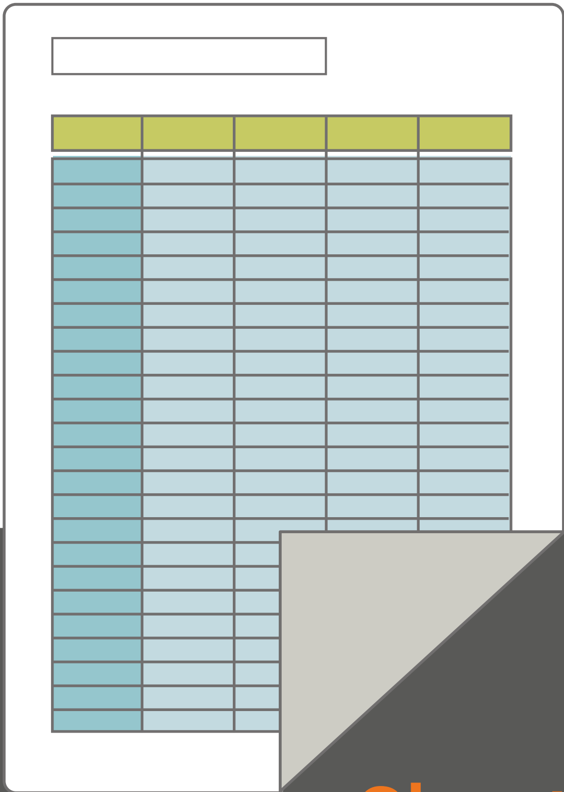


Chapter 1

The Balance Sheet

What is a balance sheet?

Businesses may produce a balance sheet several times a year, to help them monitor their performance and avoid possible problems. By law, however, they must produce one audited balance sheet at the end of each financial year.

A balance sheet is a snapshot of an organisation's financial position on a certain day. It shows its assets: everything the business owns, and its liabilities: everything it owes.

Balance Sheet for X-AMPLE Ltd as at 30th September 2016		
		£
Fixed assets		
Tangible		1 000 000
Intangible		500 000
Investments		500 000
Total fixed assets		**2 000 000**
Current assets		
Stock		4 000 000
Debtors		2 500 000
Investments (short-term)		1 000 000
Cash		500 000
Total current assets		**8 000 000**
Total assets		**10 000 000**

Current liabilities		£
Creditors: amounts falling due within a year		(5 000 000)
Long-term liabilities		
Creditors: amounts falling due after more than one year		(1 000 000)
Total liabilities		**(6 000 000)**
Net assets		**4 000 000**
Capital & Reserves		
Called-up share capital		2 500 000
Retained earnings		1 500 000
Shareholders' funds		**4 000 000**
Net current assets		3 000 000
Total assets less current liabilities		5 000 000

A balance sheet is a snapshot of an organisation's financial position.

An asset is something owned.

A liability is something owed.

Overall, the balance sheet provides a way of assessing what the business is worth. This is done by calculating the net assets for the business.

A business's net assets are its total assets, minus its total liabilities.

A business has total assets of £10m, and total liabilities of £6m. £10m minus £6m = £4m. Therefore, its net assets are £4m.

Net Assets = Total Assets – Total Liabilites

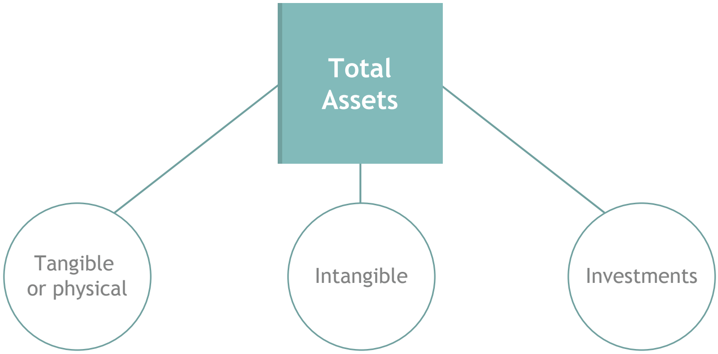
The balance sheet also details what type of assets the business has. These are split into:

- fixed assets – that are valuable to the business over many years.
- current assets – that will be held for less than a year before being turned into cash.

Fixed assets are further divided into those which are:

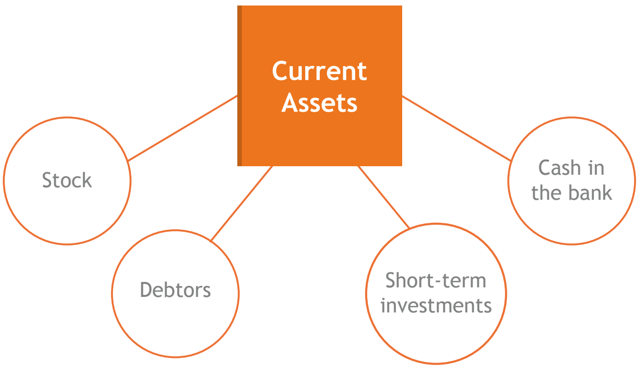
- tangible or physical – such as land, buildings, plant, equipment, machinery, fixtures and fittings, and motor vehicles.
- intangible – things that cannot be touched, such as licences, intellectual property, patents and goodwill.
- investments in other companies and financial assets held for the long-term.

These figures are added together, to give the total fixed assets.



Current assets are divided into:

- stock, which should be sold within a year.
- debtors – money owed that the company should receive within a year.
- short-term investments in other companies.
- cash in the bank.

