Accounting - Self Study Guide for Staff of Micro Finance Institutions

LESSON 2

The Balance Sheet

OBJECTIVES The purpose of this lesson is to introduce the Balance Sheet and explain its components: Assets, Liabilities and Equity (Fund Balance; Reserve Balance). The relationship between these components will be explained.

You will develop a basic understanding of how the Balance Sheet is created and how the operations of the organization are recorded on the Balance Sheet. You will also see how the Balance Sheet is "static" in nature. Topics include:

- The Balance Sheet
- The Accounting Equation *(ASSETS = LIABILITIES + EQUITY)*
- Assets
- Liabilities
- Equity
- Comparative Balance Sheet

The Balance Sheet

An organization or a business has resources which are called **assets** (for example, cash, equipment, loan portfolio outstanding, etc.). These assets must be funded either by borrowings (debt) or by capital contributed by the owners (or donors). When outside parties finance any portion of an organization's assets, they acquire claims against the organization equal to (or greater than, depending on the risk) the value of the financing. These are referred to as **liabilities**. When owners or donors fund part of an organization's assets, this is referred to as **equity**.

The fundamental relationship in accounting is based on the fact that every addition to an organization's assets is financed either by outside parties or by the owners. *This relationship states that the total claims of owners and outside parties are always equal to the value of an organization's assets.*

Equality between Assets and Claims

Assets	Claims
Total Value	By Outside Parties and by Owners

For example, Betina decided to buy a sewing machine to start her own business. She had personal savings of $500. She then borrowed $1,000 from a micro-finance organization to buy the machine for $1,500. After completing these transactions, the total value of the "business" is $1,500, of which $1,000 was financed by the micro-finance organization and $500 financed by Betina.

Consequently the total claims against the business are equal to the value of its assets:

Assets		Claims	
Sewing machine	1,500	by the MF organization by Betina	1,000 500
Totals:	1,500		1,500

The Balance Sheet reports the financial position of an organization *at a specific point in time* by providing a summary of an organization's assets and claims on its assets (liabilities and equity). **The Balance Sheet should always balance**. That is to say, total assets should always equal total liabilities plus equity. The amount remaining when liabilities are subtracted from assets is the **equity** (owners' contribution) of the organization.

Assets	Claims
Assets	Liabilities (by Outside Parties)
	Equity (by Owners)
Total Assets =	Total Liabilities + Equity

The Accounting Equation

A fundamental characteristic of every Balance Sheet is that:

TOTAL ASSETS = TOTAL LIABILITIES + EQUITY

The relationship of assets to liabilities and equity is why the statement is called the Balance Sheet.

For example:

ASSETS = LIABILITIES + EQUITY

$106,300= $65,000 + $41,300

The amounts listed in this equation are taken from the Sample Balance Sheet on the next page. By looking at the example we can see that the Balance Sheet is simply a detailed explanation of the accounting equation.

Why does it balance? *The two sides of the Balance Sheet are two views of the same resources of the organization.* Assets are the resources owned by the organization. Liabilities and equity tell us who funded these resources to the organization and how much each group funded. Everything the organization owns or has rights to (assets) had to be funded by either creditors or by owners. Therefore the total claims of the creditors (liabilities) plus the claims of owners (equity) equal the total assets of the organization.

Refer to the Sample Balance Sheet below. Note that the figures on the Balance Sheet are cumulative since the beginning of the organization's activities. For example, at the start of each new accounting period, the opening Balance Sheet has an amount recorded for each line. The Balance Sheet is referred to as 'static" because it always details the financial position of an organization *at a specific point in time*.

The Income Statement, on the other hand, does not have any opening balances and records the financial activities of an organization during a specified period of time. This will be explained in greater detail in Lesson 3: The Income Statement.

SAMPLE BALANCE SHEET

ABC Credit Programme
BALANCE SHEET
As at 31st December, 1995

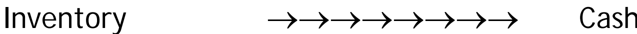
ASSETS			LIABILITY AND EQUITY	
			LIABILITIES	
Cash & Bank Current Accounts	5,000			
Interest Bearing Deposits	8,000		Short-term Borrowings (commercial rate)	18,000
		13,000	Client Savings	0
Loans Outstanding:				
Current	66,000		Total Current Liabilities	18,000
Past-Due	17,000			
Restructured	1,000			
Loans Outstanding (Gross)	84,000		Long-term Debt (commercial rate)	12,000
(Loan Loss Reserve)	(7,000)		Long-term Debt (concessional rate)	35,000
Net Loans Outstanding		77,000	Restricted/Deferred Revenue	0
Other Current Assets		500		
Total Current Assets		90,500	**TOTAL LIABILITIES**	**65,000**
Long-term Investments		12,500		
Property and Equipment:			**EQUITY**	
Cost	4,000		Loan Fund Capital	40,100
(Accumulated Depreciation)	(700)		Retained Net Surplus/(Deficit) prior years	200
Net Property and Equipment		3,300	Net Surplus/(Deficit) current year	1,000
Total Long-term Assets		15,800	**TOTAL EQUITY**	**41,300**
TOTAL ASSETS		**106,300**	**TOTAL LIABILITIES AND EQUITY**	**106,300**

