Balance Sheets

A balance sheet is a statement of a firm's assets, liabilities and owners' equity at a specific date (i.e. it is a "snapshot" of the financial strength of a business at a particular moment in time).

It summarises the financial state of the business at that date. When added together, the liabilities and owners' equity represent the sources of capital (i.e. it tells us where the money came from) and the assets represent the uses of the capital (i.e. it tells us how the money was spent).

The two sides of the account must always balance, since every penny raised as capital must have been used for some purpose and must be accounted for.

Assets

An **asset** is an item that will give present or future monetary benefits to a business as a result of economic events. Therefore, an asset is basically an item or money that the business owns.

There are two main types of classification of assets - fixed assets and current assets.

a) A fixed asset

b) A current asset

Fixed Assets

A **fixed asset** is acquired for the purpose of use in the business and is likely to be used by the business for a considerable period of time (more than 12 months).

There are three categories of fixed assets:

a) Tangible fixed assets (physical items such as land, buildings, machinery, and vehicles, the purchase of which is known as 'capital expenditure').

b) Intangible fixed assets (non-physical items, which are very difficult to place a value on, such as brand names, goodwill and patents).

c) Financial fixed assets (investments that the business has, such as shares and debentures in other companies).

Current Assets

A **current asset** is either part of the operating cycle of the enterprise or is likely to be realised in the form of cash within 12 months.

There are five categories of current assets:

a) Cash in the bank.

b) Cash on the premises ("petty cash").

c) Debtors (customers who have purchased goods on credit, and have not yet paid).

d) Stock (raw materials, work-in-progress and unsold finished goods).

e) Prepayments (where the business has paid in advance for the use of an item, rent for example).

Liabilities

A **liability** is the amount outstanding at the balance sheet date, which the business is under obligation to pay. Therefore, a liability is basically an item or money that the business owes to a third party.

There are two main types of classification of liabilities:

a) long-term liabilities

b) current liabilities

Long-term liabilities

A **long-term liability** is a source of long-term borrowing and will exist on the balance sheet for more than 12 months. T**here are three categories of long-term liability:**

a) Bank loans.

b) Mortgages (essentially a long-term loan to purchase land and buildings).

c) Debentures.

Current liabilities

A **current liability** can be simply defined as amounts of money owing to third parties which will be settled within 12 months. **They arise mainly through the process of day-to-day trading and there are five categories.**

a) Bank overdraft.

b) Creditors (suppliers who the business has not yet paid).

c) Accruals (debts for which a bill has not yet been received).

d) Corporation tax (owed to the Government).

e) Dividends payable.

Shareholders funds

There are several other items that appear on a Balance Sheet - most notably shareholders' funds (also called **'owners equity'**) and reserves.

These items show us where the business got its original capital from (i.e. the money it used to start-up), how much money the shareholders have a claim on within the business and what the business has done with any retained profits over the years.

It also shows us the effect of a rise in value (an **appreciation**) of any of the assets owned by the business.

In a sense, owners' equity is a liability of the business, in as much as it is a claim on the assets. However, it differs from other liabilities in that it does not have a definite date by which it is to be repaid and it is not a fixed amount.

The owners' equity is usually left in the business as long as it is required and it can fluctuate in value. Owners' equity is a residual claim on the business after all the other liabilities have been settled.

Using simple algebra, we can see that:

If	**Assets = liabilities + owners' equity**
Then	**Owners' equity = assets – liabilities**

Therefore, the owners of the business own the assets of the business less what the business owes to other bodies.

Balance sheet format

The usual layout for a balance sheet is as below:

Balance Sheet for 'My company PLC', as at 01/04/00

	£(000)	**£(000)**
Fixed Assets		**500**
Current Assets:		
Cash	**100**	
Debtors	**150**	
Stock	**50**	

Total Current Assets		**300**
Less Current Liabilities:		
Overdraft	**20**	
Creditors	**140**	
Total Current Liabilities		**160**
Net Current Assets [=Working Capital]		**140** [300-160]
Net Assets [=Assets Employed]		**640** [500+140]

Represented by:		
Long-Term Liabilities	**200**	
Share Capital	**250**	
Reserves	**190**	
Capital Employed		**640** [200 + 250 + 190]

ASSETS EMPLOYED = CAPITAL EMPLOYED: the two parts MUST always balance.

Remember, a balance sheet shows what a company owns (**assets**), what it owes (**liabilities**) and where the company got its money (**capital**) from at a specific point in time.

One of the most important parts of a balance sheet is the **'net current assets'** section. This is the day-to-day finance that is needed for running a business.

It is also referred to as **'working capital'** and it is calculated by deducting current liabilities from current assets. Working capital is used to pay for expenses such as wages, raw materials and utility bills.

If a business does not have sufficient working capital then it can face problems when paying its short-term debts (**current liabilities**). It may be the case that the business suffers a liquidity crisis and has to sell off some fixed assets, for example, in order to raise the necessary cash to meet its debts.

It is vital, therefore, that close control is kept over working capital, and the business must ensure that it does all that it can to keep enough cash available to pay its current liabilities.

On the other hand, if the business has too much cash tied-up in working capital, then it can be argued that this cash is not being used productively to help the business grow and diversify into new products and markets.

The purpose of a Balance Sheet

The purpose of a Balance Sheet is to communicate information about the financial position of the business at a particular moment in time. It summarises information contained in the accounting records in a clear and understandable form.

It can give an indication of the financial strength of the business and can also indicate the relative liquidity of the assets.

It also gives some information on the liabilities of the business and when they will fall due. The combination of this information can assist the user in evaluating the financial position of the business.

It should be remembered, however, that the Balance Sheet is only **one** part of the financial statements required to give an accurate appraisal of the financial position of a business, and as such the importance of just one of these statements should not be over-emphasised.

It is only by collectively analysing the Balance Sheet, the Profit & Loss account and the Cash Flow Forecast of a business that an overall impression can be gathered on the financial strength of the business.