UNIT-6 Balance Sheet (Statement of Financial Position)

Learning Outcomes

By the end of this unit the learner will be able to:

- ✓ Understand meaning and definition of Balance sheet
- ✓ Describe the Classification of assets and liabilities
- ✓ Understand the adjustment of Balance sheet
- ✓ Describe how to prepare the Balance sheet.

Unit 6

Balance Sheet (Statement of Financial Position)

Things to Expect

This unit will familiarise you with several important accounting concepts such as assets, liabilities, and net worth. It will guide you to a step-by-step process of creating a balance sheet and using it to analyse a business's liquidity and leverage.

Things to Know Before Getting Started

The Purpose of Financial Statements

One of the main purposes of financial statements is to communicate a business's financial position to the parties interested in this information. The balance sheets, income statements, and cash flow statements are the three most widely prepared financial statements.

The Balance Sheet, which is also known as a Statement of Financial Position, is produced on a standard accounting format and records a business's assets, liabilities, and owner's equity. The Balance Sheet of a large business, such as, General Motors, will be prepared on the same format as that of a smaller business because it has to conform to the basics of accounting standards and concepts. The reason accounting is referred to as the language of business is because it is carried out along standardized methods and time-tested concepts. One does not have to be a certified accountant to adopt the Generally Accepted Accounting Principles (GAAP), in order to prepare financial statements for his business.

The usefulness and strength of the GAAP lies in the fact that it has standardized accounting practices for all businesses, which makes financial statements reliable and comparable from one accounting period to another.

The integrity and reliability of a financial statement depends on the information or raw data that has been used to produce it. Sometimes a business has to undertake the task of restructuring their record keeping before they move on to the process of preparing financial statements.

In order to determine which information would be required for financial statements and which has to be ignored or discarded, the following questions can provide some help:

- Are the financial records, which are related to all of the company's assets, i.e., the equipment, plant, inventory, and furniture, etc., and liabilities, i.e., personal and bank loans, in one place?
- Is there a record (amounts and sources) of the cash that was spent to initiate the business and buy the inventory?
- Does the business have a record of how much it owes to the bank, creditors, and others?
- Does the business know how much it owes and what is due in the next twelve months?
- Does the business have an estimate of the percentage of its receivable amount that has not yet been received by the business?

Why Create a Balance Sheet?

Balance Sheets summarise a company's assets and liabilities, as well as, the overall financial well-being of the business. It is usually prepared at the end of an accounting period, which can be a month, every three months, or once a year. However, new businesses are not advised to wait for the end of an operating cycle or the end of the year to prepare their balance sheets because they should keep themselves updated with their financial position more frequently. Balance Sheets are considered to be very important decision-making and management tools.

Balance Sheets, along with other financial statements, contribute towards a very important and sophisticated financial analysis of the business. It not only gives a picture of the firm's flexibility, liquidity, and leverage; a comparison of balance sheets from different accounting periods also allows restructuring and important decision-making.

How to Prepare a Balance Sheet

The following is a basic formula to understand how Balance Sheets are prepared:

Assets = Liabilities + Net Worth

If the Balance Sheet is prepared on a two-column format, all assets are recorded on the left, liabilities on the right, and the net worth of the company is recorded beneath the liabilities. If it is prepared on a one-column format, then, assets are recorded first, followed by liabilities and finally, the net worth.

Here is a sample Balance Sheet for the ABC Company.

ABC CO Statement of Financial Position as at 31 December 2013

Non- Current assets	$
Property , plant and equipment	150,000
Goodwill	50,000
Current assets	
Inventory	100,000
Trade receivables	75,000
Cash	50,000
Total assets	**425,000**
Equity and liabilities	
Equity	
Share capital	50,000
Retained earnings	15,000
Long term liabilities	
Long term borrowings	325,000
Short term liabilities	
Trade payables	35,000
Total equity and liabilities	**425,000**

Assets

Each type of asset is explained in this unit and a worksheet is provided for more detailed understanding of assets later on in our course.

