Balance Sheet

Ram Kumar Kakani

Introduction

- A basic objective of accounting is to convey information necessary to make an accurate analysis of the health of the entity
- This information is obtained through the Balance Sheet
  - Balance Sheet is a quantitative summary of a company's financial condition at a specific point in time, including assets, liabilities and net worth.
  - It is a snapshot of the financial health of an entity
  - It measures the position of a company's assets, liabilities and shareholders' equity as on a given date

What is a Balance Sheet?

- Balance Sheet is concerned with
  - Reporting financial position of an entity as of a particular point in time
  - Done by listing all the things of value owned by the entity as also the claims against these things of value
  - Position as represented by the balance sheet is valid only until another transaction is carried out by the entity

- Allows comparisons with the past financial status
- Also comparison between multiple entities (on financial health)

Balance Sheet – Conceptual Basis

- I want to purchase a car costing Rs. 500,000. To do so, I have to borrow. A bank agrees to finance me if I can invest Rs. 100,000 on my own

- Two relevant questions:
  - What are the things of value you **own**?
  - How much do you **owe**, and to whom?

Illustration…

Things of value owned by me	Rs.	Amounts owed by me	Rs.
Savings deposit in bank	50,000	Loan from a friend	50,000
Term deposit in bank	150,000	Own claim or net worth	200,000
Other personal possessions	50,000		
Total	250,000	Total	250,000

- Say, the bank grants me the loan of Rs. 4,00,000 and I buy the car for Rs. 5,00,000. After purchase of the car my financial position statement will change as follows:

Illustration…

Things of value owned by me	Rs.	Claims against things of value	Rs.
Savings deposit in bank	50,000	Loan from a friend	50,000
Term deposit in bank	50,000	Own claim or net worth	2,00,000
Car	5,00,000	Bank Loan	4,00,000
Other personal possessions	50,000		
Total	6,50,000	Total	6,50,000

- As a result of this transaction my worth is increased from Rs. 2,50,000 to Rs. 6,50,000
- But, my net worth remains the same. Why?

Learnings from the example …

- Things of value possessed by an entity are referred to as assets
- Accountants use the term “assets” to describe things of value measurable in monetary terms
- The amount owed by an entity expressed in monetary terms, which represents a claim by outsiders against its assets, is referred to as “*liabilities*”
- Liabilities are claims of outsiders, against an entity and are legally enforceable

And …

- Net worth of the owner(s) of the entity = The value of assets owned by the entity less liabilities (or outsider's claims)
- Also known as "owner(s) equity"
  - As it represents the claims of owner(s) in case of an entity
- Hence, financial position statement is
  - a summary of the assets, liabilities and net worth as of a particular point in time
- Balance sheet of an entity is the position statement prepared at any point in time

Lets compare …

Assets	I	II	Liabilities & Net Worth	I	II
Bank Savings Deposit	50,000	50,000	Loan from a friend	50,000	50,000
Term deposit in bank	1,50,000	50,000	Own claim / Net worth	2,00,000	2,00,000
Car	-	5,00,000	Bank Loan	-	400,000
Personal Possessions	50,000	50,000			
Total	2,50,000	650,000	Total	25,0,000	6,50,000

- Outsiders claim has priority over the owner(s) claim on the assets and hence owner(s) equity is always a residual claim against assets
- It follows from this that at any point in time, for all accounting entities owner(s) equity and liabilities will be equal to assets owned by that entity.

Balance Sheet Equation

- This idea fundamental to accounting could be expressed as an **equality**:
  - Assets = Liabilities + Owners Equity
- Owner(s) claim is **residual**:
  - Owners Equity = Assets – Liabilities
- It shows the duality represented by **‘benefit-sacrifice’,** from the point of the view of an entity

Balance Sheet Changes

- Balance sheet represents the position at a particular point in time
- Any material transaction or exchanges can change the position
- Let us look at some specific examples of transactions changing Balance Sheet

Possible changes in Balance Sheet

Possibility	Example
An increase in assets followed by an increase in liabilities and *vice versa*	
A decrease in assets followed by a decrease in liabilities and *vice versa*	
An increase in assets followed by an increase in equity and *vice versa*	
A decrease in assets followed by a decrease in equity and *vice versa*	
An increase in an asset followed by a decrease in another asset and *vice versa*	
An increase in a liability followed by a decrease in another liability and *vice versa*	

Balance Sheet in business – Illustration

- First step in accounting is “creation” of the entity
- Ram starts “Ramstore” on January 1, 2011 with an investment of Rs. 20,000 brought from his personal savings

Assets	Rs.	Liabilities And Owners Equity	Rs.
Cash	20,000	Owners equity	20,000

Transactions during January

- *On January 2 the store purchases a shop for Rs. 50,000 paying Rs. 10,000 cash and signing a mortgage for Rs. 40,000.*
  - A new asset, shop premises, is acquired worth Rs. 50,000.
  - A new liability, mortgage on the shop is contracted in the amount of Rs. 40,000.
- Owners equity = Total assets – Liabilities, that is,
  - Rs. 20,000 = Rs. 60,000 – Rs. 40,000.

