The Balance Sheet

On the international level, the form of a balance sheet is not strictly prescribed by the legislation. The economic entities can design the exact form of their own balance sheet. The only thing prescribed by legislation is to obey the basic accounting principles. However, typical items can be found:

ASSETS

I. Current Assets

I.1. Cash

Any medium of exchange that a bank will accept at face value: cash, bank deposits, currency, checks.

Check: a written instrument signed by the depositor (*drawer*), ordering the bank (*drawee*) to pay a certain sum of money to the order of a designated person (*payee*).

"Checks" presented in the balance sheet refer to demands on money (the examined entity is the payee)

Cash is presented at FACE VALUE.

I.2. Marketable securities (temporary investments)

When a company has excess cash that is not needed immediately, it may put it into income-yielding investments, which can be quickly and easily converted into cash.

Temporary investments in securities include stocks (shares) and bonds (will be detailed later)

Marketable securities should be presented at HISTORICAL COST. The gain or loss originating from the difference between the market price and the historical cost (also called as *book value*) remains unrealized until the securities are sold.

I.3. Receivables

Receivables include all money claims against people, organizations or other debtors.

Accounts Receivable

Receivables originating from sales of products or services on a credit basis.

Notes Receivable

Money claims related to *promissory notes* (or simply *notes*). A promissory note is a written promise by the maker (payer) to pay a sum of money on demand or at a definite time to the payee.

The reason why the payee accepts a note instead of payment is *interest*.

Face value of the note
+ Interest on the note
= Maturity value

The interest rate is usually stated as yearly interest. The calculation of interest on a given time interval:

*Principal * Interest Rate * Time =Interest*

Example. Our firm accepted a note instead of a $ 3,000 payment on 1 March. The term of the note is 90 days, the interest rate is 12%. (1 year = 360 days)
What is the maturity value?

Face value	$ 3,000
+ Interest	$ 90
	(3,000*0,12*90/360)
= Maturity value	$ 3,090

Example. We have a 60-days note with maturity value of $ 2,244. Interest rate is 12%.
Determine the face value.

The interest contained by the maturity value is 12%*60*360= 2%.

Face value = $ 2,244 / 1,02 = $ 2,200

Discounting Notes
If the holder (payee) of the note needs cash immediately, he can sell the note to a bank at a discounted price.

If doing so:
(1) The payee will receive cash before maturity date (although at a lower value than the maturity value)
(2) The bank will realize a gain on buying the note at a discounted price and collecting the total sum at maturity date.

The calculation of the discounted value:

$$\text{Proceeds} = \text{Maturity value} * \left(1 - \frac{\text{Discount rate}}{100} * \frac{\text{Number of days remaining}}{360}\right) - \text{Transaction cost}$$

Example. Our company discounted its note 60 days before maturity due to liquidity problems. The note's face value is $ 850, the maturity value is $ 900, discount rate applied by the bank is 24%. The bank charged $ 4 for the transaction.
Determine the amount of cash we received.

Proceeds = 900 * (1-0,24*60/360) –4 = $ 860

As a result, we gained only $10 interest (=860-850) instead of $ 50 (900-850).

Receivables should be presented in the balance sheet at FACE VALUE (without interest) based on the Conservatism Concept.

Important Rules related to Receivables:

- Uncollectible Receivables MUST NOT presented in the balance sheet. (Uncollectible=will never be realized). These should be written off. The write-off of uncollectible receivables is irreversible.
- Doubtful Receivables should not be presented in the balance sheet, either, they should be written off as "Allowance for Doubtful Accounts" (Doubtful=Not likely to be realized). This write-off is reversible. If the reasons for allowance disappear (the money is collected), the account should be reinstated.
- Receivables not been acknowledged by the customer should not be presented in the balance sheet.

I.4. Inventories

Inventories consist of

(1) Material used in the process of production
(2) Finished products and work in progress
(3) Merchandise goods (being purchased and sold)

Based on the Matching Concept and the Cost Concept the accountant's task is to distinguish:

- Inventories that have been sold during the financial year: *Cost of Sales (Income Statement)*
- Inventories that have not been sold yet: *Current Assets (Balance Sheet)*

II. Fixed Assets

II.1. Intangible assets

Intangibles are long-lived assets without physical qualities that are useful in the operations of an enterprise for more than 1 year. The typical items of intangibles are:

Software

Patents: exclusive rights to produce and sell goods that have one or more unique features.

Tradable rights: i.e. rental rights, rights of usage, trademarks, licences etc.

Goodwill: it is an intangible assets originating from the acquisition of another business, where the price paid is significantly higher than the value of the acquired company's assets less its liabilities. This extra amount paid refers to a higher-than-average profitability, reputation, or other advantageous characteristics of the acquired business.

