PIPSO
Pacific Islands Private Sector Organisation

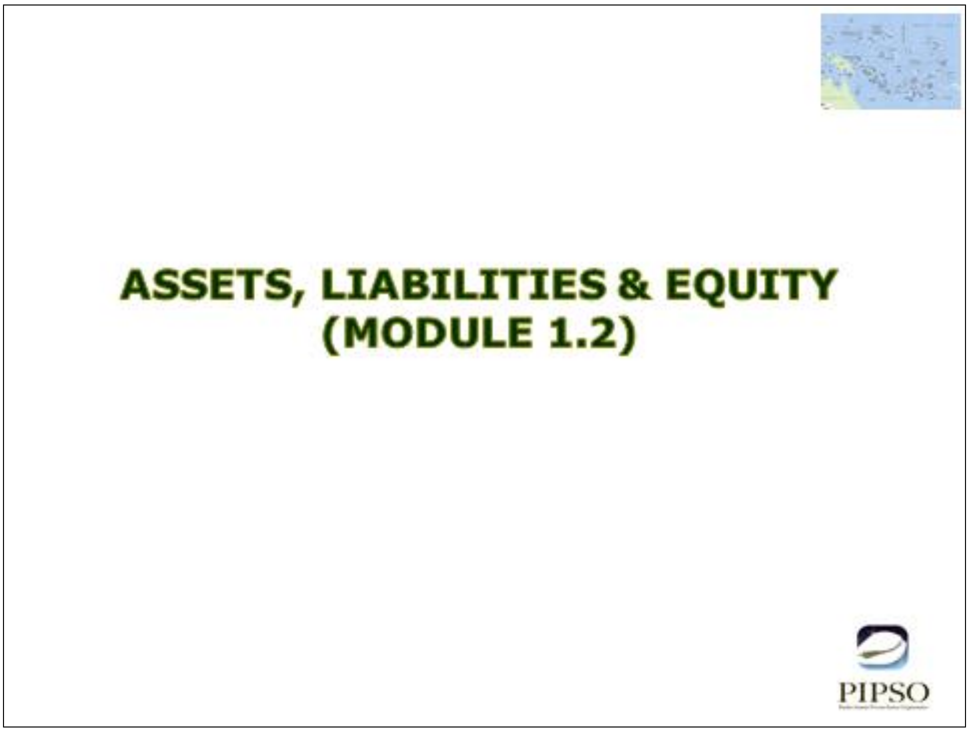
August 15

ASSETS LIABILITIES & EQUITY

2016

This Module introduces the elements of the accounting equations & balance sheet, i.e. assets, liabilities & equity. This relationship in fundamental to the accounting concepts developed later in Level 2 of this Toolkit. The focus remains on cash, however.

MODULE 1.2



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PURPOSE

This module is to provide the building blocks required for understanding many of the future modules without taking the focus from cash accounting.

This module introduces some accounting language that is used throughout future modules. This is kept to a minimum. The terms introduced are:

- Assets
- Liabilities
- Equity, (owner's equity, capital or proprietorship)

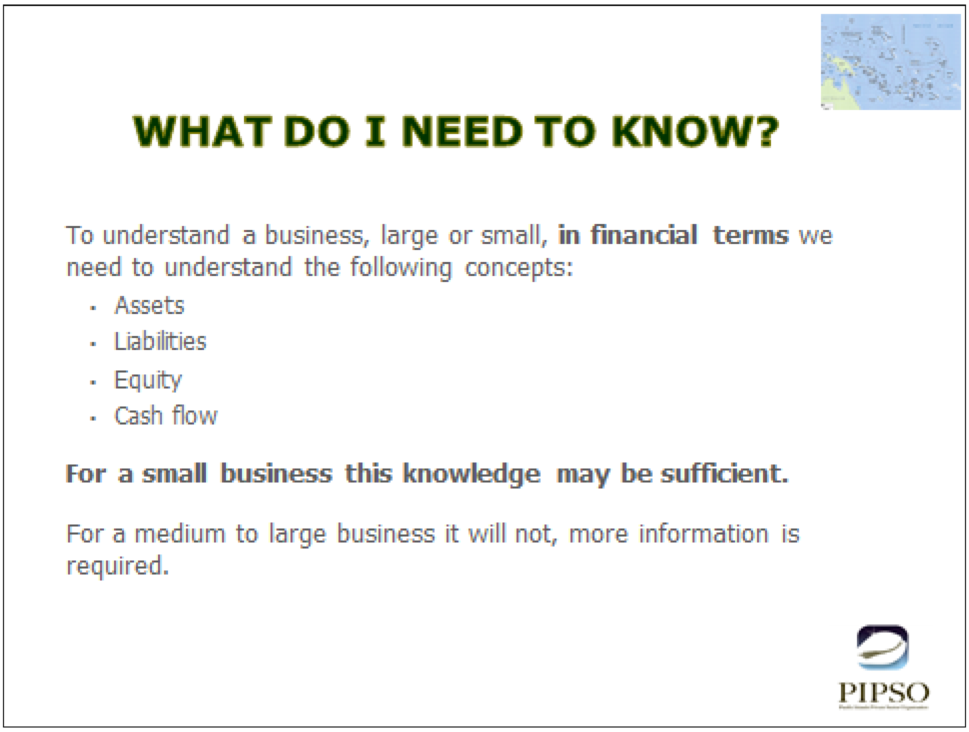
The distinction between current & non-current assets & liabilities is also explained. Examples of each of the above are provided & discussed as a precursor to introducing the basic accounting equation that forms the basis for the preparation of the balance sheet of a business, which is its foundation stone.

