The Keys To Understanding Your Balance Sheet

Right from when you get your first set of management or annual accounts you'll probably notice that one of the reports is a balance sheet. Especially for new business owners you might wonder what exactly it is and what it has to do with balancing.

The balance sheet is a vital financial document for your business so learning what it means and how you can read it can make a big difference.

What is a balance sheet?

A balance sheet tells you something about the financial strength of a business on a particular day – usually your year or month end.

It will show you all the financial assets and liabilities of the business. Assets means what a business owns or has a right to, and that can be valued in money terms. Liabilities show what a business owes to another party.

There are different ways to value those assets and liabilities. For instance, you could value a building at the amount it cost you to buy, or the amount you could expect to get if you sold it today.

There are many arguments about how assets and liabilities should be valued, which is why there are accounting standards. These help accountants to be consistent in the way they treat transactions.

Usual practice is that the values will be based on the amount paid out or received by the business on the date of the transaction. But, there can be adjustments to these values and these will normally be explained in the notes to the accounts.

Does a balance sheet show you what your business is worth?

No, a balance sheet is not designed to show you the market value of your business.

The market value of many assets can be different to their historical cost on the balance sheet. For instance, a property could be worth a lot more than the business paid for it.

Also, your business may have assets that aren't included on the balance sheet, such as goodwill. These hidden assets are difficult to value in the ordinary running of a business, but in the event of a sale could enhance the sales amount. The converse is true of hidden liabilities, such as warranties.

It's also important to recognise that a balance sheet is a snapshot of the business on a particular date. The snapshot could look quite different on another day. As well, things could have changed between the date shown on the balance sheet and the date you're reading it. For example, a debtor might have unexpectedly defaulted.

In what way does a balance sheet balance?

The balance sheet is based on the fundamental truth that the assets and liabilities of a business will always be equal.

To get your head around this you may need to firstly realise that for accounting purposes a business is viewed as separate to its owners.

Imagine a business that is just starting up and its owner placing €100 in the business bank account. The business now owns an asset of €100. But at the same time it also has a liability of €100, because it owes that amount back to its owners.

Its balance sheet would look like this.

Assets:	
Cash in bank	€100
Total assets	€100

Liabilities:	
Owners' investment	€100
Total liabilities	€100

Suppose the next day the business buys supplies for €40. It's assets and liabilities would now look like this.

Assets:	
Stock	€40
Cash in bank	€60
Total assets	€100

Liabilities:	
Owners' investment	€100
Total liabilities	€100

Now you might be wondering why profit is shown as a liability? Profit is a good thing, so surely it's an asset of the business.Then on day 3 the business sells all that stock for €60. Its assets and liabilities will look like this:

Assets:	
Stock	€0
Cash in bank	€120
Total assets	€120
Liabilities:	
Owners' investment	€100
Profit	€20
Total liabilities	€120

Well, you're definitely right that profit is a good thing. But for the purpose of the balance sheet the question is: does the business own the profit?

The answer is no. Profit is the return on the investment made by the owners of the business so it belongs to them. Therefore, from the business' point of view, profit is due to be back to the owners so it's a liability. And that's how it's shown on the balance sheet.

What do the individual elements of a balance sheet mean?

The format of balance sheets can vary, but the most common way is that the top half deals with the various assets and liabilities involved in the business' trade. Then the bottom half focuses on the owners' interests in the business.

Here's a fairly simple example.

Fixed assets	
Current assets	€70
Less current liabilities	€40
Net current assets	
Less long term liabilities	
Net assets	
Share capital	
Profit and loss account	
Shareholders' funds / Owners' equity	

Current Assets – These are the items that the business is using in its day-to-day trading. Typically this would include stock, trade debtors (customers who owe the business money) and positive bank balances.**Fixed Assets** – These are items that aren't normally traded by the business, but are needed in order for it to function. Examples would be property, machinery or vehicles. Fixed assets may be split between tangible – you can touch them – and intangible – you can't touch them. An example of an intangible asset would be purchased goodwill.

Current Liabilities – These are the short-term debts – due in less than a year – that the business has in its day-to-day trading. Examples would be trade creditors (money the business owes to suppliers), taxes and a bank overdraft.

