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Equity as a fundamental economic category in light of accounting standards

1. Introduction

Enterprises should pursue their activities in a manner enabling them to achieve the assumed goals. What is a long-term financial goal of business entities is increase in equity. Equity serves financing assets necessary for starting and pursuing a business activity. It is a source of achieving growth of the funds committed by owners and covering losses, if any. Therefore, various stakeholders in an enterprise are interested in the value of equity. Equity, as one of the basic economic values describing long-term enterprise performance, needs to be determined in a proper manner. The measurement of equity and the factors affecting its level is handled by accounting. This is because such a measurement should be conducted in a credible and reliable manner, in accordance with specific principles, standards and laws. The information concerning the value and structure of equity, as well as its changes over a period, is disclosed in financial statements. This information is used by stakeholders in an enterprise when assessing its financial position and making economic decisions.

The present paper is devoted to the issues of equity recognition in the accounting system

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of an enterprise. The aim of this paper is to present the essence of and the manner of determining equity as a synthetic measure of long-term enterprise performance and presenting the information about it in financial statements. This aim has been achieved based on the overview of the Polish and foreign literature on accounting as well as Polish and international regulations (standards and laws) on accounting and financial reporting.

2. Equity as the basic financial category subject to measurement in accounting

The measurement of performance achieved by a business entity is one of the basic tasks carried out by accounting (Nowak 2013). Accounting is oriented towards measuring various financial data related to determining the asset and capital position, as well as the achieved accounting profit. One of such basic financial categories subject to measurement in accounting is equity.

Equity is a fundamental economic category which shapes the financial position of a business entity. Therefore, equity is one of three primary balance sheet components that are subject to regulation by accounting and financial reporting standards. Two other balance sheet components are assets and liabilities. Moreover, equity is subject to regulation by the Polish Code of Commercial Partnerships and Companies.

Accounting standards, which are conceptual assumptions, standards or laws, do not offer an explicit definition of equity. Yet it was specified in accordance with the so-called residual equity theory (Dobija 2010, p. 18). Hence, accounting standards comprise an indirect manner of defining equity, that is by indicating the method of its determination.

Equity is a resultant of two other economic categories occurring in the balance sheet, that is assets and liabilities. Definitions of these balance sheet components are provided in *The Conceptual Framework for Financial Reporting* developed by the International Accounting Standard Board. Similar definitions were adopted in Poland under the Accounting Act. From the viewpoint of accounting and financial reporting, it is important to identify assets and liabilities, which are primary categories with respect to equity, in order to determine equity.

Definitions of assets and liabilities provided in *The Conceptual Framework for Financial Reporting*, which are crucial for determining equity, will be quoted here (*International*… 2011, pp. A44-A55). An asset is a resource controlled by an entity as a result of past events and from which future economic benefits are expected to flow to the entity. A liability, in turn, is a present obligation of an entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

The definition of equity worded by the International Accounting Standard Board in *The Conceptual Framework for Financial Reporting* reads as follows: equity represents the residual amount after all the liabilities have been deducted from the assets of an entity (*International*… 2011, p. A44). The definition adopted in the Polish Accounting Act is similar: equity corresponds to net assets in value terms, i.e. assets of an entity reduced by liabilities (*Act*… 2000, Article 3 par. 1 subpar. 29). This means that accounting identifies equity in the balance sheet with the net asset value, which is the residual amount of assets after all liabilities of an entity have been settled.

The concept of equity adopted in accounting can be described with the following identity equations (Buk 2011, p. 19):

ASSETS = EQUITY & LIABILITIES
ASSETS = EQUITY + LIABILITIES
EQUITY = ASSETS – LIABILITIES
EQUITY = NET ASSETS

Determining equity based on the assets and liabilities recognised in the balance sheet allows the specification of its value. The point of departure for this valuation is the values of assets and liabilities of an entity. This is because the value of equity disclosed in financial statements depends on methods of valuating these two categories. It is important that the definitions of assets and equity & liabilities provided in accounting standards are fairly unambiguous. What is a greater problem in accounting is identifying liabilities. Principles and methods of valuating their individual components are also specified. This makes valuation of equity possible.

Equity is a complex economic category. The structure of equity and the nature of its components depend on factors such as the legal & ownership form and specificity of the activities pursued by a business entity. This causes certain problems related to determining its amount. Each equity component is associated with specific valuation principles in accounting regulations and presentation methods in financial statements. Definitions of equity specified by accounting standards are applicable to all types of entities. The equity valuation method depends on the adopted concept, which is the subject of discussion in the next section of this paper.