When introducing the concepts, it is of benefit to drawa parallel with yourprivate possessions (home, vehicle furniture & white goods), your personal obligations (items on credit, power & communications obligations) &your personal "net worth" (the difference between what you have & what you owe). What you have for private you will also have for business.

We will then introduce thebalance sheet format &you will have the opportunity to construct a simple one from data provided.

On completion of this Module participants should understand the meaning of the accounting terms; assets, liabilities & equity, the basic accounting equation & the construction of a simple balance sheet. These are concepts that provide the foundation for many future Modules.

WHAT I NEED TO KNOW



There are three (3) major components or elements that together make up the normal balance sheet of a business. Three comprise major headings &,within these, there are two more common sub-headings.

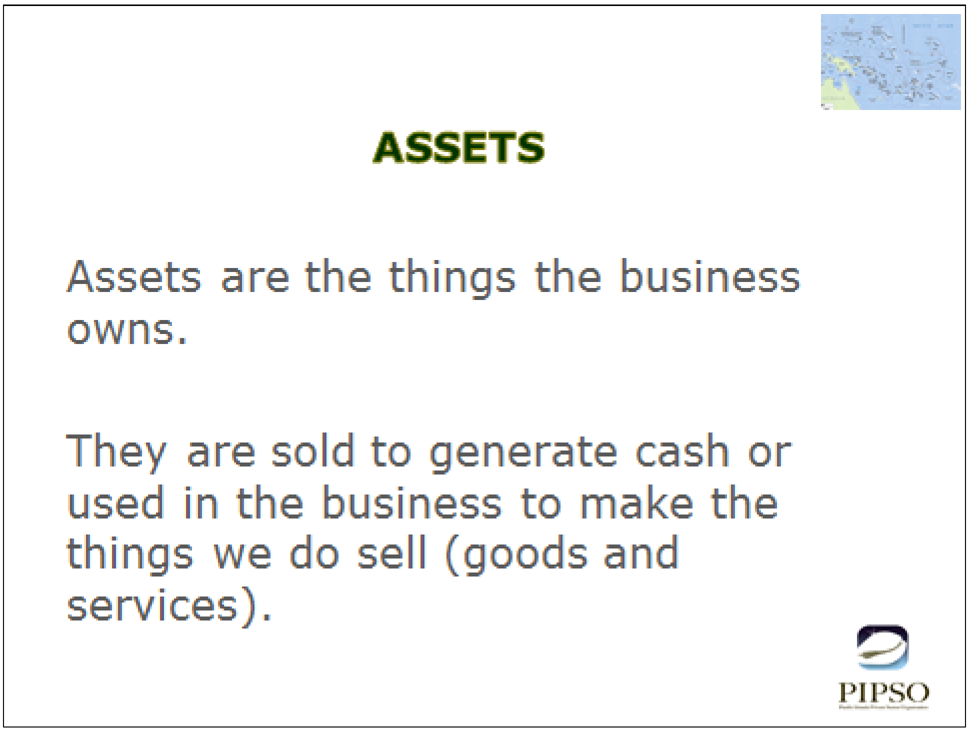
A basic understanding of the meaning of each of theheadings& the relationship between them is dealt with in this module. It does not matter whether the business uses a cash accounting system or the more complex accrual system. A cash accounting system is sufficient for a small business owner. As you grow so may:

- The complexity of the accounting system
- The need to give credit to customers to increase sales
- The opportunity to benefit from credit purchases from suppliers
- The need to carry more inventory (stock) available for sale

This leads to the need to manage“working capital”& at some point you will be better served by a double entry“accrual”accounting system, but not to start with.

Anowner of a larger business will normallyintroduce adouble entry bookkeeping system & accrual accounting concepts to better manage the business profitability rather than cash flow.We will leave this for consideration until Level 2 of this Toolkit. For now, an understanding of simple cash records will suffice for most micro to small businesses&, in particular,for sole traders &partnerships, which do not take the business form of a company. Business form is discussed in Module 1.7, Business Structure, Tax & Regulation.

