

Lecture 6

BALANCE SHEET – REPORTING FINANCIAL POSITION (CHAPTER 3)

Key terms

Financial position, status report, accounting period, dual-aspect concept, form of balance sheet, balance sheet changes.

Basic concept of the balance sheet

Balance sheet

- financial statement,
- part of the annual report (i.e. publicly reported as of the end of accounting period),
- its more formal and officially used name is a *“Statement of Financial Position”*.
- *Name of the statement has to consist from:*
 - name of „Balance Sheet“ or *“Statement of Financial Position”*,
 - date (the specified moment in time), and
 - name of the company.

Basic concept of the balance sheet

Balance sheet

- is the *cumulative result of the firm's past activities*.
- shows the *financial position* of an accounting entity (unit) *as of a specified moment in time* (Balance sheet as of December 31st, 20X1);
- *status report* („snapshot“ as of an instant in time) - it records financial status of an entity, its financial condition of the date it was prepared.
- every item of balance sheet is expressed in money (*monetary unit* of the state where the enterprise is operating) → reflects only those matters that can be measured in monetary terms.

Basic concept of the balance sheet

Balance sheet

- reports the assets and liabilities of the entity:

- **Fixed assets (long-lived, non-current)**

Assets that are acquired in order to use them to produce goods and services that will generate future benefits (cash inflows).

- **Current assets**

Those assets which will typically become cash or be consumed in one year or one operating cycle, whichever is greater.

- **Liabilities**

Claims of owners (equity) and outside parties (not-own capital) against the accounting unit as of the balance sheet date.

- **Owners' equity**

Residual interest in the assets of an entity after deducting liabilities.

Basic concept of the balance sheet

Balance sheet

- reflects *dual-aspect concept* (the **assets** listed on the left-hand side of balance sheet are **equal in total** to the **equity + liabilities** listed on the right-hand side – *these two sides have to be always in balance*).

$$\text{Assets} = \text{Liabilities} + \text{Owners' Equity}$$

Basic concept of the balance sheet

Forms of balance sheet:

- 1) *account form* („T“ letter form, usually used internally during the accounting period),
- 2) *report form* (assets are listed at the top of the page and liabilities are listed beneath them as it is prepared for external users; *horizontal* as well as *vertical* form is possible according to 4th EU Dir.).

Basic structure of the balance sheet (horizontal)

| ASSETS | | Balance Sheet as of December, 31st | | LIABILITIES | |
|---------------------|---|--|---|-------------|--|
| A | Receivables for subscription | A | EQUITY | | |
| B | FIXED ASSETS (F.A.) | A1 | Capital (legal, registered) | | |
| B1 | Intangible F.A. | A2 | Other equity accounts | | |
| B2 | Tangible F.A. | A3,4 | Legal reserves, reserves created from net profit, retained earnings | | |
| B3 | Financial investments | A5 | + Profit/ "-" Loss of current period | | |
| C | CURRENT ASSETS (C.A.) | B | NOT-OWN CAPITAL (CURRENT LIABILITIES) | | |
| C1 | Inventories | B1 | Allowances (provisions) | | |
| C2 | Receivables (long-term, short-term) | B2 | Payables (long-term, short-term) | | |
| C3 | Financial assets (short-term) | B3 | Bank loans (long-term, short-term) | | |
| D | OTHER ASSETS (ACCRUALS) – TEMPORARY ACCOUNTS OF ASSETS | C | OTHER LIABILITIES (ACCRUALS) – TEMPORARY ACCOUNTS OF LIABILITIES | | |
| TOTAL ASSETS | | = | TOTAL LIABILITIES | | |

Basic concept of the balance sheet

Content of balance sheet:

Balance sheets differ for firms in different industries.

The composition of assets depends upon the industry in which a firm operates.

(A company in the steel and automobile industries will own many property, plant and equipment assets X A company in the retail industry will show a high monetary amount of inventory but may show only one building on one piece of land)

Balance sheet analysis

Using **ratios, numbers on the balance sheet** can be compared in order to gauge the financial strength or weakness of a company.

Ratios are useful only **when** they are **compared** with something else, such as that company's ratio in former years or industry average ratios.

Ratios are **based on past data**, which may be problematic, and they are also only as good as the data that comprise them.

Limitation: Ratio calculations are only the first step in analyzing a firm's condition:

- a) Information useful for analyzing and clarifying financial statements is contained in other parts of a company's financial reports, such as the **notes to the financial statements**.
- b) **Different accounting methods** used by businesses will have different effects on the balance sheet numbers and therefore, on the ratios derived by using balance sheet accounts.

Balance sheet analysis

- **Vertical analysis**, or **vertical percentage analysis**, is based on the percentage relationship of each line in the balance sheet to the total.
- **Liquidity ratios** represent the ability of a company to convert its assets to cash (current ratio, quick ratio).
- **Asset management ratios** focus on the composition of the firm's assets as well as changes in the composition of assets over time.
- **Debt management ratios** are the composition ratios drawn from a vertical analysis of the right side of the balance sheet (**debt-to-assets ratio**).

