What are Assets & Liabilities in Accounting? Definition & EXAMPLE

The words “asset” and “liability” are two very common words in accounting/bookkeeping.

Some people simply say an asset is something you own and a liability is something you owe. In other words, assets are good, and liabilities are bad. That’s not wrong, but there’s a little more to it than that. Let’s look at a complete definition.

What is Assets in Accounting?

Assets are defined as resources that help generate profit in your business. You have some control over it.

To make your famous cream cake, you need your oven. These two things are examples of **assets.**

To be an asset it has to satisfy three requirements:

- It’s something you have control over
- You have control as a result of a past event
- It has a future economic benefit

Now, let’s say after you got your loan of $10,000, you went out and bought a new oven. But not just any oven. You bought the latest and greatest model. You bought the Bakemaster X Series 3000.

Let’s see if your new Bakemaster fits the requirements of an asset.

Something you have control over?

You paid for it didn’t you? You can keep it, you can sell it, you can even bake your shoes in it if you want to! Yep, it’s in *your control.*

As a result of a past event?

In this case, going to the store and handing over your cash will constitute a *past event*.

Has a future economic benefit?

With your new Bakemaster, you’re going to be baking some serious cream cakes which customers are going to pay top dollar for. That’s definitely a *future economic benefit*.

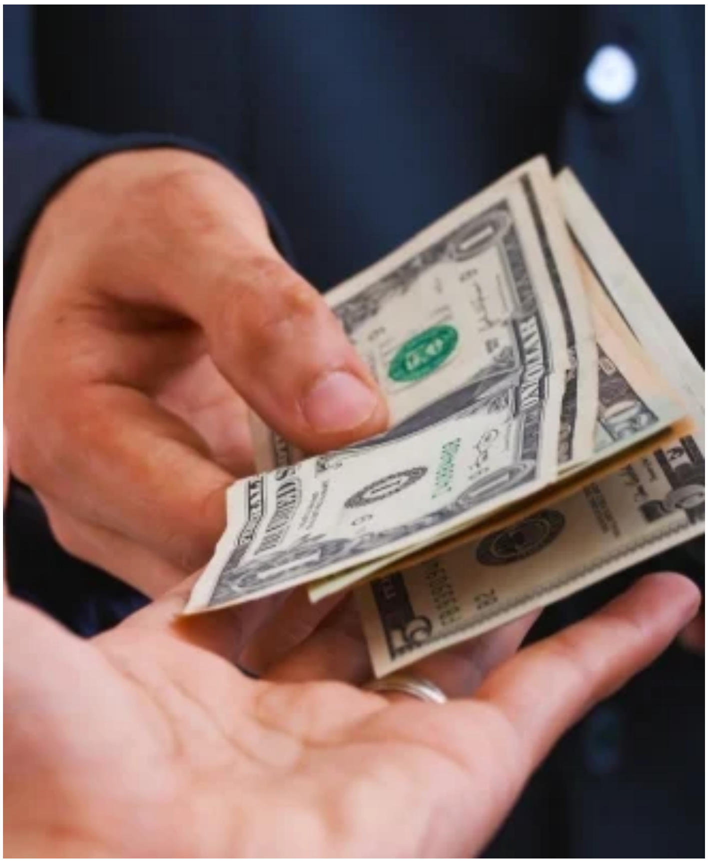
Because your new oven meets three requirements, it’s an asset.

Now let’s take a look at an example, where something might not fit the definition of an asset.

Example

A customer calls your store and says he had a dream about your cakes. He says he's coming in tomorrow to spend $1,000 in your bakery on every lemonade buttercream flavored treat he can find.

You think the $1,000 should be recorded as an asset in your records.



Let's see if it fits the definition of an asset.

Something you have control over?

Sorry, you don't have the $1,000 yet. You can't spend it. You can't even touch it! *not in your control.*

As a result of a past event?

The event needed for you to gain control of that cash will be when he comes in and hands it to you. Hasn't happened yet though! So in this case, *no event has taken place.*

Has a future economic benefit?

$1,000 can buy a lot of things. Of course, it has a future economic benefit.

Sorry, but this time you're only 1 for 3. The $1,000 holds a future benefit, However you do not have control of the money and the past events needed for you to gain control have not occurred yet.

Therefore, **the $1,000 is not an asset.**

Another example:

Your friend lets you borrow his car as a delivery vehicle. However, one night the road is slippery and your driver crashes into a tree. The car is completely damaged and is no longer drivable. Let's see if the car is an asset:

Something you have control over?

The car doesn't belong to you. It was lent to you by a friend, and you didn't sign a lease or contract giving you any rights to the car. Therefore, *the car is not in your control.*

As a result of a past event?