ASSETS



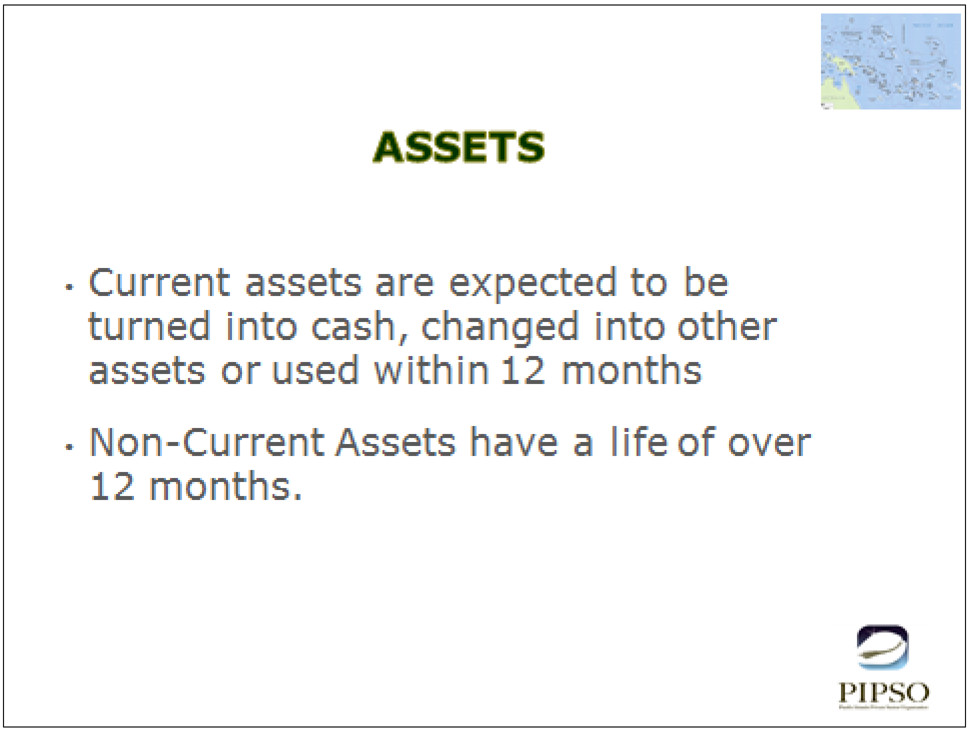
Can assets that are personal be used in a business? Yes
Can assets be shared? Yes
Can business assets be used for private purposes? Yes

But be aware of the reporting &tax consequences

IMPORTANT: Purely private assets are not to be confused with business assets, e.g. personal white goods, oven, home furniture, your home(if owned)& private vehicles.

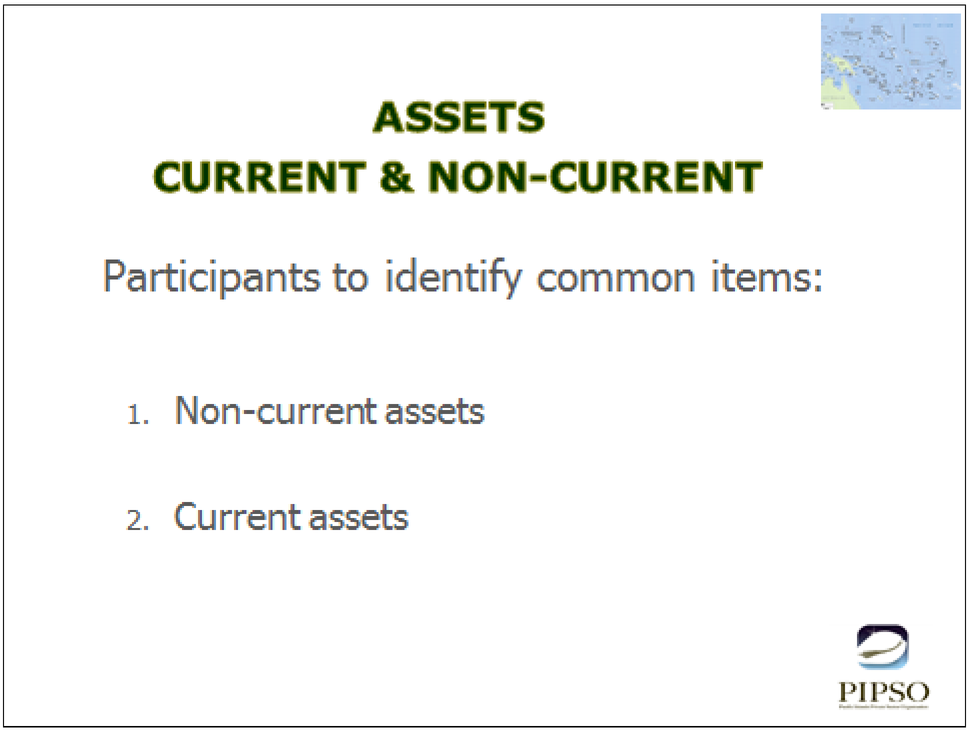
It is possible, however, that you use a room or two in your home for business purposes. There may be taxation benefits available from this, once the business is big enough to be paying tax. If in doubt, seek accounting advice on the alternative treatments available to you where private assets are used in a business to determine your best option for accounting & taxation purposes. The tax implications will vary across the countries in the Pacific & are not addressed herein.