Source: SEEP Financial Services Working Group

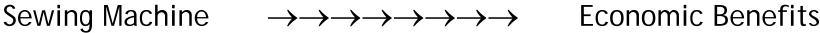
Assets

The resources of an organization are called assets. They have value because they can be exchanged for other goods or services, or can be employed productively to generate revenue. For example, if you have Tk10 in your pocket, it is an asset because with it you can buy a cup of tea and a biscuit.

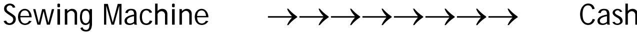
Assets represent what is owned by the organization or owed to it. Every asset (other than cash) is either an account receivable (cash owed to the organization) or is expected to be converted to cash, either directly through its sale or indirectly through the economic benefits it provides to an organization. For example, a client may purchase potatoes for resale. The potatoes become her "inventory" (asset) which is sold and turned into cash.



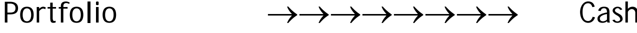
In a previous example, Betina purchased a sewing machine. This is an asset acquired because of the future economic benefit - clothing available for sale for cash.

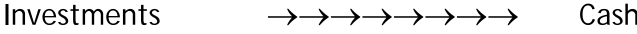


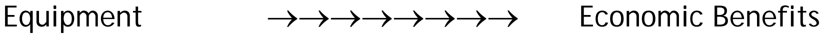
In the future, Betina may sell her sewing machine. In this case, the sewing machine is inventory which when sold is turned into cash.

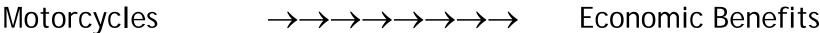


Common examples of assets of a micro-finance organization are cash, outstanding loan portfolio, investments, equipment, and motorcycles.









Refer to ***Accounting Definitions (Balance Sheet): Assets*** on the next page.

Accounting Definitions (Balance Sheet): Assets

Assets represent what is owned by the organization or owed to it. Assets are those items in which an organization has invested its funds for the purpose of generating future receipts of cash. On the Balance Sheet, total assets are always equal to the sum of liabilities plus equity.

Assets may be divided into *Current* or *Long-term:*

⇒ *Current Assets:* cash and marketable securities, accounts receivable, and inventories which in the normal course of business will be turned into cash within a year.

- **Cash and Bank Current Accounts** - all balances available to the organization on demand, such as cash, and funds on deposit in non-interest bearing accounts.
- **Interest Bearing Deposits** - funds on deposit with a financial institution with a term of less than a year which are earning interest income for the organization.
- **Loans Outstanding**:

  Current - the total amount of loans outstanding at a point in time (total owed an institution by its borrowers) which is current, i.e. no late payments or defaults.

  Past Due - the total amount of loans outstanding, which have an amount past due. 'Past Due' should be defined by the organization. The time frame for Past Due should reflect when the risk of default (borrower will not pay) increases, considering the type of loan, loan term, payment schedule and the programme's past experiences. It is common to consider loans Past Due when a payment completes one entire cycle without being paid, i.e. when two payments have been missed. Therefore, loans with monthly payments are considered Past Due after 30 days. Each micro-finance organization must explain how it defines Past Due when reporting the quality of the loans outstanding.

  Restructured - loans outstanding in which the original terms have been re-negotiated. They can either be refinanced or rescheduled. Refinancing a loan involves disbursing a new loan to augment an existing loan before the existing loan is fully repaid. Refinancing generally refers to increases in the principal amount outstanding. Rescheduling a loan involves changing the payment period and/or the loan term on an outstanding loan. Both are usually done to prevent a borrower from defaulting on a loan, or so that a borrower is no longer in arrears and is more able to meet payments on time. Restructuring loans should be done sparingly as they can affect delinquency rates significantly.

