A Guide to Understanding Balance Sheets

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Introduction

The financial position of any business can be determined from three key financial statements: the balance sheet, the profit and loss account, and the cash flow statement.

A balance sheet is a financial 'snapshot' that summarises the value of a business (the assets of the business less its liabilities) at a specific point in time. All limited companies have to prepare a balance sheet as part of the annual accounts they submit to Companies House, but a balance sheet can be prepared at any time.

This factsheet explains the main features of a balance sheet, what kind of information it should contain and provides definitions of the key terms that are used on a balance sheet.

Understanding a balance sheet

A balance sheet is a good indicator of whether a business is solvent (meaning it can meet its financial obligations) and is able to trade on a continuing basis. It shows how a business is financed, how much capital is employed in the business and how quickly the assets of the business can be turned into cash.

A balance sheet shows all the assets of a business (anything owned by the business or owed to the business) less its liabilities (all the money owed by the business to its creditors). The resulting 'net asset value' will always be equal to the sum of the capital and reserves of the business, which includes any investments in the business plus the net profit the business has accumulated from its trading activities.

It is important to remember:

- A balance sheet does not show the profitability of a business. This is shown by the profit and loss account (see BIF 8, A Guide to Understanding Profit and Loss Accounts, for more information). If you have balance sheets from two consecutive years, you may be able to calculate the level of profit a business has achieved by comparing the change in value of the profit and loss reserve. However, this can understate the profit achieved if a business pays dividends to shareholders.
- A balance sheet does not reflect the true market value of a business' assets. It is necessary to put a value on any assets listed on a balance sheet, but the true value may be more or less than the figures given on the balance sheet.
- A balance sheet does not show the market value of a business. The market value of a business depends on past and potential future profitability and the current value (as opposed to cost) of any assets.

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A balance sheet is different from, but complementary to, the profit and loss account, and is critical to understanding the financial strength of a business.

A business can generate good profits but be regarded as being financially vulnerable if it has a weak balance sheet due to its low net asset value. On the other hand, a business can potentially sustain a period of poor profitability when it has a strong balance sheet, due to its high net asset value.

The following example of a balance sheet demonstrates how the net assets of the business (assets minus liabilities) are equal to the net worth (capital plus reserves):

Balance sheet at 30 April 2016	
Fixed assets (1)	
Tangible assets	
- Equipment	45,000
- Buildings	95,000
	140,000
Current assets (2)	
Stock and work in progress	10,000
Trade debtors	20,000
Cash at bank	5,000
	35,000
Current liabilities (3)	
Trade creditors	(17,000)
Other creditors	(5,000)
Loans	(10,000)
	(32,000)
Net current assets (2 minus 3)	3,000
Total assets less current liabilities (4) (1 + 2 minus 3)	143,000
Long-term liabilities (5) (falling due after one year)	(100,000)
Net assets (4 minus 5)	43,000
Capital and reserves	
Owner's capital	30,000
Retained profit	13,000
Net worth	43,000
(Figures in brackets represent negative values)	

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Key balance sheet terms

Fixed assets

Fixed assets usually have a useful life of more than one year. Fixed assets can be 'tangible' assets which physically exist, such as buildings and equipment, or 'intangible' assets that have a subjective value, such as intellectual property or goodwill.

The cost of tangible fixed assets, such as equipment, is depreciated over their expected lifetimes. This allows for the loss in value of those assets over time and it is this depreciated value (the 'net book value') that appears in the balance sheet. In the example balance sheet, the 'net book value' of the tangible fixed assets is £140,000.

If a business spends a large amount of money developing a new product, this expenditure can be capitalised (turned into an asset) and shown on the balance sheet as an intangible asset. If a business buys another business for more than its net worth, the difference in value is classed as 'goodwill', which represents the likelihood that existing customers will continue to buy. Since it is difficult to value both intellectual property and goodwill, except when they come to be sold, it is considered good practice to depreciate the value of intangible assets over a short period of time so that they can be 'written off' in the balance sheet ('amortised') as quickly as possible.

See BIF 41, Understanding and Calculating Depreciation, for more information.

Current assets

These are assets that can be turned into cash within one year and typically include:

- Stock and work in progress. Stock is usually valued at cost rather than its market value. However, old stock may be written down to its 'net realisable value'; that is, the price that it might attract if sold. Work in progress is the value of raw materials and components that are in the production process, but are not yet finished goods.
- Trade debtors. The value of trade debtors is the amount of money owed to a business by its customers. This figure includes value added tax (VAT) if a business is registered for VAT and charges VAT on its invoices.
- Cash at bank. This is the value of any money the business has that is deposited in bank accounts on the date the balance sheet is created. This figure may be adjusted for any cheques that have been issued to pay suppliers, but which are still waiting to be cashed.