The distinction between current & non-current assets is an important one. Non-current assets are those used to produce the goods & services the business sells to customers. These are items that are used in, but not sold as a part of, the business. Therefore, the purchase & sale of non-current assets is a less frequent event. Non-current assets are generally not readily convertible to cash. Except for land, they usually lose value due to the passage of time & wear & tear during use. The recognition of this loss in value is recorded as Depreciation, discussed further in Module 2.5, Accrual Reporting.



Current assets are usually created as a natural part of the daily activities of the business. The major components of current assets are cash at bank, inventories (stock) being the goods & services held awaiting sale to customers & debtors to whom you extend credit.

NOTE: the terms “inventory” or “inventories” mean the same thing as “stock” or ”stock of supplies” & the terms are often interchanged.



What are the assets you have in your business?

What assets do you own privately but use in the business?

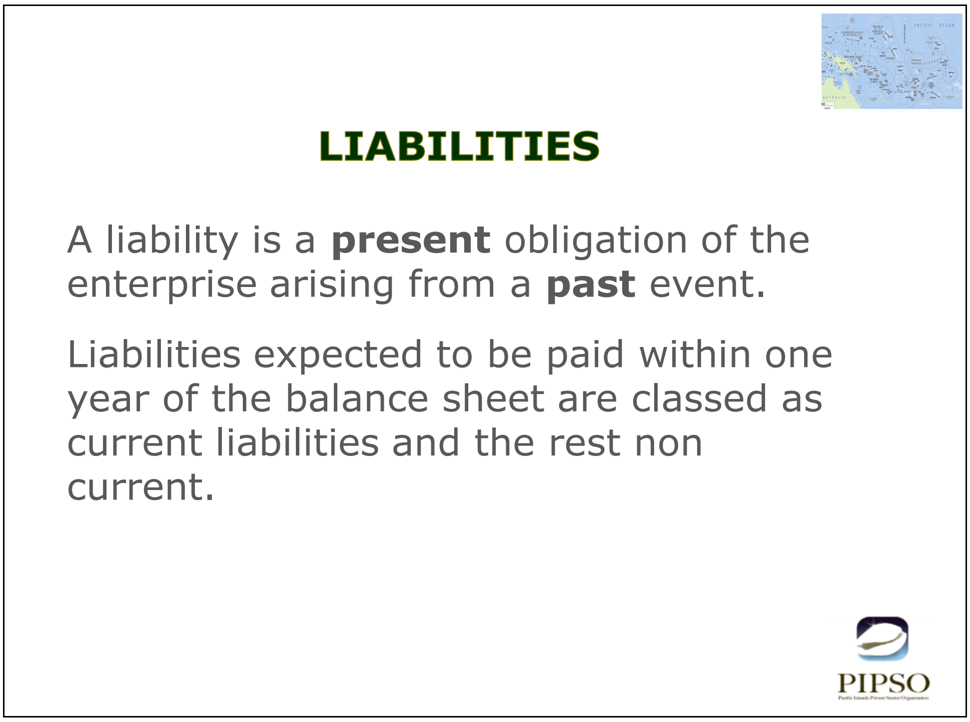
NOTE FOR FACILITATOR

Ask participants for examples. Either yourself, or call on a participant, to create a list of Current & Non-Current assets on the white board or butchers paper based the items called out by the group. If in doubt get each table in turn to nominate an asset & state whether it is business, private or may be both. This can be done for either business or private or both. It is useful to highlight the difference however you do it.

Assets may include:

Current	**Non-current**
Cash	Property
Debtors/Accounts receivable	Plant
Inventories	Equipment
VAT/GST paid on purchases	Furniture
Insurance, rent or other amounts paid in advance	Office fittings
	Motor vehicles
	Computers
	Office equipment
	Boats

LIABILITIES



In plain English, a liability is an obligation you have **today** to pay cash, or provide goods or other services to an individual or business at some time in the future. The obligation arose from a **past** business transaction or event.

IMPORTANT: Once gainstress the separation of private liabilities, e.g. personal credit cards, home or car loans that are not related to business.

Liabilities are amounts owed to outside persons or businesses but may include amounts owed to related parties, i.e. the owner(s) or other family members, as creditors or lenders to the business. They are external obligations not to be confused with an owner’s investment in the business.

What are the liabilities do you have in your business?

What liabilities do you have privately?