  Loan Loss Reserve - the amount set aside to cover losses on the loan portfolio. When the Reserve is created (or adjusted) a loan loss expense (referred to as the Loan Loss Provision) is recorded on the Income Statement as an expense. The amount of Loan Loss Provision is then recorded on the Balance Sheet as a *negative* asset - Loan Loss Reserve - reducing the net outstanding loan balance (or as a liability).

Actual loan losses, or write-offs, are reflected on the Balance Sheet only (and not on the Income Statement) as a reduction of the Loan Loss Reserve *and* the Gross Outstanding Loan Balance. The resulting effect is to leave the Net Portfolio on the Balance Sheet unchanged since the Reserve has already been made (and expensed as a Loan Loss Provision). If the Loan Loss Reserve is too low relative to the value of loans to be written off, then the Loan Loss Reserve needs to be increased through making a Provision for Loan Losses on the Income Statement. (The Loan Loss Reserve is sometimes treated as a liability and is reduced when loans are written off.)

- **Net Loans Outstanding** - is the sum of all loan balances still owed to the organization, that is, all loans disbursed and not yet repaid or written off, net of any Loan Loss Reserve. The Net Loans Outstanding figure reflects only the principal due, and does not include interest expected to be received.

- **Other Current Assets** - items which do not appear above, such as:

  accrued interest - interest that has come due but has not yet been received is recorded as **accrued**; some organizations only accrue interest after the loan term has ended and there is still interest outstanding;

  accounts receivable - any promise to pay the organization for services already rendered or products already delivered; and

  prepaid expenses - examples are pre-paid rent or insurance premiums paid for the upcoming period.

⇒ *Long-term Assets* include property, plant and equipment, and represent those assets not readily redeemable to cash. Examples are land, buildings, machinery, equipment, furniture, automobiles, and investments or receivables held for longer than one year.

- **Long-term Investments** - investments not intended as a ready source of cash such as stocks, bonds and promissory notes that will be held for more than one year.

- **Property and Equipment**

  Cost - property and equipment (fixed assets) are recorded at cost or current market value at acquisition.

  Accumulated Depreciation - the annual, non-cash expense that is determined by estimating the useful life of each asset. Depreciation represents a decrease in the value of property and equipment to account for that portion of the useful life that is used up during each accounting period. (*Amortization* is similar to depreciation but refers to expensing property over time.)

- **Net Property and Equipment** - the cost of property and equipment less accumulated depreciation.

Liabilities

Liabilities are what the organization owes to other parties either in the form of a loan which it received or obligations for the organization to provide goods and services at a later date. Liabilities are debts the organization has incurred which remain outstanding as of the date of the Balance Sheet. These debts usually require payment of assets (cash) or the rendering of services or delivering of products.

For example, an organization incurs a liability when it buys services or products for its operations and agrees to pay cash at a later date. This is called an Account Payable. If an organization borrows money, it incurs an obligation to repay the loan. The liability created is called a Loan Payable.

Accounts Payable →→→→→→ Pay Cash

Loans Payable →→→→→→ Pay Cash

An organization also incurs a liability if it receives payment for a product or service which will be delivered at a later date.

Receipt in Advance →→→→→→ Deliver Products

Receipt in Advance →→→→→→ Provide Services

Liabilities are generally recognized (reported) only after a transaction has taken place. The receipt of cash or other assets by the organization in exchange for a promise to pay cash or deliver products or services in the future indicates that a transaction needs to be recorded.

In the sewing machine example, Betina borrowed $1,000. Once she received the funds, she incurred a liability of $1,000. This liability needs to be recorded.

Refer to ***Accounting Definitions (Balance Sheet): Liabilities*** on the next page.

Accounting Definitions (Balance Sheet): Liabilities

Liabilities represent what is owed by the organization to others either in the form of a loan which has been extended to it or obligations for the organization to provide goods and services in the future.

- **Short-term Borrowing** - the outstanding amounts that the organization owes to a bank or other lenders which are due within one year.

- **Client Savings** (Group Savings Deposits/Emergency Fund etc.) - both voluntary and compulsory client savings that have been deposited in the organization which the organization must return. Although a liability for the organization, deposits are different from borrowed funds because there is no due date or amortization schedule. Generally organizations pay a rate of return on client savings. If these are not paid out to clients, they are sometimes referred to as *accrued interest* and increase the liability of the organization to the client.

- **Long-term Debt (commercial rate)** - the outstanding amount that the organization owes to a bank or other lender for which it is paying a market rate of interest. Long-term debt is defined as that which has a term greater than one year.

- **Long-term Debt (concessionary rate)** - the outstanding amount that the organization owes to a bank or other lender for which it is paying the lender a rate of interest below the market rate for a term greater than one year.