Balance Sheet divide assets into three categories: current assets, long-term (fixed) assets, and other assets. Assets are arranged in order of their liquidity, or in other words, their ability to be converted into cash readily. Therefore, liquidity can be defined as the process of converting assets into cash.

Anything that can be converted into cash within a period of one year or a normal business cycle is classified as a current asset. Examples of current assets are: cash, prepaid expenses, stocks and bonds, inventory, and accounts receivable, etc. Small businesses most commonly use accounts receivable, cash, prepaid expenses, and inventory as their current assets.

Cash can exist in the following forms - cash in hand, cash in bank, or petty cash.

Accounts receivable describes the money that customers owe the business. The business must be able to access this information readily because it is important to take action when customers are not able to repay their debts to the business. There is an allowance, which is made for those debtors who the business thinks, will not be able to pay back their debt. This is called allowance for bad debts and is deducted from accounts receivable.

Inventory is often considered a company's largest current asset. It includes completed goods ready for sale, half finished goods that will be sold when they are manufactured and raw materials used for manufacturing goods.

The monetary amount assigned to it in the balance sheet is the cost of replacing inventory. In other words, it is the money that will be required to replace or reproduced inventory in case it gets damaged, stolen, or destroyed.

Prepaid expenses are classified as current assets because they are goods and services that the business has paid for, but have not yet consumed or received. Examples of prepaid expenses are the following: prepaid insurance premiums and prepaid rent, etc. The last month of a rental lease, that the business might have prepaid as security deposit, is also an example of prepaid expense that will be carried on as an asset, until it has been used. Prepaid expenses are also known as unexpired expenses.

Current assets are summed up and the total amount is shown against 'Total Current Assets' on the balance sheet.

Step 1: Complete the Current Asset Section of the Worksheet.

This is known as long-term assets, fixed assets are the assets that produce revenue. They are different from current assets because they are not for the purpose of resale and their life exceeds the short-term i.e. one year or one business cycle. Fixed assets vary with the type of business (whether it is manufacturing or service), size of the business and the kind of market it is operating in. Usually, small businesses do not have a large amount of fixed assets because they start with minimum capital.

Examples of fixed assets include buildings, motor vehicles, machinery and equipment, land, furniture, fixtures, and any other items that are expected to last a long time in the ownership of the business.

Fixed assets, except land, are recorded in the balance sheet at their original or historic cost and depreciation is subtracted from the cost. Deducting depreciation from the cost of an asset is a practice to avoid overvaluation. Subtracting depreciation means that the wear and tear of using an asset is assigned a monetary value, which is then deducted from the cost at which the asset was bought. Sometimes, the original cost of an asset is more than the invoice price because it takes into account other costs such as, shipping, installation, and associated expenses.

Even if you are not familiar with depreciation and do not know how to calculate it, you can still prepare a Balance Sheet, although, it will not be conformed with GAAP. In this case, the Business Builder assumes that you know how to calculate depreciation and have chosen one out of the various methods of calculating depreciation.

Now we talk about categories of fixed assets, which are mostly used by small business. These include, furniture and fixtures, machinery, equipment, motor vehicles etc.

- Office furniture, display shelves, tables, storage bins, counters, and other furniture of day-to-day office use are listed in the Balance Sheet under the line item, ‘Furniture and Fixtures’. They are recorded at their original cost (plus any associated expenses) minus depreciation.
- The original value (less depreciation) of motor vehicles owned by the business e.g. delivery trucks, are listed under the lined item ‘Motor Vehicles’.
- Fixed assets of businesses also include machinery and other equipment. These are the most important and largest fixed assets for manufacturing businesses. On balance sheets, machinery and equipment is recorded just like any other fixed asset – valued at original cost while subtracting depreciation.
- Then there is another category of fixed assets which have intangible values e.g. patents, royalty arrangements, and copyrights.

Step 2: Complete the Fixed Assets Section and the Other Assets Section and compute the total assets of your Business.

