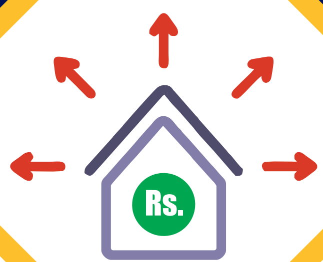
Information Booklet

Accounting & Finance

3

UNDERSTANDING BUSINESS ASSETS AND LIABILITIES

for SMEs



SMEDA

National Business Development Program for SMEs

Introduction

Small and Medium Enterprises Development Authority (SMEDA) works under the Ministry of Industries and Production, Government of Pakistan and was established in 1998 with the objective to propel economic growth through development of SMEs. SMEDA serves as an SME strategy-advisory body for the Government of Pakistan and facilitates partners in meeting their SME development agendas.

SMEDA envisions growth of a globally competitive SME sector, through creating an enabling environment and support services for increase in the national economy. SMEDA strives to achieve this vision by providing assistance in employment generation and value addition to the national income, through development of the SME Sector, by helping increase the number, scale and competitiveness of SMEs.

National Business Development Program for SMEs (NBDP) is a project of SMEDA which intends to provide hands-on support services to SMEs. The aim of this business development support provided by NBDP is to advance new businesses and improve efficiencies in existing SME value chains to empower them to contend in global market. NBDP expects to facilitate around 314,000 SME beneficiaries over the period of five years.

Disclaimer

Objectives

- To explain the concept and importance of maintaining business assets and liabilities in small and medium enterprises.
- To understand the central role of asset and liability management in small and medium enterprises.

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ⓐ Balance Sheet – Concept and Importance[1]

Balance sheet displays total assets and liabilities of a business and how these assets are financed, either through debt or equity. It is an important financial statement used for financial modelling and accounting. Balance sheet is also referred to as the net worth statement or a statement of financial situation and can be summarized in the form of an equation as indicated below:

Assets = Liabilities + Equity

A simple balance sheet

Total Assets Current Assets + Non-Current Assets	**Total Liabilities** Current Liabilities + Non-Current Liabilities
	Total Shareholder' Share Capital + Retained Earnings

Importance of Balance Sheet:

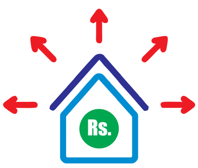
- Balance sheet presents financial position of a business at the end of a specified date.
- Balance sheet allows creditors, shareholders, lenders and other salient stakeholders to see what a business owns as well as what it owes to other parties as of an indicated date.
- Balance sheet enables investors, lenders, creditors and shareholders to examine the following elements:
  - If a business meets its financial obligations?
  - How much money has already been invested in the business?
  - If a business has taken a high debt?
  - What kind of assets has the business purchased with its financing?

ⓑ Assets and Liabilities – Definition and Types

Asset

A business asset is a piece of property or equipment purchased exclusively or primarily for business use. It can include tangible and intangible items such as intellectual property, cash, inventory, accounts receivable, land, buildings and equipment.

Assets can be broadly categorized into the following three types:
- Current assets
- Fixed assets
- Liquid assets



Liability

Liability is a responsibility of the business arising from previous events. It is legal financial debt or obligation of a business that arise during the course of business operations and can be settled over time through the transfer of economic benefits including money, goods, or services. Liabilities include loans, accounts payable, mortgages, deferred revenues and accrued expenses.

Liabilities are of three types as indicated below:
- Short term liabilities
- Long term liabilities
- Contingent liabilities

[1] Corporate Finance Institute, 2019.
Available at: https://corporatefinanceinstitute.com/resources/knowledge/accounting/balance-sheet/ [Accessed 14th August 2019]

Types of Assets:

Three main types of assets are explained below:

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Current Assets

Any asset that can be sold, consumed or exhausted through the normal operations of a business within the current fiscal year or operating cycle is referred to as a current asset. Such assets are expected to be converted into cash within a year and are primarily for the purpose of trading. Some examples include:

- Cash
- Cash equivalents
- Short-term deposits
- Office supplies
- Stock
- Account receivables

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Fixed Assets

A long-term tangible asset including property or equipment that a business owns and uses for its operations to generate income is called a fixed asset. These assets cannot be consumed or converted into cash within a year. Some examples include:

- Land
- Building
- Machinery
- Property
- Equipment

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Liquid Assets

An asset that can be converted into cash quickly is called liquid assets as it is related to cash itself because the asset can be sold any time with a low impact on its value. Some examples include:

- Current account
- Savings account
- Marketable securities
- Patents
- Trademarks

f Short-Term and Long-Term Liabilities

Liabilities are mentioned on the right side of the balance sheet. Liabilities can be settled for a specified period of time through the transfer of financial paybacks e.g., money, products or services.

Short-Term Liabilities:

Short-term liabilities (current liabilities) are financial obligations and responsibilities that are due within a year.