II.2. Tangible assets (plant assets)

This category embraces long lived assets that have physical features. The most typical tangibles are:

(1) Land
(2) Buildings
(3) Machinery
(4) Production equipment, etc.

All intangible and tangible assets ***with the exception of land*** lose their capacity to generate profits through the time. The reasons for this are (1) physical deterioration and (2) obsolescence. This decrease in value is expressed by a yearly cost called **DEPRECIATION.**

The tangible and intangible assets should be presented in the balance sheet at **Book Value** that is computed as the initial cost less accumulated depreciation.

II.3. Investments

Investments are primarily securities of other companies held by the examined company in order to control the other company or to earn a return on the investment. Therefore they are to be distinguished from marketable securities, which are only reflecting the temporary use of excess cash.

The types of securities are:

Shares: Securities representing property rights, this means that the shareholder is part-owner of the issuer company. The yield of the share is called *dividend*, which is a variable amount depending on the company's profits. Shares have no maturity, but their owner can sell them.

Shares (as a part of Investments) should be presented in the balance sheet at **Historical Cost.** The price is usually expressed as a percentage of the Par Value (Face Value).

Bonds: A bond is a certificate promising to pay its holder the bond's *par value (face value)* at maturity date plus interest at specified dates (usually once a year).

Bonds should be presented at **historical cost.** However, a bond's historical cost is not simply the price paid for it. Regarding that interest is paid on the bond (say once a year), the money paid for the bond consists of:

(1) the historical cost of the bond
(2) interest expense paid to the seller (for the time between the last interest payment date and the date of purchase)

Example. We bought 20 pieces of corporate bonds on 15 April for $ 24,000. Their par value is $ 1,000 each. The interest payment day is 15 October, the annual rate of interest is 12%.

Compute the historical cost of the package.

Solution: It has been 6 months since the last interest payment. Thus the purchase price contains 20*1,000*0.12*6/12 = $ 1,200 interest . The historical cost of the bonds is $ 22,800 (= 24,000–1,200), the rest is interest expense ($ 1,200).

A special type of bonds are **discount bonds.** These are issued below their par value (=at a discount). At maturity date, the issuer pays back the par value of the bonds to the holder. Thus, the holder's yield is not regularly paid interest, but the difference between the par value and the purchase value (historical cost, which is less than the par value)

Discount bonds should also be presented at **historical cost.**

Long-term receivables: Receivables that have a maturity of more than one year. An example can be a long-term loan granted to another company.

A very important rule is that the instalments of long-term receivables falling due within one year must be transferred to Receivables (Current Assets) at the end of the financial year.

Long-term bank deposits: Bank deposits with a maturity of more than one year.

If the term of a fixed deposit matures within one year, it must be transferred to Cash (Current Assets) at the end of the year.

SHAREHOLDERS' EQUITY AND LIABILITIES

I. Shareholders' Equity

The basic components of Shareholders' Equity are Paid-in Capital, Share Premium Account (Capital Surplus Account), Retained Earnings, Net income for the year and Other Reserves.

I.1. Paid-in Capital (Share Capital)

Paid-in Capital is made up of the par value (face value) of common stock and preferred stock.

Common stock: shares that have equal rights, the most important of which are:

(1) the right to vote in matters concerning the company
(2) the right to share in the company's profits
(3) preemptive right to purchase a proportionate number of additionally issued shares (and thus to maintain the same fractional interest in the company)
(4) the right to share in assets upon liquidation

Preferred stock: shares providing preferential rights, i.e. extra votes or ensured amount of dividends (even if the company had a loss in the financial year)

I.2. Share Premium Account (Capital Surplus)

The shares are usually issued at a higher price than their par value. The difference between the shares' issue price and par value (which is always a surplus) should be presented as Capital Surplus.

Example. The "Starter" Company was established on 1 January 2004 with 1,000,000 pieces of common stock at a par value of $ 0.25 each, while the issue price was $ 0.40 per share.

Determine the sum of Share Capital and Capital Surplus.

Solution:

Share Capital = 1,000,000 * 0.25 = $ 250,000

Capital Surplus = 1,000,000 * (0.40 - 0.25) = $ 150,000

I.3. Other Reserves

Amounts of money that have been paid in by the owners (for example to resolve a weak liquidity position) without acquiring any extra rights. The company does not have an obligation to repay, the reserves will be presented as part of the owners' equity. (= It is not a credit).

I.4. Retained Earnings

The accumulated profits (losses) of the former financial years.