Liabilities

The claims that can be made by the creditors against assets of businesses are termed liabilities. In other words liabilities are the debts of businesses. On a Balance Sheet, the more important liabilities, which need to be paid sooner than others, are placed before any others. For instance, “accounts payable” appear before
“notes payable” because, usually, the accounts payable have to be cleared within 30 days and notes payable have 90 day period.

The following are the two types of liabilities: Current Liabilities and Long- Term Liabilities.

Current liabilities: This category of liabilities include notes payable (e.g. to banks), accounts payable, accrued expenses (e.g. wages and salaries), accrued payroll taxes, the part of any long-term debt which is due within one year and all other obligations that have to be met within one year. The kinds of liabilities vary from businesses to businesses. For small businesses current liabilities mainly comprise accounts payable, notes payable and accrued payroll taxes.

- **Accounts Payable** includes the amount that one still has to pay for any goods or services that have been received;
- **Notes Payable** includes the amount that one has to pay on a loan within one year; and
- **Accrued Payroll Taxes** includes the amount that has to be given to employees who have given their services, worked, and are waiting to be paid.

Long-Term Liabilities are loans that the company has to repay after more than year from the date of the balance sheet. This usually includes start-up loans that the business has taken from banks, finance companies, and relatives, etc.

Step 3: Complete the Liabilities Section of the Worksheet. Compute Total Liabilities.

Net Worth

The following formula summarizes the balance sheet:

Assets = Liabilities + Net Worth

This formula can be rearranged to the following:

Net Worth = Assets – Liabilities

Net Worth is the amount that we get after subtracting liabilities from the assets. Net Worth is also called 'Owner's Equity' and it is a sole proprietorship. Owner's Equity is the owner's investment in the business, plus, any profit made by the business or minus any losses incurred by it.

Step 4: Complete the Net Worth Section of the Worksheet. When this is done, you Should have a Completed Balance Sheet for your Business.

BALANCE SHEET WORKSHEET

Enter your Company Name here:____

ASSETS	**BEGINNING:**___________	**PROJECTED:**_________
Current Assets		
Cash in bank	£ ____________________	£ ___________________
Accounts receivable	£ ____________________	£ ____________________
Inventory	£ ____________________	£ ____________________
Prepaid expenses	£ ____________________	£ ____________________
Other current assets	£ ____________________	£ ____________________

Total Current Assets	£	£
Fixed Assets		
Machinery & equipment	£	£
Furniture & fixtures	£	£
Leasehold Improvements	£	£
Land & buildings	£	£
Other fixed assets	£	£
(LESS accumulated depreciation on all fixed assets)		
Total Fixed Assets (after subtracting depreciation)	£	£
Other Assets		
Intangibles	£	£
Deposits	£	£
Goodwill	£	£
Other	£	£
Total Other Assets	£	£
TOTAL ASSETS	£	£
LIABILITIES AND EQUITY		
Current Liabilities		
Accounts payable	£	£
Interest payable	£	£
Taxes payable	£	£
Note payable, short-term (due within 12 months)	£	£
Current part, long-term-debt	£	£
Other current liabilities	£	£
Total Current Liabilities	£	£
Long-term Debt		
Bank loans payable	£	£

Notes payable to stockholders	£ ____________________	£ ____________________
LESS: Short-term portion	£ ____________________	£ ____________________
Other long-term debt	£ ____________________	£ ____________________
Total Long-term Debt	£ ____________________	£ ____________________
TOTAL LIABILITIES	£ ____________________	£ ____________________
Net Worth	£ ____________________	£ ____________________
TOTAL LIABILITIES & NET WORTH	£ ____________________	£ ____________________

Four simple formulas are used to enhance the information provided in the Balance Sheet. These are discussed in the next section.

The details provided above are enough to help you in preparing a Balance Sheet.

How to Analyze a Balance Sheet

After completing the Balance Sheet, the company can make some simple calculation in order to interpret the information provided in the Balance Sheet. This can give the company a better understanding of its financial position and financial indicators, such as, leverage and liquidity.

Ratio shows a relationship between numerical values. It is the size of two quantities in relation to each other and expressed as the quotient of one divided by the other. Analysing financial ratios is an important aspect of making financial comparisons between two companies and of determining the financial trends of a business.