Current liabilities are closely monitored by the management to ensure that a business has enough financial liquidity and is in a position to meet its financial obligations and outstanding dues. Examples of current liabilities include accrued expenses, bills payable, accounts payable, interest payable, loans and bank account overdrafts.

Long-Term Liabilities:

Long-term liabilities (non-current liabilities) are obligations and debts that are due after one year of the operating cycle of a business. Businesses require long-term loans to acquire immediate capital. Long-term liabilities include amount for purchasing capital assets such as office building, computers etc. or investing in the existing business for expansion.

Long-term liabilities are important for determining a long-term credit worthiness of a business. Businesses face a solvency crisis if they fail to repay their long-term liabilities.

The examples of non-current liabilities include long-term notes payable, bonds payable, mortgage payable, deferred tax liabilities, and capital lease etc.

Contingent Liabilities:

Contingent liabilities are also referred to as potential liabilities and are dependent on the results of a future event. For instance, if a business is facing a PKR 200,000 lawsuit, it will face a heavy financial liability if the lawsuit proves successful. However, if the lawsuit is unsuccessful, it will not have any financial bearing or liability on the business.

As per accounting standards, contingent liability is only recorded when the liability is probable, and the amount can be reasonably estimated. Examples of contingent liabilities include lawsuits or product warranties.

g Owner's Equity

Owner's equity represents the owner's investment in the business minus the withdrawals from the business plus the net income (or minus the net loss). Owner's equity is viewed as a residual claim on the business assets because liabilities have a higher claim. Owner's equity can also be viewed (along with liabilities) as a source of the business assets.

Owner's equity is one of the three main sections of a balance sheet and one of the components in accounting equation:

Assets = Liabilities + Owner's Equity

For example, if the accounting record of a business indicate assets of PKR 15,000,000 and liabilities of PKR 10,000,000, the amount of owner's equity is PKR 5,000,000.

Based on the cost principle and other accounting principles, the amount of owner's equity should not be considered to be the fair market value of the business. The accounting equation indicates how much of business assets belong to, or are owned, by whom.

Owner's equity can increase or decrease in four ways:

1. It increases when an owner invests in a business, it is called a capital contribution.
2. It increases or decreases when the business has a profit or a loss.
3. It decreases when an owner takes money out of the business, such as if the person takes an “owner's draw".
4. It decreases if liabilities increase and assets do not increase by the same amount.

For example, if a small business starts with PKR 150,000/- in assets, including cash, supplies, and some equipment. The business owner invested PKR 30,000/- of his/her own money in the business and borrowed loan for the remaining PKR 120,000/- from a local bank. Against this, the initial accounting equation would look like this:

Total assets 150,000 = Total Liabilities 120,000 + Total Owner's Equity 30,000

At the end of the first year, this business generates a profit of PKR 75,000. This increases the owner's equity and the cash available to the business by that amount. The profit is calculated on the business's income statement, which lists revenues or income and expenses.

Now the equation becomes:

Owner's Equity 105,000 = Assets 225,000 less Liabilities 120,000

Understanding Important Balance Sheet Ratios

Financial ratios are key indicators of the financial performance of a business and are usually derived from its income statement, balance sheet and cash flow.

These financial ratios help in analyzing two important points:

1.Track the Business Performance:

Determining individual financial ratio per period and tracking the change in its values over time is done to spot trends that may be developing in a business. For example, an increasing debt-to-asset ratio may indicate that the business is overburdened with debt and may eventually be facing default risk or bankruptcy.

2. Make Comparative Performance Judgement:

Comparing financial ratios with that of major competitors is carried out to identify whether the business is performing better or worse than the industry average. For example, comparing the return on assets between companies helps an analyst or investor to determine which assets of the business are being used most efficiently.

The financial ratios can be used externally and internally as explained below:

External users:

Financial analysts, retail investors, creditors, competitors, tax authorities, regulatory authorities, and industry observers.

Internal users:

Management team, employees, and owners.

Financial ratios are grouped into the following categories:

1 Liquidity ratios

2 Leverage financial ratios

3 Efficiency ratios

4 Profitability ratios

5 Market value ratios

1. Liquidity Ratios:

Liquidity ratios are the ratios that measure the ability of a business to repay both short and long-term obligations. Common liquidity ratios include the following:

Current ratio measures the ability of a business to pay off short-term liabilities with current assets: **Current ratio = Current assets / Current liabilities**
Acid-test ratio measures the ability of a business to pay off short-term liabilities with quick assets: **Acid-test ratio = Current assets – Inventories / Current liabilities**
Cash measures the ability of a business to pay off short-term liabilities with cash and cash equivalents: **Cash ratio = Cash and cash equivalents / Current liabilities**
Operating cash flow ratio is a measure of the number of times a business can pay off current liabilities with the cash generated in a given period: **Operating cash flow ratio = Operating cash flow / Current liabilities**