The event needed for you to gain control of the car is you signing an agreement and paying to purchase the car or rent it. Sorry, but *no such event has taken place.*

Has a future economic benefit?

The car is completely damaged and cannot be driven. *It won't be providing a future economic benefit for anyone.*

Sorry, but this time you're 0 for 3. The car is not an asset.

Hopefully, that gives you an understanding of assets and when you recognize them. But what about liabilities?

Let's take a look.

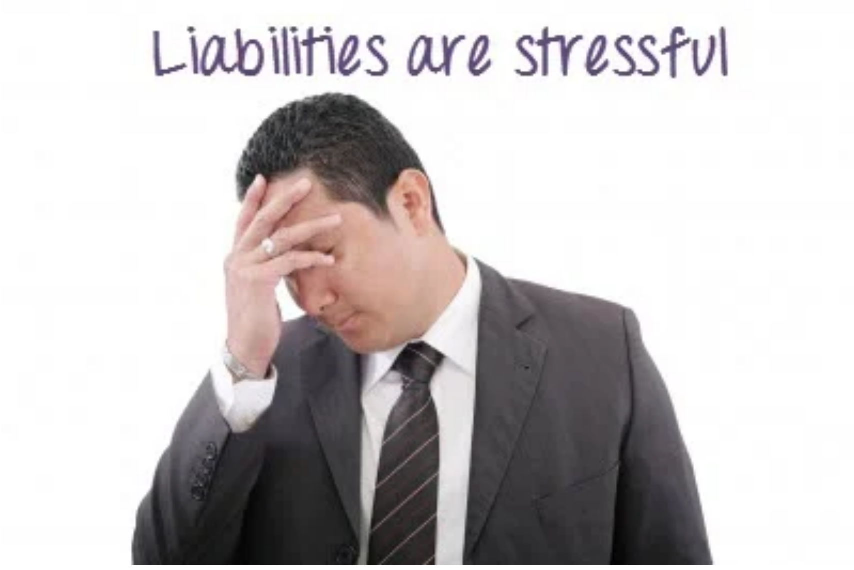
What is Liabilities in Accounting?

Liability is defined as obligations that your business needs to fulfill. In simple words, Liability means credit.

A liability requires three things:

- Presents the business with an obligation
- The Obligation is a result of past events
- Settling the obligation will require an outflow of valuable resources

Remember when Anne decided to give you that loan? Well, before you walked out of the bank, she said to you, "You're going to need to pay $1,000 each month until the whole $10,000 is paid back!"



Let's see if the loan from Anne fits the definition of a liability.

Presents the business with an obligation?

You took the money. Now you're required to pay it back! presents *an obligation*.

As a result of past events?

You signed the loan agreement. The obligation comes as a result of this *past event*.

Requires an outflow of valuable resources?

Paying back the loan requires the outflow of money. Money is valuable! That's certainly an *outflow of valuable resources*.

Bingo! The loan satisfies all the requirements, so we'll be recording it in our books as a liability.

Example

The sink in your store is leaking. One of your staff takes a look at it and tells you that you'll definitely need a plumber to come in and fix it, which will cost you around $200. You want to list the $200 as a liability in your records.

Let's see if the $200 fits the definition of a liability.

Presents the business with an obligation?

You are not obliged to pay anybody at this stage. The leaking sink is simply an inconvenience which you can either choose to fix or not to fix. Therefore there's no obligation to the business...yet.

As a result of past events?

You'll need to call the plumber and receive the $200 invoice before any liability can be recognized. This event hasn't occurred yet!

Requires an outflow of valuable resources?

With no obligation to pay anybody just yet, no outflow of resources should be expected.

Luckily for you, the $200 doesn't fit the requirements for liability. You can keep this one off your records!

Activity:

Think about the stuff you have in your life. Perhaps you drive a Ferrari, or maybe you simply ride a bicycle. Maybe you own a mansion, or maybe you live at the bottom of the ocean in a submarine. Either way, you probably needed a mortgage for it. In this case, your Ferrari would be an example of an **asset** whereas your mortgage is a **liability.** Use the worksheet below and list at least 3 assets and 3 liabilities you have in your business or your personal life. Use the checklist to make sure they fit the definition of an asset.

Assets Interactivity

Liability Interactivity

Below is a list of everyday thing you come across. Classify them as Asset, Liability or perhaps neither

	Assets	Liability	Neither	Status
Bank				
Loan				
Building				

Hired furniture				
Rented property				
Mortgage				
Car				
Lawyer’s fees				
Bank account				
Credit Debit Card				
Investments				
Bonds				
Job				
Unpaid bills				
House				
Hire purchase contracts				
Future bills				
Computer				

Cellphone				
Past bills				
Television				
Furniture				