It helps the management in taking informed decisions based on the information provided by the Balance Sheet. The Ratio Analysis is also important for loan officers to determine the financial credibility of the parties who are borrowing money for the company.

The following four financial ratios can be calculated from the information provided in the Balance Sheet:

- Current Ratio;
- Quick Ratio;
- Working Capital; and
- Debt/Worth Ratio

Current Ratio

The Current Ratio, also known as the Liquidity Ratio, measures the number of times that the business's current assets exceed its current liabilities. It indicates a business' financial strength and solvency.

The formula for computing current ratio is as follows:

Current Ratio = Total Current Assets ÷ Total Current Liabilities

The Current Ratio addresses the question of whether the business has enough assets to meet its current liabilities easily and with a margin of safety. Generally, a current ratio of two is considered to be strong. However, the strength of the Current Ratio can differ depending on the size of the business, its nature and the kind of current assets and liabilities that it possesses. The quality of the accounts receivable and the cash value of inventory can be doubtful whereas there is very little doubt concerning the amount if debts that are due.

The Current Ratio increases as current assets increase or as current liabilities decrease.
This can happen in the following ways:

- Acquiring a long-term loan i.e. payable after a year;
- Paying back debts;
- Investing profits into the business; and
- Selling a fixed asset.

A very high Current Ratio suggests that cash is lying idle with the business and it is not being utilized efficiently to give optimum returns. The business should buy equipment or invest in something profitable for the business with the unutilised cash.

Quick Ratio

This is also called the " Acid Test Ratio," it is used to measure a business's liquidity. It only considers those assets that can most readily be converted into cash to pay back current liabilities. This is shown in the following formula:

Quick Ratio = (Current Assets - Inventory) ÷ Current Liabilities

Cash, stocks, bonds, accounts receivable, and all current assets on the Balance Sheet, except the inventory, are called quick or liquid assets. The quick ratio basically determines whether the business is in a position to meet its liabilities in adverse conditions or in a short span of time. Quick Ratios between 0.5 and one are considered healthy, if the business can get its debtors (accounts receivable) to pay quickly.

Working Capital

Lenders usually use working capital ratio to determine a company's credit worthiness and its financial well-being. It must always be a positive number. Most loan agreements have a specified working capital ratio that must be maintained by the company they are lending to.

Working Capital = Total Current Assets - Total Current Liabilities

The Current Ratio, Quick Ratio, and Working Capital all measure the company's liquidity. As per general rule, the higher these ratios are, the more liquid and financially healthier a business is considered to be. However, if a business is too liquid, it indicates that there is too much cash that is not being put to efficient use.

Debt/Worth Ratio

The Debt/ Worth Ratio is also called the " Leverage Ratio" and it measures the company's solvency. In other words, it indicates how much a company relies on borrowing and loans instead of owner's equity. It is a measure of the amount owned by the business as opposed to the amount that is owed to lenders.

The following formula is used to calculate Debt/ Worth Ratio:

$$\textbf{Debt/Worth Ratio} = \frac{\textbf{Total Liabilities}}{\textbf{Net Worth}}$$

Step 5: Compute the Current Ratio, Quick Ratio, Working Capital, and Debt/ Worth Ratio for your Company.

Conclusion

Information is the one tool that gives managers an insight into - and control over - financial matters of the business. How this information is used and the decisions made, which are based upon it, determine the success or failure of a business.

The Balance Sheet is only a statement that presents a picture of the business's assets and liabilities at one point in time. It is up to managers to interpret, analyse, compare, and evaluate the information provided in the balance sheet and monitor the company's progress. They can also draw up plans for the company's future based on their usage of information.

Further Reading:

- ✓ *Clyde Stickney, Roman Weil, (2007), Financial Accounting: An Introduction to Concepts, Methods and Uses.*
- ✓ *Michael P. Griffin, (2009), MBA Fundamentals Accounting and Finance.*
- ✓ *Ronald C. Spurga, (2004), Balance Sheet Basics.*