EXERCISE 3.1

**Prepare balance sheet from following items
as of December, the 31st, for Public limited company (Plc.)
producing textile products:**

| | |
|-------------------------------|--------------|
| • Building, halls, structures | 9 400 000,- |
| • Machines, equipment | 3 600 000,- |
| • Products | 359 000,- |
| • Customers | 217 950,- |
| • Cash on hand | 3 000,- |
| • Bank accounts | 180 000,- |
| • Material in store | 530 000,- |
| • Legal capital | 13 934 950,- |
| • Long term bank loans | 124 000,- |
| • Current bank loans | 75 000,- |
| • Suppliers | 156 000,-. |

EXERCISE 3.1

Closing balance sheet as of December, 31st

| Assets | Liabilities |
|------------------------|-------------------------|
| Fixed Assets: | Equity: |
| | |
| | |
| Current Assets: | Not-own-capital: |
| | |
| | |
| | |
| | |
| ∑ Assets | ∑ Liabilities |

EXERCISE 3.2

Prepare a balance sheet for Ltd. company as of ***1st January*** from following items (in CZK). Divide and list assets to fixed asset and current asset AND liabilities to equity and non-own capital:

EXERCISE 3.2

| ASSETS | Balance Sheet as of January, 1 st | LIABILITIES |
|--------|---|---|
| A | Receivables for subscription | A |
| B | FIXED ASSETS (F.A.) | EQUITY |
| | | Legal capital |
| | | ? |
| | | |
| | | |
| C | CURRENT ASSETS (C.A.) | B |
| | | NOT-OWN CAPITAL (CURRENT LIABILITIES) |
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| | | |
| | | |
| D | OTHER ASSETS (ACCRUALS) – TEMPORARY ACCOUNTS OF ASSETS | C |
| | | OTHER LIABILITIES (ACCRUALS) – TEMPORARY ACCOUNTS OF LIABILITIES |
| | = | |
| | TOTAL ASSETS | TOTAL LIABILITIES |

EXERCISE 3.2

- Buildings 840 000,-
- Customers 350 000,-
- Suppliers 400 000,-
- Accumulated depreciation (buildings) 200 000,-
- Legal reserve 90 000,-
- Reserve for the social needs of employees 70 000,-
- Cash on hand 20 000,-
- Merchandise in store 200 000,-
- Short-term bank loan 300 000,-
- Bank account 500 000,-
- Bills of exchange to be paid 140 000,-,
- Research and developments 200 000,-,
- Retained earnings from previous years 800 000,-,
- Other ownership interests 160 000,-,
- Material in store 250 000,-,
- Employees 100 000,-,
- Receivables for subscription 100 000,-,
- Payables for unpaid subscribed participations 160 000,-,
- Finished products 140 000,-,
- Legal capital ? .

EXERCISE 3.3

Following items of assets and liabilities are in Plc. Company in December, the 31st (in CZK):

Shares with controlling influence in enterprises 320 000,-, Intangible fixed assets 280 000,-, Accumulated amortization - intangible F.A. 100 000,-, Bank account 700 000,-, Employees 200 000,-, Suppliers 400 000,-, Low-valued tangible assets 180 000,-, Material in store 120 000,-, Cash on hand 10 000,-, Customers 390 000,-, Tax payables 200 000,-, Current bank loans 440 000,-, Tangible fixed assets 700 000,-, Accumulated depreciation - tangible F.A. 100 000,-, Legal capital 1 000 000,-, Merchandise in store and in retail shops 650 000,-, Finished products 140 000,-, Retained earnings from previous years 260 000,-, Legal reserve 300 000,-, Profit/Loss of current period ? .

Prepare the Balance Sheet as of December, 31st of current year!

EXERCISE 3.3

Closing balance sheet as of December, 31st

| Assets | Liabilities |
|------------------------|-------------------------|
| Fixed Assets: | Equity: |
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| Current Assets: | Not-own-capital: |
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| | |
| ∑ Assets | ∑ Liabilities |

EXERCISE 3.4

Following items of assets and liabilities are in Limited liability Company in December, the 31st (in CZK):

Bank account 500 000,-, Suppliers 400 000,-, Employees 100 000,-, Material 390 000,-, Cash on hand 20 000,-, Customers 350 000,-, Taxes to be paid 160 000,-, Bank loans (long-term) 300 000,-, Bills of exchange to be paid 140 000,-, Tangible fixed assets 600 000,-, Accumulated depreciations – tangible fixed assets 200 000,-, Legal capital 500 000,-, Receivables for subscription (for own equity capital) 100 000,-, Purchased securities with 5 years maturity 400 000,-, Valuable rights 200 000,-, Deferred expenses 60 000,-, Finished products 140 000,-, Retained earnings from previous years 200 000,-, Tax deductible provisions for repair of tangible F.A. 70 000,-, Legal reserve 90 000,-, Profit/Loss of current period ? .

