$650,000; outstanding loans, \$200,000 and \$400,000; and owner's equity, \$800,000 and \$700,000. This information allows the calculation of current assets (cash plus inventories), \$300,000 and \$450,000; and total assets, \$1,000,000 and \$1,000,000. While this business has grown in size (based on total assets) from the first year to the second, comparing the two balance sheets identifies some possible concerns including the reduction in cash reserves, the doubling of inventories, and the doubling of debt. These balance sheet items could be compared to other aspects of the firm including sales and profits to get a more complete perspective on the firm's economic performance.

### Context

Assets and liabilities deal directly with a fundamental concern in economics—the production of goods and services to satisfy economic wants. People have always relied on real assets to expand the quantity of output above and beyond that which can be produced with labor alone. The supply of capital (real assets) is financed through people's savings or their financial assets. The productive capacity and wealth of a firm or nation at any one point in time is influenced by the stock of capital in its possession.

Additions to the capital stock are needed over time, because capital wears out and investments in new assets are needed to maintain or increase production capabilities. The declining value of capital because of its use or the passage of time is known as depreciation. A number of macroeconomic policies can influence the willingness and ability of firms to make capital investments. Policies that affect interest rates are important because interest rates represent the cost of borrowing money to acquire new real assets. Lower interest rates decrease the cost of relying on creditors for funds and, hence, encourage debt financing of real assets. In addition, the government can and has promoted business firm capital investment decisions by offering firms investment tax credits or expanding the rate at which firms can deduct depreciation expenses from their taxable income.

### Bibliography

Downey, W. David, and Steven P. Erickson. *Agribusines Management*. New York: McGraw-Hill, 1987. This book contains several chapters that provide an excellent

overview of the management of assets and liabilities within a business firm. The authors' discussion of a firm's balance sheet presents a concise description of the different types of assets and liabilities, as well as techniques for analyzing the liquidity and profitability of the firm. Designed for the practicing manager but very readable for general audiences as well.

Horvitz, Paul M., and Richard A. Ward. *Monetary Policy and the Financial System*. 6th ed. Englewood Cliffs, N.J.: Prentice-Hall, 1987. Horvitz gives a thorough, yet nontechnical, description of financial intermediaries with emphasis on commercial banks while also including savings and loan associations, credit unions, and insurance companies. The different types of financial assets and liabilities are explained. Also contains a number of chapters devoted to a summary of monetary theory and monetary policy for those interested in the macroeconomic aspects of the financial system.

McEachern, William A. *Economics: A Contemporary Introduction*. Cincinnati: South-Western, 1988. Chapter 13 of this book provides a superb analysis of assets and liabilities, especially those of depository institutions. McEachern explains the concepts of money, near moneys, and liquidity. Through simplified balance-sheet illustrations, the reader is made aware of the different assets and liabilities that banks have to manage as well as how they relate to the money supply.

Parkin, Michael. *Economics*. Reading, Mass.: Addison-Wesley, 1990. Chapter 17 describes the structure of capital markets in the United States, including both the demand for and supply of capital. Parkin distinguishes financial assets from real assets. Using a flow diagram, he illustrates clearly how households, firms, and financial intermediaries interact with one another to translate savings into investments in capital markets. A balance sheet for the nation is also presented, helping the reader to appreciate the size of U.S. capital markets and to understand the relative role played by households, firms, and financial intermediaries.

Weston, J. Fred, and Eugene F. Brigham. *Essentials of Managerial Finance*. 9th ed. Chicago: Dryden Press, 1989. One of the bibles in its field, this book presents the manager's perspective on nearly all aspects of managerial finance, including financial statements, financial analyses, and the management of assets and liabilities. In addition, the book explains how various tax policies may influence capital investment decisions. Designed primarily for use as a college text but should be quite readable for nonspecialists, too.

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### Cross-References

Capital Budgeting, 239; Capital Goods and Investments, 251; Capital Theory, 257; Depreciation and Depletion, 547; The Investment Tax Credit, 1173; Liquidity, 1293; Portfolio Theory, 1743; Saving, 2050; Wealth: An Overview, 2431.