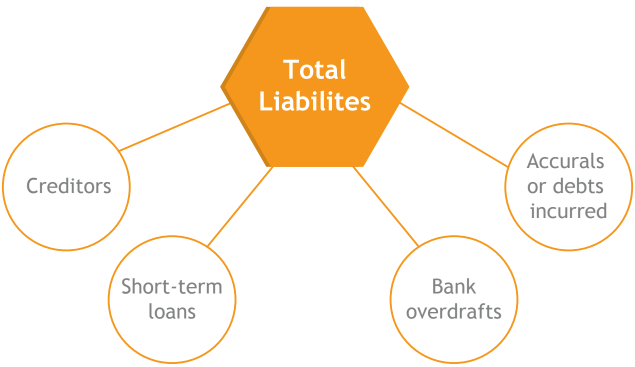


The balance sheet will also indicate whether the business' liabilities are current liabilities, which are due to be paid within a year, or long-term liabilities, which can be paid over more than one year.

The details of the business' **current liabilities** are found in the notes accompanying the balance sheet and include:

- bank overdrafts, which could be called in for repayment without notice.
- short-term loans, due to be paid within a year.
- creditors, to whom the business must pay what it owes within a year.
- accruals or debts incurred, for which invoices have not yet been received.

On the balance sheet, these appear simply as 'creditors: amounts falling due within one year'. This figure appears in brackets because it is a liability that will be subtracted from the business' assets.



Current liabilities		£
Creditors: amounts falling due within a year		(5 000 000)

Long-term liabilities might include:

- long-term loans or mortgages that the organisation has taken out.
- taxes that have been deferred to be paid in later years.
- pension obligations.

These details can be found in the accompanying notes, but appear on the balance sheet as 'creditors: amounts falling due after more than one year'. Again, the brackets indicate that this liability will be subtracted from the business' assets.

Long-term liabilities		£
Creditors: amounts falling due after more than one year		(1 000 000)
Total liabilities		(6 000 000)

Current liabilities
are due to be paid within a year.

Long-term liabilities
can be paid over more than one year.

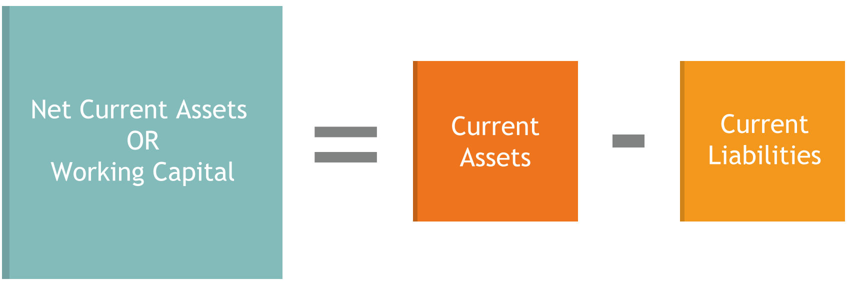
The last section of the balance sheet is the capital and reserves section. This tells us where the money to pay for the business' net assets came from. It shows how much capital was raised by selling shares to shareholders (called-up share capital), and how much of the business' profits were reinvested (retained earnings).

Capital & Reserves		£
Called-up share capital		(2 500 000)
Retained earnings		(1 500 000)
Shareholders' funds		(4 000 000)

The total capital and reserves figure of £4m is also known as the shareholders' funds, because it represents a valuation of the owners' investment in the business. It must therefore equal the net assets figure of £4m. In this way, the balance sheet must balance.

How do I know if my organisation can pay its bills?

We can also calculate the figure for net current assets – the business' working capital - when we draw up a balance sheet,. This is produced by adding up all the current assets, then subtracting its current liabilities.



For example:

Current assets of £8m, minus current liabilities of £5m would give net current assets – or working capital – of £3m.

		£
Total current assets		**8 000 000**
Current liabilities		
Creditors: amounts falling due within a year		(5 000 000)
Net current assets		3 000 000

This is important because businesses need working capital to pay their bills. If they don't have enough, they may have to close. They might have sufficient fixed assets to cover all their liabilities, but not have sufficient current assets that they can convert into cash quickly, to pay for their current liabilities. This is known as a liquidity problem, because the cash does not flow. The business may fail because it is illiquid.

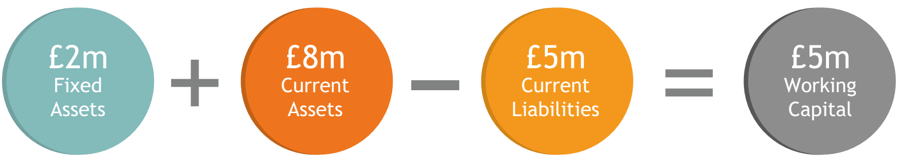
How much working capital a business needs depends on the industry and how it operates, but as a general rule, its net current assets must be positive or there are serious concerns that it will fail.

We sometimes need to calculate the capital employed by the business which is the figure derived from total assets, minus current liabilities. This shows how much money has been invested in the business to enable it to function.

Working capital is needed to pay bills.

		£
Total fixed assets		2 000 000
Total current assets		8 000 000
Current liabilities		
Creditors: amounts falling due within a year		(5 000 000)
Total assets less current liabilities		5 000 000

In this example, fixed assets of £2m, plus current assets of £8m, minus current liabilities of £5m, gives us a figure of £5m for total assets less current liabilities.



This money comes both from shareholders and long-term loans, and gives the figure for the total amount of capital employed by the business.

This sum is equal to shareholders' funds plus long-term liabilities.

Long-term liabilities		£
Creditors: amounts falling due after more than one year		(1 000 000)
Total liabilities		(6 000 000)
Net assets		4 000 000
Capital & Reserves		
Called-up share capital		2 500 000
Retained earnings		1 500 000
Shareholders' funds		4 000 000
Net current assets		3 000 000
Total assets less current liabilities		5 000 000

"As a general rule, a business' net current assets must be positive or there are serious concerns that it will fail"