Question One

Understanding Balance Sheet

The balance sheet is one of the most important financial statements of any company besides profit and loss account and cash flow statement. It is a statement of the values of the assets owned at a specific time, or liabilities, held by other entities against the owner of those assets. Unlike other financial statements, the balance sheet cannot cover a range of dates. In other words, it may be good "as of December 31, 2002", but cannot cover from December 1 - December 31. This is because a balance sheet lists items such as cash on hand and stocks, which change daily.

The net worth of an entity can be defined as the total value of the assets owned less the total value of liabilities. This can be an indicator of wealth. A balance sheet is typically compiled at the end of each accounting period, which is also the beginning of the next accounting period.

Balance sheet is reported to investors at least once per year. The name 'balance sheet' is derived from the fact that these accounts must always be in balance. Assets must always equal the sum of liabilities and owner's equity (Assets = Liabilities + Owner's Equity).

What Will A Typical Balance Sheet Show Users?

Among other things, the balance sheet will show users the value of the items the company owns, how much money the business has to work with in the short term.

Assets

Items get classified on a balance sheet under well-defined names. Standard assets classifications are:

1. Cash
2. Accounts receivable
3. Inventory
4. Prepaid expenses
5. Land
6. Property, plant & equipment (PPE)

As the first four items will be converted into cash within a year and are known as current assets.

Assets are commonly thought of as items the company owns. A better definition of assets is probably the future economic benefits obtained or controlled by a business entity as a result of past transactions or events. The assets are usually broken into two basic types of assets: Current Assets and Fixed Assets.

Current Assets are items that are expected to bring on an economic benefit within the next twelve months. The current assets include Cash, Accounts Receivable (Debtors), Stocks, and Prepaid Items. Accounts Receivable is the amount owed to the company from customers minus any provision for doubtful accounts. Stocks are the amount of goods held for sale in the normal course of business as well as the raw materials to be used to create the company's products and products that are in process. Prepaid Items are items such as insurance and rent that the company has already paid, but has not yet received the economic benefit.

Fixed Assets are also known as long-term assets. Fixed assets are the assets that produce revenues. They are distinguished from current assets by their longevity. They are not for resale. Many small businesses may not own a large amount of fixed assets. This is because most small businesses are started with a minimum capital. Fixed assets will vary considerably and depend on the business type (such as service or manufacturing), size and market.

Fixed assets include furniture and fixtures, motor vehicles, buildings, land, building improvements, production machinery, equipment and any other items with an expected business life that can be measured in years.

Liabilities

Liabilities also fall into well-defined categories such as:

1. Notes payable
2. Accounts payable
3. Wages payable
4. Taxes payable
5. Debentures
6. Bank loans
7. Net worth

The first four items on this list will be met within a year and are known as current liabilities.

Liabilities represent amounts a company owes to other entities or amounts a company is obligated to pay in the future. In order to qualify as a liability, the item must involve an obligation for a future transfer of assets to another entity due to a previous transaction or event. Current liabilities are obligations due within twelve months and include items such as taxes due, wages earned but not paid, and amounts due to suppliers.

Working Capital

Working capital should always be a positive number. It is used by lenders to evaluate a company's ability to weather hard times. Often, loan agreements specify a level of working capital that the borrower must maintain. The current ratio, quick ratio and working capital are all measures of a company's liquidity. In general, the higher these ratios are, the better for the business and the higher degree of liquidity.

Is There A Need To Know How Much An Entity Is Worth?

The balance sheet is the fundamental report of any company's assets, liabilities, debts and capital invested. Thus, before investing in any company, an investor can use the balance sheet to examine the following:

- Can the firm meet its financial obligations?
- How much money has already been invested in this company?
- Is the company overly indebted?
- What kind of assets has the company purchased with its financing?

The above are just a few of the many relevant questions one can discover by studying the balance sheet. The balance sheet provides a diligent investor with many clues to a firm's future performance.

As an owner of a business, we could also spot the degree to which our company is leveraged, or indebted. An overly leveraged company may have difficulties raising future capital. Even worse, it may be headed towards bankruptcy. These are just a few of the danger signs that can be detected with careful analysis of a balance sheet.

Thus, as an owner, we will want to know if our company is in danger of not being able to make its payments and to take early measures to turn the company around.

How Much Does A Balance Sheet Reveal?

The net worth value reflected on a balance sheet may not entirely reflect the company's true value, since assets are normally shown on the balance sheet at what the company paid for them, without any adjustment for increases or decreases in their value since then.

The real value of the business maybe different from the net assets shown by the balance sheet. This is because factors that affect the value of a business may not be recorded yet. For example, a purchaser will be interested in the future earnings of the business, whether assets such as property have be revalued recently, and whether there are potential liabilities in the future such as law suits. The value of the assets in the balance has also been based on the assumption that the business is a going concern, otherwise the break-up value of the assets may be far less than the value in the balance sheet.

Conclusion

The balance sheet is a measure of the solvency of any businesses, and the degree of the owner’s investment which acts as the “cushion” that protects creditors. Solvency measures the liabilities of the business relative to the amount of owner equity invested in the business. It provides an indication of the ability to pay off all financial obligations or liabilities if all assets were sold. If assets are not greater than liabilities, the business is insolvent.

The objective of the balance sheet is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions.

However, a balance sheet does not show what the individual assets are worth and also does not show what an entity is worth. Instead, it only reveals the net value of the assets. It also does not provide all the information that users may need to make economic decisions since they largely portray the financial effects of past events and do not necessarily provide non-financial information.