- **Restricted/Deferred Revenue** - funds received, but restricted for use in future years are classified as a liability on the Balance Sheet because they would have to be returned to the funding organization if the specified programmes were not carried out. Restricted funds are not recorded as earned until the service or product which they are funding is delivered. When the organization receives restricted or deferred funds, it incurs an obligation (liability) to provide the services described in the grant agreement. As the organization provides the services (i.e.: technical assistance to micro-entrepreneurs) it incurs expenses. Deferred revenue is then reflected as grant revenue and used to cover those expenses.

Equity

Equity is equal to assets less liabilities. Unlike liabilities, the equity of an organization does not have to be repaid. It therefore represents the value or net worth of the organization.

Equity is often referred to as the **net worth** since its reported value is equal to the difference between total assets and total liabilities. This difference represents the organization's net assets. It is obtained by rewriting the basic equation:

ASSETS = LIABILITIES + EQUITY ⇒
ASSETS – LIABILITIES = EQUITY

Refer to *Accounting Definitions (Balance Sheet): Equity* below.

Accounting Definitions (Balance Sheet): Equity

Equity includes capital contributions of any investors or donors, retained earnings, and the current year surplus. (Note: sometimes equity can include soft loan capital contributed by donors, often referred to as *quasi-equity*. For the purposes of this training, soft or concessional loans are included as liabilities.)

- **Loan Fund Capital** - represents what has been contributed over time to the organization and not spent. Sources of Loan Fund Capital include grants designated to go to capital, investor contributions, the proceeds of fundraising activities, and/or membership or share purchases.

- **Retained Net Surplus/(Deficit) prior years** - the amount of income (or loss) accumulated since the formation of the organization. It may also be referred to as undistributed profits or earned surplus.

- **Net Surplus/(Deficit) current year** - the amount of income (or loss) generated in the current year.

The Sample Transactions on the next page illustrate how various business transactions affect the Accounting Equation and thus the Balance Sheet.

SAMPLE TRANSACTIONS (Balance Sheet)

	ASSETS				=	LIABILITIES			+	EQUITY
	Cash	Current Loans Outstanding	Loans Past Due	Investments	Property & Equipment	Short-term Borrowing	Client Savings	Long-term Debt	Restricted/Deferred Revenue	Equity
Purchase office furniture for cash	↓				↑					
A loan to a client becomes Past Due		↓	↑							
Purchase equipment on short-term credit					↑	↑				
Take out a long-term loan from a bank	↑							↑		
Pay outstanding balance on a short-term loan	↓					↓				
Donor contribution to Loan Fund Capital	↑									↑
Disburse a loan to a client	↓	↑								
Client repays a current loan	↑	↓								
Receive a client deposit	↑						↑			
Pay off outstanding long-term loan from bank	↓							↓		
Receive a 2 year donation restricted for Operations	↑								↑	
Payment of dividends to shareholders	↓									↓
Purchase a computer and pay half on credit	↓				↑	↑				

To summarize, a Balance Sheet shows the overall financial position of an organization at a specific point in time and is cumulative since the beginning of the business operations. It is often useful to compare Balance Sheets from previous periods in order to determine how the organization is growing and how well it is managing its financial resources.

Comparative Balance Sheet

Refer to the Sample Balance Sheet (Comparative) on the next page.

It is often useful to conduct a **trend analysis** over a number of years in order to see how the Balance Sheet has changed. Trend analysis simply refers to calculating the percentage change year after year (and/or various ratios over time, discussed in detail in the FINANCE module) and noting how assets are growing and how those assets are funded.

Note the change in the level of debt from one year to the next. It is important to maintain a balance between debt and equity, as too much debt may result in difficulty repaying the loans. An organization must ensure that it does not take on too much debt relative to its ability to repay. Equity, on the other hand, does not require repayments at a specific time although it must be emphasized that the amount contributed by the owner or other investors must earn a positive return or the business will not be successful in the long term. (This is explained in greater detail in the FINANCE module.)

If the organization has a large amount of equity and very few liabilities, it is likely limiting its income generating potential by not making use of external sources of debt, e.g. a line of credit or a loan can be borrowed for, say, 10% and on-lent to clients at 15%. Therefore, it may be better for the organization to increase its liabilities in order to increase its income-generating assets (i.e. loan portfolio). It is important to note that an organization should maintain an appropriate balance between equity and liabilities.