3. Equity and accounting profit in light of international standards

Equity is closely related to another category subject to measurement in accounting – accounting profit. Generally, it can be assumed that profit is achieved when the equity (asset) value is higher at the end of a period than at its beginning (Hicks 1975, p. 172). The manner of defining accounting profit depends on the adopted capital concept and, in consequence, on the concept of capital maintenance (Hendriksen E.S., Van Breda, 1992, p. 296).

Two concepts of capital are indicated in *The Conceptual Framework for Financial Reporting*:

1. concept of financial capital,
2. concept of physical capital,

with which concepts of capital maintenance are always related:

3. concept of financial capital maintenance,
4. concept of physical capital maintenance.

The relations between the said concepts are presented in table 1.

The concepts of capital maintenance describe the relations between concepts of capital and concepts of profit. This is because they constitute a point of reference for profit determination. Generally, it can be stated that an entity maintains its capital when its value at the end of a given period is equal to its value at the beginning of this period. All excess of the amount necessary to maintain the capital from the beginning of the period constitutes profit. In other words, profit is the part of asset increase that constitutes the amount necessary to maintain the capital. Thus defined profit constitutes return on capital (*International*… 2011, A55).

Table 1. Concepts of capital and capital maintenance versus profit

Concept	Financial concept	Physical concept
Concept of capital	The term „capital" is synonymous to the terms „net assets" and „equity"	Capital is operating capacity of an entity expressed by productive capacity
Concept of capital maintenance	Profit is achieved when the financial (or monetary) value of net assets at the end of a period exceeds the financial (or monetary) value at the beginning of the period, excluding any and all payments for owners and contributions made by owners over the period	Profit is achieved when the productive capacity (or operating capacity) of an entity (or resources or funds needed for achieving such capacity) at the end of a period exceeds the productive capacity at the beginning of the period, excluding any and all payments for owners and contributions made by owners over the period

Source: own work based on *International*… 2011, p. A55

A similar position regarding the issue of relations between equity and accounting profit is presented in the Statement of Financial Accounting Concepts (SFAC) developed by the US Financial Accounting Standards Board. The standard *„Elements of Financial Statements"* (SFAC No 6, 1985) defines accounting profit as all changes in equity of an entity during the reporting period as a result of transactions and other events with non- owners.

International Financial Reporting Standards do not impose an accounting model, i.e. concepts of capital and capital maintenance, on entities. However, when maintaining accounts and preparing financial statements, the financial concept is broadly applied. Polish regulations provided for in the Accounting Act are also based on the concepts of financial capital and capital maintenance. Therefore, further discussions in this section will concern this particular concept.

When preparing financial statements in accordance with the concepts of financial capital and capital maintenance, the problem of applying appropriate units of measurement arises. Pursuant to *The Conceptual Framework for Financial Reporting*, capital maintenance can be measured with:

a) nominal monetary units,
b) constant purchasing power units.

If equity is defined in terms of nominal monetary units, profit represents the increase in nominal money capital of net assets over a period. If, in turn, equity is defined in terms of constant purchasing power units, profit represents only that part of the increase in money capital of net assets that exceeds the increase in the general level of prices. The Polish Accounting Act adopts the concept of equity valuation by the nominal value. This concept is normally used also by business entities pursuing their activities abroad.

In accordance with the concept of financial capital maintenance based on nominal valuation, profit represents the increase in nominal equity over a period as a result of the pursued activities. This increase can be expressed with the following formula:

$$\Delta E = E_1 - Eo,$$

where:
E_1 – nominal value of equity at the end of a period,
Eo – nominal value of equity at the beginning of a period,
ΔE – increase in equity over a period.

Increase in equity can be expressed also as a result of changes in the balance of two balance sheet components: assets and liabilities. It is presented by the following formula (Dobija, 2011, p. 19):

$$\Delta E = \Delta A - \Delta L,$$

where:
ΔA – asset value change over a period,
ΔL – liability value change over a period.

Hence, a business entity gains profit if the increase in the asset value exceeds the increase in liabilities over a given period.
Increase in equity can be also associated with the revenue generated and the expenses incurred. For the purpose of presenting this association, definitions of revenue and expenses formulated in International Accounting Standards.
Revenue represent increase in economic benefits over a given period in the form of:
- increase in the asset value, or
- decrease in the liability value.

Revenue causes increase in equity.
Expenses, in turn, represent decrease in economic benefits over a given period in the form of:
- decrease in the asset value,
- increase in the liability value.