In the example balance sheet, the value of the current assets is £35,000.

Current liabilities

Current liabilities are the total value of any money owed by the business that is due to be repaid within a year. They typically include:

- Trade creditors. The total amount of money that is owed to suppliers. This figure will include VAT if the business is VAT registered and has charged VAT to its customers.
- Other creditors. This is the value of any money that the business owes for taxes, including VAT, Pay As You Earn (PAYE) and corporation tax liabilities. It can also include provisions for costs that the business has incurred for products or services that have not yet been invoiced by suppliers.

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- Loans. This is the value of any loan or hire purchase repayments that are due to be repaid within the next 12 months and will also include any overdraft balance (if the business has an overdraft).This figure is likely to be only a portion of the total loan or hire purchase repayments that are outstanding at the balance sheet date. Any repayments that are due after 12 months are included in the balance sheet as long-term liabilities.

In the example balance sheet, the value of the current liabilities is £32,000.

Net current assets

This is simply the difference between current assets and current liabilities. In the example, net current assets are £3,000. This figure should be positive to indicate that the business is able to meet its current cash needs. A negative net current asset figure indicates that a business may not be able to meet its debts as they fall due. If this is the case, the business may be insolvent.

Long-term liabilities

Long-term liabilities include the balance of any bank loans and hire purchase payments that fall due later than 12 months after the balance sheet date. In the example balance sheet, long-term liabilities are £100,000.

Net assets

The net asset value of a business is the total assets (both tangible and intangible) less the total liabilities (both current and long-term). In the example balance sheet, net assets are £43,000.

Net worth

The net worth of a business is the sum of any capital and reserves.

- Capital is any money invested by the business owner or shareholders.
- Reserves are the retained profits of the business.

The capital and reserves are sometimes referred to as the 'equity' in the business and in the example the total net worth of the business is £43,000.

It is important to remember that reserves are not the same as cash: they simply show where the money in the business has come from. A business should seek to build up its reserves (profit) as this is the best source of working capital.

The net worth of a business will always be equal to the net assets, and therefore the balance sheet will 'balance'.

In the example balance sheet, the total net assets of £43,000 balances with the total net worth of £43,000.

Hints and tips

- Balance sheets can be compared over time - for example, current year against previous year - to identify changes in the strength and performance of a business.
- An accountant or business adviser can help in the preparation of balance sheets.

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- Computerised accounting packages can generate a balance sheet quickly, although it may need to be adjusted to allow for depreciation.
- Being able to read and understand a balance sheet is important for exercising effective financial control of a business, and for assessing the financial position of competitors.
- Balance sheets can be used to calculate a number of useful financial ratios that help to benchmark a business against its competitors and to measure changes in financial performance over time. See BIF 9, An Introduction to Understanding Financial Ratios, for more information.

Further information

BIF 8 A Guide to Understanding Profit and Loss Accounts
BIF 9 An Introduction to Understanding Financial Ratios
BIF 30 How to Keep a Manual Cash Book
BIF 38 Choosing and Using an Accountant
BIF 40 A Summary of Sources of Finance for Starting a Business
BIF 41 Understanding and Calculating Depreciation
BIF 54 A Guide to Costing and Pricing a Product or Service
BIF 58 How to Forecast Cash Flow
BIF 69 A Guide to Preparing and Submitting Company Accounts to Companies House
BIF 260 An Introduction to Preparing a Budget
BIF 264 An Introduction to Tax Self-Assessment

Books

'Accounting and Finance for Non-Specialists' (9th edition)
Peter Atrill and Eddie McLaney
2014
Pearson

'FT Guide to Finance for Non Financial Managers: The Numbers Game and How to Win It'
Jo Haigh
2011
Financial Times/Prentice Hall

'Understanding Your Business Finances'
Johnny Martin
2014
Essential Business

Useful contacts

The Institute of Chartered Accountants in England and Wales (ICAEW) is a membership organisation for accountants. There is a searchable directory of accountants on its website.
Tel: (01908) 248250
Website: www.icaew.co.uk

The Institute of Chartered Accountants of Scotland (ICAS) is a membership organisation for accountants in Scotland.
Tel: (0131) 347 0100

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Website: www.icas.com

Chartered Accountants Ireland represents accountants in Ireland and offers a 'find a member/ firm' facility on its website.
Tel: (028) 9043 5840 (Northern Ireland office)
Website: www.charteredaccountants.ie

The Association of Chartered Certified Accountants (ACCA) is a membership association for accountants.
Tel: (0141) 582 2000
Website: www.acca.org.uk

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