NOTE FOR FACILITATOR

Ask participants for examples. Put on list of Current & Non-Current items on the white board using the same approach used previously for assets.

NOTE: the range of possible assets is much larger than liabilities.

Liabilities may include:

Current	**Non-current**
Bank overdraft	Bank or other non-bank term loans over 12 months from date
Any loans due within 12 months from date	Long-term borrowing over 12 months from date
Creditors/accounts payable	Employee obligations for LSL (may be current)
Provision for tax payable	
VAT/GST collected on sales	
Wages & annual leave owing to employees	

LIABILITIES

Borrowings can appear in the current & non current categories. Do you agree?

Why?

Borrowings can include bank overdrafts, bank loans & leases.

What is VAT, an asset or a liability?

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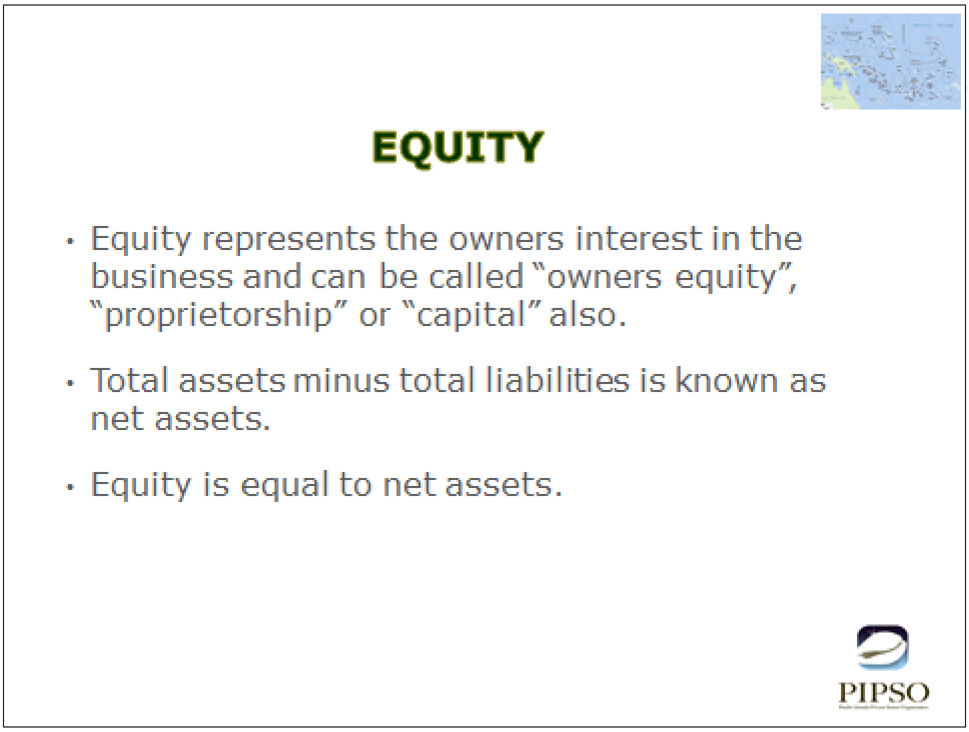
Note 1 - Borrowings& mortgages, while normally non-current, can becomeor, in-part, be current depending on when they are due. If due for repayment within 12 months from the date, then they are current, even if the original loan was longer than one year. Bank overdraft is classified as current as it can be cancelled with notice of less than one year.

Note 2 - VAT/GST can be an asset or a liability. If VAT paid exceeds VAT received, then it is an asset. If VAT received exceeds VAT paid, then it is a liability. Applying international accounting standards, VAT may be offset for reporting purposes. Therefore, it will always be shown in the balance sheet as one or the other, whichever is greater at the time.

IMPORTANT: VAT payable (to the taxation authority) is the same as VAT received (as a part of an invoice) & VAT receivable (from the taxation authority) is the same as VAT paid (as a part of an invoice).

Generally, other assets &obligations, e.g. debts to or from the same party, may not be offset.

EQUITY



Equity, often called "Owner's Equity" or "Capital", represents the value of the owner's contribution to the business, i.e. **the owner's share of the assets** of the business, i.e. the things owned by the business, excluding personal items, after deducting external liabilities.

The terms "Proprietorship" issometimesalso when referring to Equity, especially for a company.