Net Current Assets – This is just the difference between current assets and liabilities. This can be quite a useful piece of information.

Long-Term Liabilities – These are debts the business has that will be repaid more than a year from the balance sheet date. Typically this would be long-term loans.

Net Assets – This is the total of fixed and current assets minus current and long-term liabilities.

Share Capital – This will only apply to companies, and represents the number of shares issued multiplied by their nominal value. The nominal value is the value set per share in the company's constitution. It has nothing to do with market value.

Profit and Loss Account – This is the total of all the accumulated profits and losses since the business started.

Shareholders' Funds / Owners' Equity – This is the total of share capital and the profit and loss account and represents the total interest of the owners in the business.

In the case of partnerships and sole traders you will normally see a capital account instead of the share capital and profit and loss accounts. This is because they are owned in a different way to companies.

But the principle of a capital account is exactly the same. It shows the owners interests at the start of the period, then adds the profit made and deducts any withdrawals made by the owners.

Reading a balance sheet…

Balance sheets differ between industries. For example, the balance sheet for a shop will probably show very little in the way of trade debtors because most sales are made in cash form. But a solicitor generally sends invoices to clients and then has to wait a period of time before they receive the money. Their balance sheet would include trade debtors.

To read a balance sheet you need to understand what the business trade is. Then you'll know what you can expect to see and what would be considered normal or not.

The point of view and objective of the reader also affects how they read the balance sheet. What one person might consider bad, another might consider good.

There is, however, a general 5 point method that you can use to weigh up a balance sheet.

1. **Are net assets positive or negative?**

Positive is good. It means that overall the business owns more than it owes.

Negative assets means that the business could be heading for trouble unless there is some other means to support it. If you see negative assets you should immediately be asking yourself where that support is going to come from.

1. **Are net current assets positive or negative?**

You're now focusing on the short-term position of the business.

If net current assets is positive this is good. It means that the business shouldn't have a problem paying its debts in the short term. That doesn't necessarily mean there won't be cashflow pressure, but it is a healthy sign.

It would also be worth weighing up the make-up of current assets. Obviously there's a difference between cash in the bank – which is immediately available – and cash tied up in stock for resale. You would expect the stock to sell, but it may take some time and may not coincide with the dates that debts are due to be paid.

Therefore it's worth only including cash and trade debtors and seeing if they outweigh the current liabilities.

If net current assets is negative then this suggests that the business could have a problem paying its debts. Again you need to be considering how that shortfall might be met.

1. **Consider how long it takes trade debtors to pay…**

It's useful to look at how many days' worth of sales are tied up in debtors. This calculation is done as (trade debtors/annual sales) x 365.

This will give you an idea of how long the business is waiting until it gets paid. The goal for any business is to bring this time down to as short a period as possible.

If sales don't happen evenly throughout the year then this calculation can be distorted. A big sale at the year-end might make the time look longer than it actually is.

1. **Consider how long it takes to pay trade creditors…**

This looks at how much the business is relying on its trade creditors. The calculation is made as (trade creditors/annual purchases) x 365.

It's common for businesses to use the credit terms they get from suppliers as a way of helping to finance their business. So generally speaking this ratio would reflect the credit terms a business has. But businesses handle things differently. Early payment can often lead to better discounts so a business might operate on quite a short trade creditors' days ratio.

Generally here you're looking to see whether the business is paying creditors more quickly than it receives money from debtors. If it is then there will ultimately be cashflow problems.

1. **Consider the debt level…**

Total debt is the amount of short-term and long-term debt. Clearly a business that is heavily reliant on debt could have a problem maintaining repayments if trading slows down.

It's difficult to measure this looking at the absolute figures, and attitudes to risk and different situations will alter what's seen as acceptable.

Normally you'd calculate the debt as a percentage of shareholders' funds. This ratio is called 'leverage' or 'gearing'. Generally speaking more than 100% would be considered too high.

Conclusion…

Hopefully you've seen that the balance sheet is an enormously helpful tool. It's well worth taking some time to get familiar with its features and learning how to use it to successfully manage and grow your business.