SAMPLE BALANCE SHEET (COMPARATIVE)

ABC Credit Programme
BALANCE SHEET
as at December 31, 1995

	Dec. 31, 1995		Dec. 31, 1994		% Change
ASSETS					
Cash & Bank Current Accounts		5,000		2,500	+ 100%
Interest-bearing Deposits		8,000		7,000	+ 14%
Loans Outstanding:					
Current	66,000		50,000		+ 32%
Past-Due	17,000		19,500		- 13%
Restructured	1,000		500		+100%
Loans Outstanding (Gross)	84,000		70,000		+ 20%
(Loan Loss Reserve)	(7,000)		(5,000)		+ 40%
Net Loans Outstanding		77,000		65,000	+ 19%
Other Current Assets		500		1,000	- 50%
TOTAL CURRENT ASSETS		90,500		75,500	+ 20%
Long-term Investments		12,500		11,000	+ 14%
Property and Equipment:					
Cost	4,000		4,000		0%
(Accumulated Depreciation)	(700)		(300)		+ 133%
Net Property and Equipment		3,300		3,700	- 11%
TOTAL LONG-TERM ASSETS		15,800		14,700	+ 8%
TOTAL ASSETS		**106,300**		**90,200**	**+ 18%**
LIABILITIES					
Short-term Borrowings (commercial		18,000		12,000	+ 50%
Client Savings		0		0	-
TOTAL CURRENT LIABILITIES		18,000		12,000	+ 50%
Long-term Debt (commercial rate)		12,000		15,000	- 20%
Long-term Debt (concessional rate)		35,000		30,000	+17%
Restricted/Deferred Revenue		0		0	-
TOTAL LIABILITIES		**65,000**		**57,000**	**14%**
EQUITY					
Loan Fund Capital		40,100		33,000	+22%
Retained Net Surplus/(Deficit) prior		200		0	-
Net Surplus/(Deficit) current year		1,000		200	+ 400%
TOTAL EQUITY		**41,300**		**33,200**	**+ 24%**
TOTAL LIABILITIES AND EQUITY		**106,300**		**90,200**	**+ 18%**

Source: SEEP Financial Services Working Group

The Balance Sheet: EXERCISES

1. What are the main elements of a Balance Sheet?

2. What is the Accounting Equation?

3. Define: Asset, Liability and Equity.

4. Put (√) in the appropriate column:

ITEMS	ASSETS	LIABILITIES	EQUITY
Cash			
Equipment			
Client Savings			
Net Deficit - current year			
Restricted/Deferred Revenue			
Building			
Loans Outstanding - current			
Loan Fund Capital			
Long-term Investments			
Long-term Debt (concessional)			
Loans Outstanding - Past Due			
Loan Loss Reserve*			
Restructured Loans			

* Is sometimes treated as a liability.

5. For the following transactions, show how these affect the Balance Sheet:

i. Purchase land on credit (> one year)
ii. Disburse loan to client
iii. Purchase motorcycles for staff - pay half cash; half short-term credit
iv. Purchase office furniture on short-term credit
v. Take loan from bank at commercial rate of interest (> one year)
vi. Purchase a Treasury Bill for cash
vii. Client withdraws savings
viii. Receive an unrestricted donation
ix. A current loan becomes past due
x. Receive a restricted donation for operations (3 years)

	ASSETS				=	LIABILITIES			+	EQUITY
	Cash	Current Loans Outstanding	Loans Past Due	Investments	Property & Equipment	Short-term Borrowing	Client Savings	Long-term Debt	Restricted/ Deferred Revenue	Equity
i.										
ii.										
iii.										
iv.										
v.										
vi.										
vii.										
viii.										
ix.										
x.										

6. Draw the general format of a Balance Sheet.

7. The following information is available for MicroFund Inc. as at 30th June, 1995. On the basis of this information, prepare a Balance Sheet using the format shown on the next page.

PARTICULARS	$	PARTICULARS	$
Loans Outstanding - Restructured	10,000	Restricted Revenue	139,800
Client Savings	146,512	Long-term Investments	104,500
Furniture	33,490	Accumulated Depreciation	23,219
Short-term Deposit	7,366	Equipment	41,296
Long-term Debt (concessional)	150,000	Long-term Debt (commercial)	100,000
Cash	6,000	Vehicles	47,500
Loan Loss Reserve	21,000	Retained Net Surplus (prior)	6,900
Loans Outstanding - Current	350,000	Bank Current Accounts	5,000
Interest Receivable	2,500	Loans Outstanding - Past Due	70,000
Refrigerator	2,100	Short-term borrowings	7,500
Loan Fund Capital	84,621	Computer Equipment	10,000
Retained Net Surplus (current)	10,200		

MicroFund Inc.
BALANCE SHEET
As at June 30, 1995