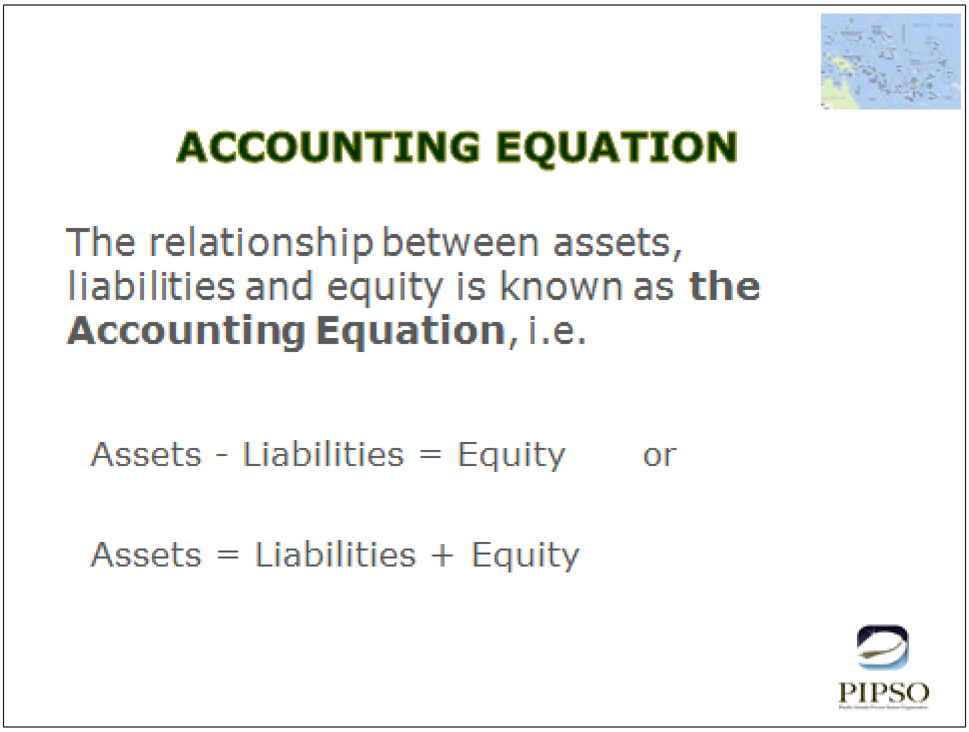
Owners' equity typicallycomprises:

- Capital
- Current year profit
- Retained earnings (prior year profits)
- Reserves (earnings put aside for a specific or general purpose)
- *Less*Drawings (owner funds withdrawn from the business) or dividends (from a company)

IMPORTANT: Owner's Equity, equity or proprietorshipalways equals Net Assets, i.e. total assets minus total liabilities equals owner's equity.

ACCOUNTING EQUATION

Having introduced the three (3) major elements of the accounting equation it is time to look at the accounting equation in the two most common forms it is presented.



The accounting equation is the mathematical expression (in terms of local currency) of a balance sheet, which may also be referred to as a statement of assets & liabilities or statement of financial position. It expresses the relationship between each of its components**at one point in time only**, i.e. at the end of the day the balance sheet is prepared for only.

Accounting systems, whether for an individual or a business, record financial events (transactions) during a period thereby recording business activity between a balance sheet on one date & another balance sheet on a later date. The period between balance sheets may vary, but businesses usually prepare financial reports & balance sheets no less frequently than annually for business & taxation purposes. For management purposes, monthly is common where the accounting system does this with relative ease.

BALANCE SHEET

BALANCE SHEET

ASSETS	$	$
CURRENT ASSETS		
Cash	55,560	
Trade Debtors	243,901	
Inventory	199,655	499,116
NON-CURRENT ASSETS		
INVESTMENTS		54,069
FIXED ASSETS		
Land & buildings	400,000	
Plant & equipment	97,883	497,883
Total Assets		1,051,068
LIABILITIES		
CURRENT LIABILITIES		
Trade creditors	327,913	
VAT/GST payable	49,186	377,099
NON-CURRENT LIABILITIES		
Loans		340,000
Total Liabilities		717,099
NET ASSETS		333,969

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A Balance sheet is simply a report which lists categories of assets, liabilities and equity.

The above balance sheet is split into the threemain sections discussed only &distinguishes between different assets, liabilities &owner's equity (net assets).

As you can see, assets & liabilities can be each split into:

- Current (less than 12 months)
- Non-current (over 12 months)
- There may be other asset categories as listed when a business grows, e.g. investments, intangibles etc., as above

NOTE FOR FACILITATOR

Ask the following questions:

1. What is the value of current assets above?
2. What is Owner's Equity?
3. Is this a sound balance sheet?

The following are the answers to the questions asked.