Prepare the Balance Sheet of 31. 12. of current year!

EXERCISE 3.4

Closing balance sheet as of December, 31st

| Assets | Liabilities |
|------------------------|-------------------------|
| Fixed Assets: | Equity: |
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| Current Assets: | Not-own-capital: |
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| | |
| ∑ Assets | ∑ Liabilities |

EXERCISE 3.5

Try to prepare Balance sheet, if you know that:

- 1) tangible fixed asset was acquired from 70 %s by owners investment and from 30 %s by long-term bank credit (loan). Its acquisition cost is 100 000 000,- CZK,
- 2) enterprise created legal reserve valued at 2 000 000,- CZK. It bears a form of cash in bank account,
- 3) enterprise has inventory – material 50 000 000,- CZK and merchandise 7 000 000,- CZK. These assets were financed from short- term bank credit 37 000 000,-, unpaid amount to supplier is 20 000 000,- CZK.

EXERCISE 3.5

Closing balance sheet as of December, 31st

| Assets | Liabilities |
|------------------------|-------------------------|
| Fixed Assets: | Equity: |
| | |
| | |
| | |
| | |
| Current Assets: | Not-own-capital: |
| | |
| | |
| | |
| | |
| ∑ Assets | ∑ Liabilities |

Development of the balance sheet: balance sheet changes

Balance sheet changes - conditions:

- The balance equation (i. e. Total assets = Total liabilities) has to be preserved.
- Each event influences two items of balance sheet.
- Every accounting transaction has to be analyzed in terms of its dual impact on the Balance Sheet!!!
- Changes that can occur:

Development of the balance sheet: balance sheet changes

Tab. 3.1 Balance sheet changes

Source: Own elaboration

| Transaction influence on the balance sheet | | |
|--|--|--|
| | ASSETS | LIABILITIES |
| 1 | <i>Increase</i> ↑ | <i>Increase</i> ↑ |
| 2 | <i>Decrease</i> ↓ | <i>Decrease</i> ↓ |
| 3 | <i>Increase</i> ↑ <i>Decrease</i> ↓ | |
| 4 | | <i>Increase</i> ↑ <i>Decrease</i> ↓ |

EXERCISE 3.6

From the following transactions (events) prepare balance sheets as they would appear at the end of each recorded day's transactions.

Day 1

- I. You start your business with £60 000,- in cash.
- II. Buy shop premises for £30 000,- -pay cash. (1)
- III. Buy shop fittings for £4 000,- - pay cash. (2)

EXERCISE 3.6

Day 2

- I. Buy stock (for re-sale) for £2 000,- - pay cash. (3)
- II. Pay £20 000,- cash into a business bank account. (4)
- III. Sell £800,- of stock for £800,- on credit to J. Todd. (5)

Day 3

- I. Buy £500,- of stock on credit from D. Nixon. (6)
- II. You receive £300,- cheque as part payment from J. Todd. (7)

EXERCISE 3.6

Day 4

- I. Sell £600,- of stock to B. Dunn for £600,- on credit. (8)
- II. Buy cash till for £350,- - pay by cheque. (9)
- III. Pay D. Nixon £500,- in cash in full settlement of debt.(10)

EXERCISE 3.6

Day 1

B.S. „(I)“

Total assets

Total liabilities

Day 1

B.S. „(II)“

Total assets

Total liabilities

EXERCISE 3.6

Day 1

B.S. „(III)“

Total assets

Total liabilities

Day 2

B.S. „(I)“

Total assets

Total liabilities

EXERCISE 3.6

Day 2

B.S. „(II)“

Total assets

Total liabilities

Day 2

B.S. „(III)“

Total assets

Total liabilities

EXERCISE 3.6

Day 3

B.S. „(I)“

Total assets

Total liabilities

Day 3

B.S. „(II)“

Total assets

Total liabilities

EXERCISE 3.6

Day 4

B.S. „(I)“

Total assets

Total liabilities

Day 4

B.S. „(II)“

Total assets

Total liabilities

EXERCISE 3.6

Day 4

B.S. „(III)“

Total assets

Total liabilities

EXERCISE 3.7

Think out examples to each category of recording of transactions fall into, so many so you are able:

A↑ L↑

Example: Purchased material for 100000, on credit (from supplier) A↑ : material 100000, L↑: supplier 100000

A↓ L↓

Example: Partial payment of supplier for 30000 from bank account A↓: bank account 30000, L↓: supplier 30000

EXERCISE 3.7

A↑ A↓

Example: Purchased merchandise, paid cash for 12000

A↑: merchandise 12000, A↓: cash on hand 12000

L↑ L↓

Example: Legal reserve created from net profit for 20000

L↑: Legal reserve 20000, L↓: net profit 20000