Expenses cause decrease in equity.
Using these relations, the following relations between equity increase and revenues and costs can be formulated:

$$\Delta E = S - C,$$

where:
S – revenues,
C – expenses.

This relation is at the same time the basic formula for profit, which is the difference between the revenue generated and the expenses incurred.
An analysis of the relations presented in this section is a method for detecting sources of increase in equity committed to the activities pursued by an enterprise. This is because the increase in the equity value is a long-term goal of an enterprise,

which is important to various stakeholders, and particularly to owners. This goal should be reflected in the activities oriented towards improving effectiveness of using the asset and financial resources held. This is the essence of the value-based management concept, that is management oriented towards increase in the value for stakeholders in an enterprise.

Hence, it is the information about the value and structure as well as changes of equity that is significant in value-based management. An important source of this information is undoubtedly obligatory financial statements. The next section of this paper is devoted to these issues.

4. Financial statements as a source of information about equity

Various stakeholders in a business entity – both external and internal ones – are interested in the information about equity. The primary carrier of the information about the value, structure and changes of equity is obligatorily prepared annual financial statements. Equity is one of the crucial components of financial statements of business entities.

Equity is a broad economic category comprising more detailed subcategories of a specific economic content. Classification of equity in financial statements reflects various rights of specific stakeholders. These rights concern: the ownership of a business entity, receiving dividends and returning the capital contributed by them. Moreover, it indicates legal and other limitations which condition equity division or its other use.

Creating certain equity components (e.g. share capital, supplementary capital in companies) is required by the law (e.g. the Polish Code of Commercial Partnerships and Companies). Creating other equity components (e.g. reserve capital in companies) is regulated by articles of association of a business entity. The case is similar with dividing (using) certain equity components. However, equity classifications specified in accounting and financial reporting standards are universal and applicable to various business entities.

Information about equity with division into its components are to be found in various parts of financial statements. Carriers of such information include:

- the balance sheet,
- the statement of changes in equity,
- notes.

For business entities in Poland, the balance sheet and notes are obligatory components of financial statements. The statement of changes in equity is prepared only by those entities whose annual financial statements are subject to mandatory audits conducted by auditors. This means that these are larger business entities.

International Accounting Standards and International Financial Reporting Standards do not specify templates for the enumerated components of annual financial statements. These standards, however, point to the information which have to be disclosed in financial statements. This refers also to the information regarding equity. Yet international standards lack unambiguous assignment of individual types of information to the abovementioned components of financial statements.

The equity structure in the balance sheet adopted in Poland is as follows:

1. Share capital,
2. Called up share capital,
3. Own shares,
4. Supplementary capital,
5. Revaluation capital,
6. Other reserve capitals,
7. Previous years' profit (loss),
8. Net result.

The balance sheet is statistical accounts. Therefore, what is disclosed there is balances of individual equity components for the closing day of present and previous financial year. The level of the listed equity items may, however, change under the influence of various transactions and events occurring in an enterprise. The most common causes of such changes include (Buk 2012):

- contributions made by owners,
- equity redemption,
- net profit or net loss,
- update of values of certain asset items,
- changes in the accounting principles (policy) adopted by an entity.

The enumerated events result in changing the values of specific equity components between the beginning and end of the reporting period. Such changes ultimately reflect the increase or decrease in the value of net assets over the period. Certainly, equity structure of a given business entity also undergoes changes. The information about it is disclosed in the statement of changes in equity.

There is compliance between the amounts of the respective equity components disclosed in the statement of changes in equity and in the balance sheet in the group of equity at the beginning and at the end of the financial year. This statements discloses also information about these revenue & profit and expense

& loss items which were charged directly against equity, excluding the profit and loss account. The information presenting the equity balance at the end of the period after taking the proposed profit distribution or manner of covering losses into consideration. Specific information disclosed in the discussed statement refer to the impact of accounting principles (policy) on equity and adjustments of the so-called fundamental errors caused by events from previous years charged against equity.

The general structure of the statement of changes in equity is as follows:

I. Opening balance of equity (OB)
+/- adjustment of fundamental error
Ia. Opening balance of equity (OB) after adjustment
II. Closing balance of equity (CB)
III. Equity including proposed profit distribution (loss coverage)

The statement presents specific equity items disclosed in the balance sheet in detail in the following arrangement:

Opening balance of equity
changes in equity
increase (due to)
………………………
decrease due to
………………………
Closing balance of equity.