1. Current Assets = $499,116
2. Owner's Equity = $333,969
   This can also be calculated as Assets -Liabilities= Net Assets or $1,051,068-$717,099

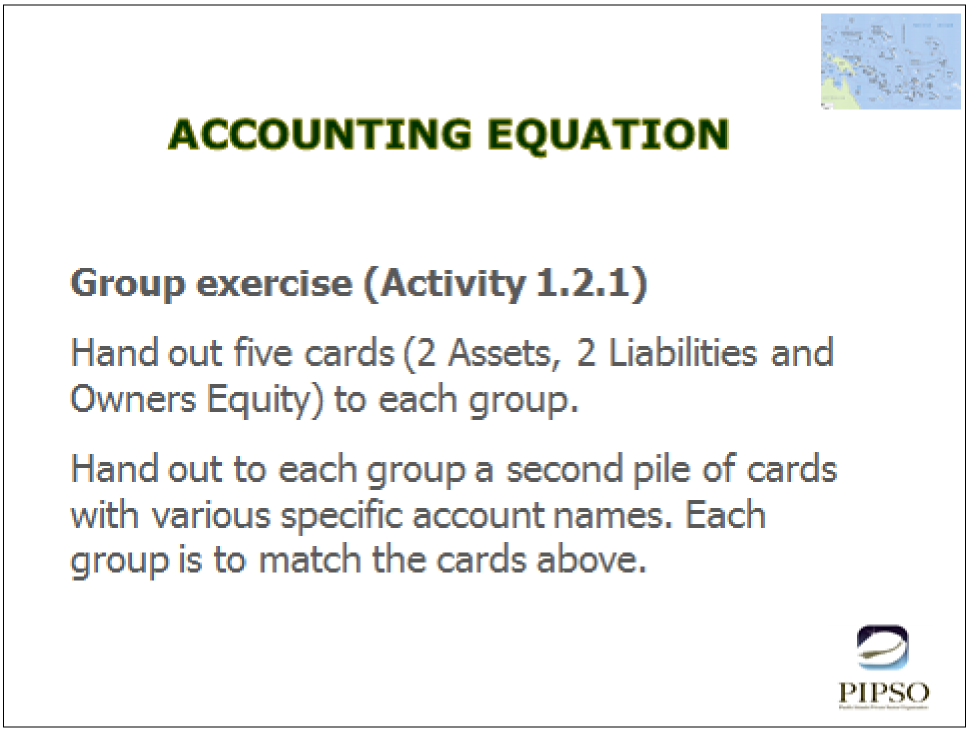
3. Is this a sound balance sheet? We do not know without further information. The answer will depend on the nature of the business, its historic financial performance& its owners attitude to business risk.

The relationship between total assets, total liabilities & owner's equity may also be measured as a ratio. This ratio is referred to as gearing or leverage. Gearing is a measure of risk to the owners of a business due to the amount of debt it has in its balance sheet, i.e. it's measured as the ratio of debt to either total assets or equity. Normally the higher the level of debt (liabilities) compared to assets (or equity) the higher the business risk to the business owner. We will explore business risk from gearing further in Levels 2 &3 of this Toolkit.

For now, we cannot determine a safe, or an appropriate, level of debt without first receiving more information about the nature of the business, its cash flow & profitability & the state of the market & competition. Some businesses with conservatively valued assets & low risk cash flows can be highly borrowed or, as we say in technical terms, geared or leveraged up. Higher gearing or leveragesimply meanshigherdebt. Other businesses would be considered to be of high or higher market risk & therefore should not borrow as much or be lower geared. We need more information onthe characteristics of the business & industry in order to assess business risk.

An example of a business that can support a high gearing ratio is a toll-way road in receipt of largely regular cash revenues in advance that is not likely to be affected by ups & downs in the local economy that may affect others.

Now let's try this classification matching exercise in groups.



ACTIVITY 1.2.1

CLASSIFICATION OF ACCOUNTS

There are 5 classifications

	CLASSIFICATION
A	ASSETS – CURRENT
B	ASSETS – NON-CURRENT
C	LIABILITIES – CURRENT
D	LIABILITIES – NON-CURRENT
E	EQUITY

Match the 21 accounts (1 to 21) that follow to the 5 categories in the balance sheet (A to E) listed above.

	ITEM OR ACCOUNT
1	Bank loan (5 years)
2	Bank overdraft
3	Cash at bank
4	Creditors
5	Current year profit
6	Drawings by owner
7	Employee entitlements
8	Furniture
9	Insurance paid in advance
10	Inventories
11	Land & buildings
12	Lounge suite & coffee table
13	Mortgage
14	Motor vehicle
15	Plant & machinery
16	Refrigerator
17	Retained earnings
18	Trade debtors
19	Unpaid wages
20	VAT paid
21	VAT received

NOTE TO FACILITATOR

This activity is designed as a group exercise to encourage discussing in a small group environment.

