

The Balance Sheet

The balance sheet is a financial snapshot of what your business owns (its' assets) and what it owes (its' liabilities) at a particular point in time e.g. year end. The difference between the assets and liabilities represents the owner's equity or financial investment in the company. This is the basic accounting equation used in the preparation of the balance sheet.

$$\mathbf{Assets = Liabilities + Owner's Equity}$$

The format of the balance sheet is standardized with assets on the left and liabilities and owner's equity on the right so that when it is prepared properly, it is "balanced". In other words, the total worth of your business, which is determined by your asset total, is equivalent to the money you or your shareholders have directly invested (equity) plus the amount of money that has been borrowed to put into the business (liabilities).

The balance sheet provides a wealth of information useful to business owners, managers, creditors, prospective investors, tax departments and the general public in some instances. From the balance sheet you can determine:

- The solvency or insolvency of the company in the short term.
- Future financial commitments.
- Owner's and shareholder's investment in the company.
- Changes or trends in the company's financial condition if compared over time.
- Extent of creditor involvement in the company.

Here is how a typical balance sheet would be set up:

Company Name Balance Sheet Date	
<u>Assets</u> CURRENT ASSETS FIXED ASSETS TOTAL ASSETS\$ _____	<u>Liabilities</u> CURRENT LIABILITIES LONG-TERM LIABILITIES TOTAL LIABILITIES..... \$ _____ <u>Owner's Equity</u> Balance at beginning of year Income for the year Less owner's drawings Total Owner's Equity TOTAL LIABILITIES & OWNER'S EQUITY..... \$ _____

Assets

Current Assets

These are any items, which could be converted into cash in the normal course of business within one year. Examples are cash, receivables, supplies, prepaid expenses, etc. These should all be itemized separately on the balance sheet.

Fixed Assets

These are items which have an expected life measured in years. They cannot be liquidated as quickly as a current asset and most of them are depreciated at set rates over the estimated life of the asset. Examples of fixed assets include building, furniture, automobiles, land, etc.

Liabilities

Current Liabilities

These are liabilities that you must meet within the next year, for example trade supplier credit or small operating loans.

Long-term Liabilities

These are financial obligations that you are committed to for a period that exceeds one year. These could include mortgages or large equipment purchases.

Owners Equity

Capital

This represents the capital investment of the owner and/or shareholders.

Balance, beginning

This is the amount of cash that has been invested in the company at the start of the period.

Income for the Year

The income for the period is the net income identified on the income statement.

Less Owner's Drawings

Drawings come directly out of the equity of the business. They are not treated as wages.

How To Analyze A Balance Sheet

Now that you have created a balance sheet for your business, there are some easy calculations that you can perform that will give you a better understanding of your company. Using data from your balance sheet, you can calculate liquidity and leverage ratios.

These financial ratios turn the raw financial data from the balance sheet into information that will help you manage your business and make knowledgeable decisions. A ratio shows the relationship between two numbers. It is defined as the relative size of two quantities expressed as the quotient of one divided by the other. Financial ratio analysis is important because it is one method loan officers use to evaluate the creditworthiness of potential borrowers. Ratio analysis is a

tool to uncover trends in a business as well as allow the comparison between one business and another. In the following section, four financial ratios that can be computed from a balance sheet are examined:

Current Ratio
Quick Ratio
Working Capital
Debt/Worth Ratio

Current Ratio

The current ratio (or liquidity ratio) is a measure of financial strength. The number of times current assets exceed current liabilities is a valuable expression of a business' solvency. Here is the formula to compute the current ratio:

$$\text{Current ratio} = \text{Current Assets} / \text{Current Liabilities}$$

The current ratio answers the question, "Does my business have enough current assets to meet the payment schedule of current liabilities with a margin of safety?" A rule-of-thumb puts a strong current ratio at two. Of course, the adequacy of a current ratio will depend on the nature of the small business and the character of the current assets and current liabilities. While there is usually little doubt about debts that are due, there can be considerable doubt about the quality of accounts receivable or the cash value of inventory.

A current ratio can be improved by either increasing current assets or decreasing current liabilities. This can take the form of the following:

- Paying down debt.
- Acquiring a loan (payable in more than 1 year's time.)
- Selling a fixed asset.
- Putting profits back into the business.

However, a high current ratio may mean that cash is not being utilized in an optimal way. That is, the cash might better be invested in equipment.

Quick Ratio

The quick ratio is also called the "acid test" ratio. It is a measure of a company's liquidity. The quick ratio looks only at a company's most liquid assets and divides them by current liabilities. Here is the formula for the quick ratio:

$$\text{Quick ratio} = \text{current assets-inventory} / \text{current liabilities}$$

The assets considered to be "quick" assets are cash, stocks and bonds, and accounts receivable (all of the current assets on the balance sheet except

inventory). The quick ratio is an acid test of whether or not a business can meet its obligations if adverse conditions occur. Generally, quick ratios between .50 and 1 are considered satisfactory — as long as the collection of receivables is not expected to slow.

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.

$$\text{Working Capital} = \text{Total Current Assets} - \text{Total Current Liabilities}$$

Debt/Worth Ratio

The debt/worth ratio (or leverage ratio) is an indicator of a business' solvency. It is a measure of how dependent a company is on debt financing (or borrowings) as compared to owner's equity. It shows how much of a business is owned and how much is owed. The debt/worth ratio is computed as follows:

$$\text{Debt / Worth ratio} = \text{Total Liabilities} / \text{Owner's Equity}$$

For More Information:

Internet: http://www.onlinewbc.gov/docs/finance/fs_balsheet1.html