

Behind the counter

The Balance Sheet

This statement also holds a lot of interesting information and although it is simply a snapshot of your business at a certain point in time, it can, along with the Income Statement help you to manage your business. In order to understand the Balance Sheet, a person needs to understand the basic accounting equation that Assets equals Liabilities less Equity. The reason for this equation dates back to the origin of the double entry bookkeeping system where every transaction will affect at least 2 accounts and that transaction must be recorded in at least 2 places. The equaling of the debits and the credits are thought to provide some basic accuracy to the information being recorded.

Balance sheets used to be printed with the Assets on the left hand side of the page and the Liabilities and Equity on the right hand side so that it was easy to see that the two sides of the balance sheet were equal. (Did I just date myself??) Today the Assets are usually printed on the first page and the Liabilities and Equity are printed on the second page, but the total still must be equal. The Assets are thought to show the resources of the business and the Liabilities and Equity show who supplied the resources.

Assets are usually broken down into 2 classes. The first one is Current Assets which list the assets that can be liquidated quickly if required. These are items such as cash, accounts receivable, inventory and short term investments. The other class of assets are the longer term assets such as Capital Assets or Property, Plant & Equipment, Long Term Investments, Intangible Assets such as Goodwill and other Assets such as prepaid expenses.

Liabilities are also segregated into the same two categories. The current liabilities section indicates what is owed by the company in the current year (period) and the long term liabilities section lists the long term obligations of the company.

Most creditors will analyze the current assets to the current liabilities (called working capital) to determine the strength and ability for a company to pay their debts and would usually like to see that current assets exceed the current liabilities by a certain ratio depending on what is normal in the type of industry. Another ratio is working capital over total assets which will indicate what percentage of assets can be liquidated quickly and what percent is a long term investment.

If you grant credit with the use of Accounts receivable you would probably want your receivables to be collected in a timely manner so that you will not place a strain on your cash flow. If you have money tied up in receivables there is less money available to you for business expansion. If you are operating with a line of credit, this becomes especially important because with uncollected receivables, you are using your line of credit and being charged interest which is not being passed on to your customer.

Calculations can be done to determine how many days you can hold receivables before they start costing you money.

Depending on how your system is set up, the inventory accounts can be helpful to indicate profitability.

If you have various sales categories and cost of sales categories on your income statement and associated inventory categories on your balance sheet, calculations can be done to determine how your inventory is moving. If your inventory is moving slowly, then perhaps you are carrying obsolete items that need to be moved out by either a sale or sent back to the supplier. Holding too much inventory and not being able to move that inventory is also a cost that you will not be able to pass on to your customers, especially if you are well into a Line of Credit or Bank Loan. Again there are calculations that can be done to find the optimum point that your inventory should be moving at.

The capital asset accounts list your long term assets and are usually written off over the estimated life of the asset either based on management's best estimate or based on the regulations in the income tax act. If management decides to depreciate using a method different than what is allowed under Generally Accepted Accounting Principles, the method must be changed to have an unqualified opinion on a Review or Audit engagement . If the method is different from what is recommended by the Income Tax Act, the difference results in what used to be known as deferred taxes, but what is referred to now as future taxes. Then there will be a difference between the accounting records and the tax records.

Moving on to the Liabilities section, the first part is the current liabilities usually holding a bank overdraft, accounts payable, payroll payable and taxes payable. The Long Term Liabilities consist of Term Loans and Loans from Shareholders which usually are not repayable in the current period.

The equity section indicates the amount of investment by the owner(s) in the business. If the business is a proprietorship, the contributions being the owner's investment and the drawings will be listed. A corporation will have share capital and retained earnings. The investment in a corporation is usually the purchase of shares along with a loan to the corporation by a shareholder. These loans can be interest bearing, but that interest needs to be recorded as income by the shareholder on their personal return and the interest rate must be a 'normal' rate so as to avoid tax problems.

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