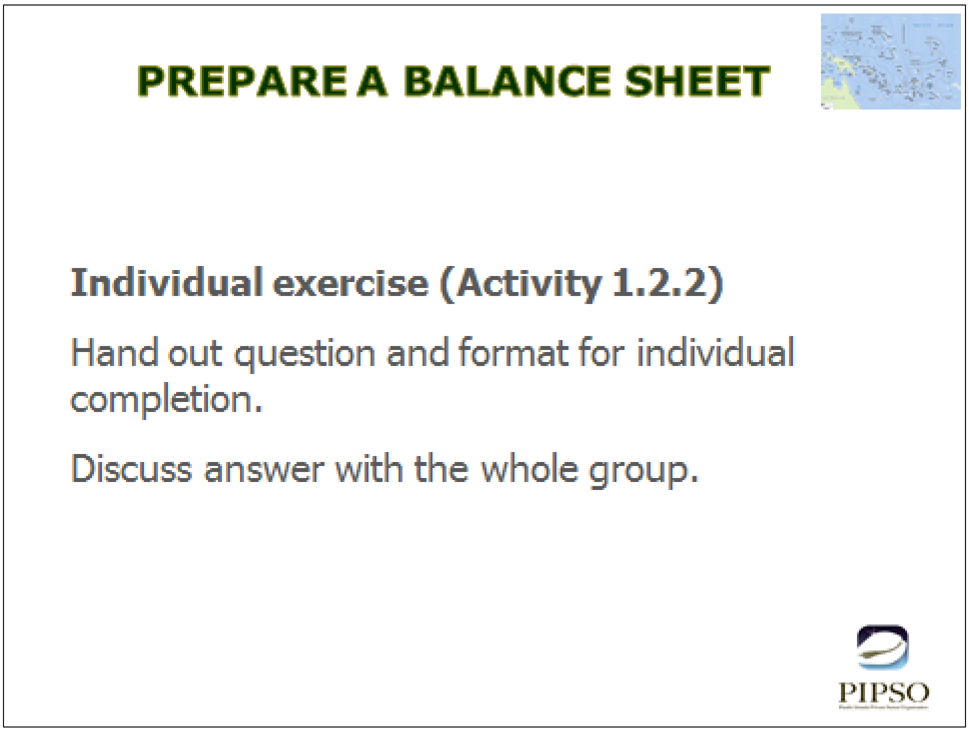
Cards are to be handed out & participants are asked to match the 21 items with the 5 categories to which they belong.

Allow sufficient time for each group to complete the task before working through the answer.

Advise participants that the EMPOYEE ENTITLEMENTS are for LONG SERVICE LEAVE, hence non-current. Write this on the white/back board for reinforcement.

To assist your understanding further, you are asked to complete a balance sheet using data provided & to calculate the capital of the business in the next activity.

This is an individual exercise, however, in a workshop environment, group discussion within tables is recommended & encouraged.



Activity 1.2.2

A Business has provided the following trial balance for the year ended 30 June 2013. Use this information to complete the balance sheet format provided & advise the owner Iam Notsosmart how much he has invested in A Business.

Ledger account	**\$ Balance**
Inventories 30 June2013	38,000
Mortgage loan	250,000
Bank	17,000
Creditors	9,500
Debtors	6,500
Motor vehicles	60,000
Annual registration payable	25,000
Office furniture	12,000
Plant & equipment	40,000
Interest due on mortgage loan	4,000
VAT payable	4,700
Land and buildings	350,000
Capital	?

Prepared for Iam Notsosmart

Balance Sheet for A Business as at 30 June 2013	
Assets (current)	**$**
Assets (non-current)	
TOTAL ASSETS	
Liabilities (current)	
Liabilities (non-current)	
TOTAL LIABILITIES	
Owner's Equity	
Capital	
TOTAL OWNERS EQUITIY	

This exercise completes this module.

ANSWERS TO ACTIVITIES

Activity 1.2.1

CLASSIFICATION OF ACCOUNTS

CLASSIFICATION	**ITEM OR ACCOUNT**
ASSETS – CURRENT	Cash at bank
	Trade debtors
	VAT paid
	Inventories
	Insurance paid in advance
ASSETS – NON-CURRENT	Land & buildings
	Plant & machinery
	Furniture
	Refrigerator
	Motor vehicle
	Lounge suite & coffee table
LIABILITIES – CURRENT	Unpaid wages
	Creditors
	VAT received
	Bank overdraft
LIABILITIES – NON-CURRENT	Employee entitlements (Long Service Leave)
	Bank loan (5 years)
	Mortgage
EQUITY	Retained earnings
	Current year profit
	Drawings by owner

Activity 1.2.2

PREPARED FOR IAM NOTSOSMART

Balance Sheet for A Business as at 30 June 2013	
Assets (current)	**$**
Inventories	38,000
Bank	17,000
Debtors	6,500
	$61,500
Assets (non-current)	
Motor vehicles	60,000
Office furniture	12,000
Plant & equipment	40,000
Land & buildings	350,000
	$462,000
TOTAL ASSETS	**$523,500**
Liabilities (current)	
Creditors	9,500
Annual registration payable	25,000
VAT payable	4,700
Interest due on mortgage loan	4,000
	$43,200
Liabilities (non-current)	
Mortgage loan	250,000
	$250,000
TOTAL LIABILITIES	**$293,200**
Owner's Equity	
Capital	230,300
TOTAL OWNERS EQUITIY	**$230,300**