2. Leverage Financial Ratios:

Leverage ratios measure the amount of capital that comes from debt. In other words, leverage financial ratios are used to evaluate the debt levels of a business. Common leverage ratios include the following:

The debt ratio measures the relative amount of the assets of a business that are financed through debt: **Debt ratio = Total liabilities / Total assets**
The debt to equity ratio calculates the weight of total debt and financial liabilities against shareholders' equity: **Debt to equity ratio = Total liabilities / Shareholder's equity**
The interest coverage ratio determines how easily a business can pay its interest expenses: **Interest coverage ratio = Operating income / Interest expenses**
The debt service coverage ratio determines how easily a business can pay its debt obligations: **Debt service coverage ratio = Operating income / Total debt service**

3. Efficiency Ratios:

Efficiency ratios, also known as activity financial ratios, are used to measure how well a business is utilizing its assets and resources. Common efficiency ratios include:

The asset turnover ratio measures the ability of a business to generate sales from assets: **Asset turnover ratio = Net sales / Total assets**
The inventory turnover ratio measures how many times the inventory of a business is sold and replaced over a given period: **Inventory turnover ratio = Cost of goods sold / Average inventory**
The accounts receivable turnover ratio measures how many times a business can turn receivables into cash over a given period: **Receivables turnover ratio = Net credit sales / Average accounts receivable**
The days sales in inventory ratio measures the average number of days that a business holds onto its inventory before selling it to customers: **Days sales in inventory ratio = 365 days / Inventory turnover ratio**

4. Profitability Ratios:

Profitability ratios measure the ability of a business to generate income relative to revenue, balance sheet assets, operating costs, and equity. Common profitability financial ratios include the following:

The gross margin ratio compares the gross profit of a business to its net sales to show how much profit a business makes after paying off its cost of goods sold: **Gross margin ratio = Gross profit / Net sales**
The operating margin ratio compares the operating income of a business to its net sales to determine operating efficiency: **Operating margin ratio = Operating income / Net sales**
The return on assets ratio measures how efficiently a business is using its assets to generate profit: **Return on assets ratio = Net income / Total assets**
The return on equity ratio measures how efficiently a business is using its equity to generate profit: **Return on equity ratio = Net income / Shareholder's equity**

5. Market Value Ratios:

Market value ratios are used to evaluate the share price of the stock of a business. Common market value ratios include the following:

The book value per share ratio calculates the per share value of a business based on equity available to shareholders: **Book value per share ratio = Shareholder's equity / Total shares outstanding**
The dividend yield ratio measures the monetary amount of dividends attributed to shareholders relative to the market value per share: **Dividend yield ratio = Dividend per share / Share price**
The earnings per share ratio measures the amount of net income earned for each share outstanding: **Earnings per share ratio = Net earnings / Total shares outstanding**
The price-earnings ratio compares the share price of a business to the earnings per share: **Price-earnings ratio = Share price / Earnings per share**

Template of Balance Sheet

Most accounting balance sheets classify the assets and liabilities of a business into distinctive groupings such as current assets (property and equipment) and current liabilities etc. These classifications make the balance sheet more useful.

The following example is a classified balance sheet:

ASSETS

Current assets	
Cash	PKR 315,000/-
Petty cash	15000/-
Temporary investments	1,500,000/-
Accounts receivable-net	6,075,000/-
Inventory	4,650,000/-
Supplies	570,000/-
Prepaid insurance	225,000/-
Total current assets	13,350,000/-
Investments	5,400,000/-
Property plants and equipment's	
Land	825,000/-
Land improvements	975,000/-
Buildings	27,000,000/-
Equipment's	30,150,000/-
Less accum deprecation	-8,400,000/-
Prop, plants & equip – net	50,550,000/-
Intangible assets	
Goodwill	15,750,000/-
Trade names	30,000,000/-
Total intangible assets	45,750,000/-
Other assets	450,000/-
Total asset	PKR 115,500,000/-

LIABILITIES

Current liabilities	
Notes payable	750,000/-
Accounts payable	5,385,000/-
Wages payable	1,275,000/-
Interest payable	435,000/-
Taxes payable	915,000/-
Warranty liability	165,000/-
Unearned revenues	225,000/-
Total current liabilities	9,150,000/-
Long term liabilities	
Notes payable	3,000,000/-
Bonds payable	60,000,000/-
Total long term liabilities	63,000,000/-
Total liabilities	72,150,000/-

STOCKHOLDERS' EQUITY

Common stock	16,500,000/-
Retained earning	33,000,000/-
Accum other comprehensive income	1,350,000/-
Less Treasury stock	-7,500,000/-
Total stockholders' equity	43,350,000/-
Total liabilities and stockholders' equity	PKR 115,500,000/-

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