The scope and specificity of the information presented in the statement of changes in equity are significantly higher than those disclosed in the balance sheet. The information about equity components disclosed in the balance sheet are more synthetic in nature. What is particularly important is the information about the directions (increase and decrease) of changes and their causes, which are absent from the balance sheet. Additionally, the statement of changes in equity discloses also the information which is not presented in the balance sheet and which an entity may but does not have to disclose in notes.

The business entities which are not required to prepare the statement of changes in equity present certain data about changes in specific equity items in notes, in the section of notes and explanations. What needs to be disclosed there is particularly data regarding the opening balance at the beginning of the financial year, increase and use, as well as the closing balance of supplementary and reserve capitals. Moreover, the information concerning net profit distribution and loss coverage for a financial year needs to be disclosed. The scope of the information to be disclosed in notes is much broader than that presented in the statement of changes in equity.

Various stakeholders in a business entity show interest in the information regarding equity and its changes. This information is particularly significant to investors, both current and prospective ones. This is because investors from stakeholder groups incur the highest risk related to investing capital in a given enterprise. In exchange for the risk taken, they expect an adequately high return on investment in the form of dividends or increase in the market price of shares. This is critical when taking decisions about retaining, purchasing or selling financial instruments.

Management staff of a business entity is also interested in the information about equity. They are responsible for protecting the resources entrusted with the entity by investors and multiplying the share capital made available thereto. The management staff and managers of a given business entity make economic decisions directed at achieving its long-term goal, which is value maximisation for owners, to which equity corresponds. Equity changes reflect the efficiency and effectiveness of the operations carried out by the management board and managers, fulfilment of the obligations related to protecting and using resources of a particular business entity and increasing the originally invested and, if applicable, additionally contributed capital by investors.

Other important stakeholder groups in a business entity include lenders and contracting parties (suppliers and recipients). They are also among those who find the information about equity and its changes significant when evaluating results and making business decisions about the enterprise. Hence, the significance of such information for various stakeholders in a business entity cannot be overestimated.

5. Conclusion

The measurement of enterprise performance is one of the basic tasks of accounting. Equity is a special financial category subject to measurement in the accounting system. The significance of equity in the activities pursued by an enterprise is so great that the method of its determination is specified in accounting regulations. The manner of presenting the information about equity is indicated in the financial reporting regulations, particularly in International Financial Reporting Standards and the Polish Accounting Act. Owing to these regulations, the information about equity, its level and structure are characterised by reliability and relevance. This is because the information about equity is used by stakeholders in an enterprise when making economic decisions.

Abstract

Equity as a synthetic measure of enterprise performance in light of accounting standards

Equity is one of the fundamental economic categories which describe the financial position of an enterprise. Equity is a synthetic and complex value which is formed under the influence of multiple factors. The volume and structure of equity depends not only on the actions taken in various areas of activities pursued by a given enterprise but also on external factors. The information about equity is used by various stakeholders in a given enterprise when making economic decisions. Therefore, the method of determining equity and presenting information about it is subject to Polish and international accounting and financial reporting regulations. The present paper presents the essence of equity as a synthetic measure of enterprise performance in light of accounting standards and laws.

***Keywords*:** *equity, financial reporting, accounting standards, financial position assessment.*

Streszczenie

Kapitał własny jako fundamentalna kategoria ekonomiczna w świetle standardów rachunkowości

Kapitał własny jest jedną z podstawowych kategorii ekonomicznych opisujących sytuację finansową przedsiębiorstwa. Kapitał ten jest wielkością syntetyczną i złożoną, kształtującą się pod wpływem wielu czynników. Wielkość i struktura kapitału własnego zależy nie tylko od działań podejmowanych w różnych obszarach aktywności przedsiębiorstwa, ale także od czynników zewnętrznych. Informacje na temat kapitału własnego są wykorzystywane przez różnych interesariuszy przedsiębiorstwa przy podejmowaniu decyzji ekonomicznych. Dlatego sposób ustalania kapitału własnego i prezentowania informacji na jego temat podlegają regulacjom rachunkowości i sprawozdawczości finansowej o zasięgu krajowym i międzynarodowym. Artykuł niniejszy ukazuje istotę kapitału własnego jako syntetycznej miary finansowych rezultatów działalności przedsiębiorstwa w świetle norm rachunkowości o charakterze standardów i przepisów prawnych.

***Słowa kluczowe*:** *kapitał własny, sprawozdawczość finansowa, standardy rachunkowości, ocena sytuacji finansowej.*

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