I.5. Net income for the year

Earnings after taxes and distribution to shareholders (dividends) that is presented in the Income statement as "Net Income". At the beginning of every financial year, its content is transferred to the Retained Earnings account and thus its balance becomes zero.

II. Liabilities

Liabilities are amounts of money owed to different parties such as banks, creditors, employees, authorities etc. We can divide them into two groups: Long-term liabilities (falling due after 1 year) and Short-term liabilities or Current liabilities (falling due within 1 year).

II.1. Long-term liabilities

The most commonly presented items are as follows:

II.1.1. Liabilities from bonds issued

These are liabilities originating from the issue of bonds. When the company issues the bonds, it receives money for them (the *issue price*). However, the *par value* should be repaid to the holders at the maturity date, which is, therefore, presented as a liability for the company.

A special type of bonds are **convertible bonds.** These are similar to ordinary bonds, but their holder has the right to exchange them for shares (convert them into shares) and thus to become from a creditor to a part-owner of the firm.

II.1.2. Long-term debts

Loans from banks, financial institutions or other creditors that fall due in more than a year.

III.1.3. Deferred tax liabilities

In the international world, economic actors are given the opportunity to defer their tax payments if part of their revenues are not realized in the given financial year. Then, if the revenues become realized, they pay the income taxes deferred from former financial years.

The instalments of long-term liabilities that fall due within one year should be transferred to Short term liabilities at the end of the financial year.

II.2. Current liabilities

The most typical items of short-term liabilities are:

II.2.1. Accounts payable

Amounts owed to suppliers originating from the purchase of assets on a credit basis.

II.2.2. Notes payable

Liabilities related to promissory notes. The Conservatism Concept should be applied, which results in the fact that notes payable should be presented at **maturity value** (at the highest possible value, which contains interest as well).

II.2.3. Short-term debts

Loans, credits due to banks, financial institutions etc. The instalments of long-term debts that fall due in the next financial year should also be presented here.

DEFERRALS AND ACCRUALS

As it was discussed earlier, economic actors should apply the Matching Concept, which says that the expenses and the revenues of a specific event should be presented in the same financial year. Sometimes, however, revenues and expenses do not occur in the same financial year that they belong to.

Deferrals and accruals are tools of resolving this problem.

Deferral: It is a delay of the recognition of an expense already paid or of a revenue already received. Deferrals can be divided into two groups:

- Prepaid expenses: the best examples of this are costs or fees paid in advance such as rental fee, subscription fee etc. The part of this expense that belongs to the next year should not be presented as an expense in the income statement but as a deferral in the balance sheet (among Current assets).

  Example. On 1 December 2003, our company has paid the 3-month rental fee of its downtown office in advance for December, January and February. The amount paid was $ 3,300.

  How should this transaction be presented in our annual report?

  Solution:

  Expense of Year 2003 = $ 1,100
  (in the income statement)

  Deferral (becomes expense in Year 2004) = $ 2,200
  (in the balance sheet)

- Unearned revenues: revenues that are already received but (partly) belong to future financial years should not be presented as revenues but as a deferral in the balance sheet (among Current liabilities). In order to illustrate it we should see the former example from the other party's point of view:

Example. One of our offices is rented by a partner company. We collected the $ 1,800 rental fee for the next 3 months on 1 December 2003.

How should this event presented in our annual report?

Solution:

Revenue of Year 2003 = $ 600
(in the income statement)

Deferral (becomes revenue in Year 2004) = $1,200
(in the balance sheet)

Accrual: an expense that has not been paid or a revenue that has not been received but belongs to the current financial year. Again, two groups can be distinguished:

- Accrued expenses: expenses that are only recorded in the next year but should be presented as the current year's expense:

Example. We have received the telephone bill for December 2003 ($100) on 7 January 2004. What should be done with this expense?

Solution: The expense should be presented in the 2003 Annual report as:

Expense of Year 2003 = $ 100
(in the income statement)

Accrual (among current liabilities) = $ 100
(in the balance sheet)

- Accrued revenues: revenues that are only received later but should be presented in the current year's report.

Example. The "Sir Arthur" Consulting Company has sent an invoice about a $ 300 consultancy fee to one of its clients on 14 January 2004, which involves last year's consulting services. How should this event be handled?

Solution:

Accrual (among current assets) = $ 300
(in the balance sheet)

Revenue for Year 2003 = $ 300
(in the income statement)

A summary of how to present Deferrals & Accruals:

Prepaid expenses ⇨ **Current Assets (+)**
Expenses (–)

Unearned revenues ⇨ **Revenues (–)**
Current Liabilities (+)

Accrued expenses ⇨ **Expenses (+)**
Current Liabilities (+)

Accrued revenues ⇨ **Current Assets (+)**
Revenues (+)