Modified Trial Balance

- This shows that there is no change in the owner(s) equity. Thus, the new Balance sheet will be as follows:

RAMSTORE

Balance Sheet as of January 2, 2011

Assets	Rs	Liabilities And Owners Equity	Rs
Cash	10,000	Mortgage on shop	40,000
Shop premises	50,000	Owners equity	20,000
Total	60,000	Total	60,000

Further transactions…

- On January 3, the store purchased merchandise for Rs. 5,000 in cash
- The store also purchased merchandise for Rs. 15,000 on credit from Dhruva

RAMSTORE

Balance Sheet as of January 3, 2011

Assets	Rs.	Liabilities And Owners Equity	Rs.
Cash	5,000	Mortgage on shop	40,000
Merchandise inventory	20,000	Accounts payable	15,000
Shop premises	50,000	Owners equity	20,000
Total	75,000	Total	75,000

And more…

- On January 4, the store sells the entire merchandise inventory for Rs. 25,000 cash

RAMSTORE

Balance Sheet as of January 4, 2011

Assets	Rs.	Liabilities And Owners Equity	Rs.
Cash	30,000	Mortgage on shop	40,000
Merchandise inventory	-	Accounts payable	15,000
Shop premises	50,000	Owners equity	25,000
Total	80,000	Total	80,000

Business profit is earned in this process of exchange of 'utility differential' for a 'monetary differential'

Importance of Balance Sheet

- Best indicators of the financial position of a company
- Provide information to various stakeholder about the company
- It helps customer to assess the capabilities of the company to take up the order (in case of long term contract)
- It helps lender to know about the capacity of a company to pay back the borrowed
- Government use it for tax computation

Revenue and Expenses

- The increase in owner(s) equity to match the asset increase realized from a sale transaction is referred to as '*revenue*'
- The decrease in owner(s) equity to match the decrease in assets suffered to earn revenue are referred to as '*expenses*'
- Revenues increase owner(s) equity and the expenses decrease owner(s) equity
  - *The owner(s) equity increases or deceases to the extent of profit or loss earned by the entity.*

Owner's Equity

- Owner(s) equity comprises two parts:
  - Owners Equity = Contributed Capital + Retained Earnings

RAMSTORE

Income Computation

Owners equity on January 4, 2011	25,000
Less: Owners equity on January 1, 2011	20,000
Profit earned during the period	5,000

Take always…

- The *dual aspect principle* has particular relevance to balance sheet
- All the figures are expressed in *monetary units*, irrespective of its nature
- All the transactions we reflected were only with respect to the *business entity*, 'Ramstore' (specific entity)
- All the valuations were based on the assumption of a *going concern*, and not based on liquidation or break up value
- All the asset valuations were based on *historical cost as the basis of valuation*

Balance Sheet Items' Classification

- Lists assets, liabilities and capital separately
- Usually grouped into sub-groups and listed in the order of their liquidity or length of time required for conversion into cash
- Listed in the ascending or descending order of liquidity
- Prepared at the end of a specified period, usually, a year; referred to as '*accounting period*', '*fiscal year*', or '*financial year*'
- Let us look at a typical Balance Sheet … (next slide)

Ramsons Limited

Balance Sheet as at 31 December 2010 (all figures are in Rs. '000)

Assets	Rs.	Liabilities & Shareholders' Equity	Rs.
Current Assets		Current Liabilities	
Cash	500	Notes payable	600
Marketable Securities	200	Accounts payable	1,000
Notes/Bills receivable	300	Accrued Liabilities	800
Accounts receivable 1,000		Income Tax payable	400
Less: estimated loss on collection 100	900	Bank overdraft	200
Prepaid expenses	500	Total Current Liabilities	3,000
Merchandise inventory	1,100	*Long term Liabilities*	
Current Assets Total	3,500	Debentures	1,000
Fixed Assets		Long term loans	2,000
Land	2,000	Long term Liabilities	3,000
Buildings, plant and machinery: 3,000		*Shareholder's Equity*	
Less: Accumulated depreciation 1,000	2,000	Ordinary share capital	2,000
Property Plant and Equipment	4,000	Capital Reserves	500
Intangible Assets		Reserves & Surplus	1,500
Goodwill	1,500	Share holders equity	4,000
Deferred Expenditure	1,000		
Intangible Assets	2,500		
Total Assets	10,000	Total Liabilities & Shareholders' Equity	10,000

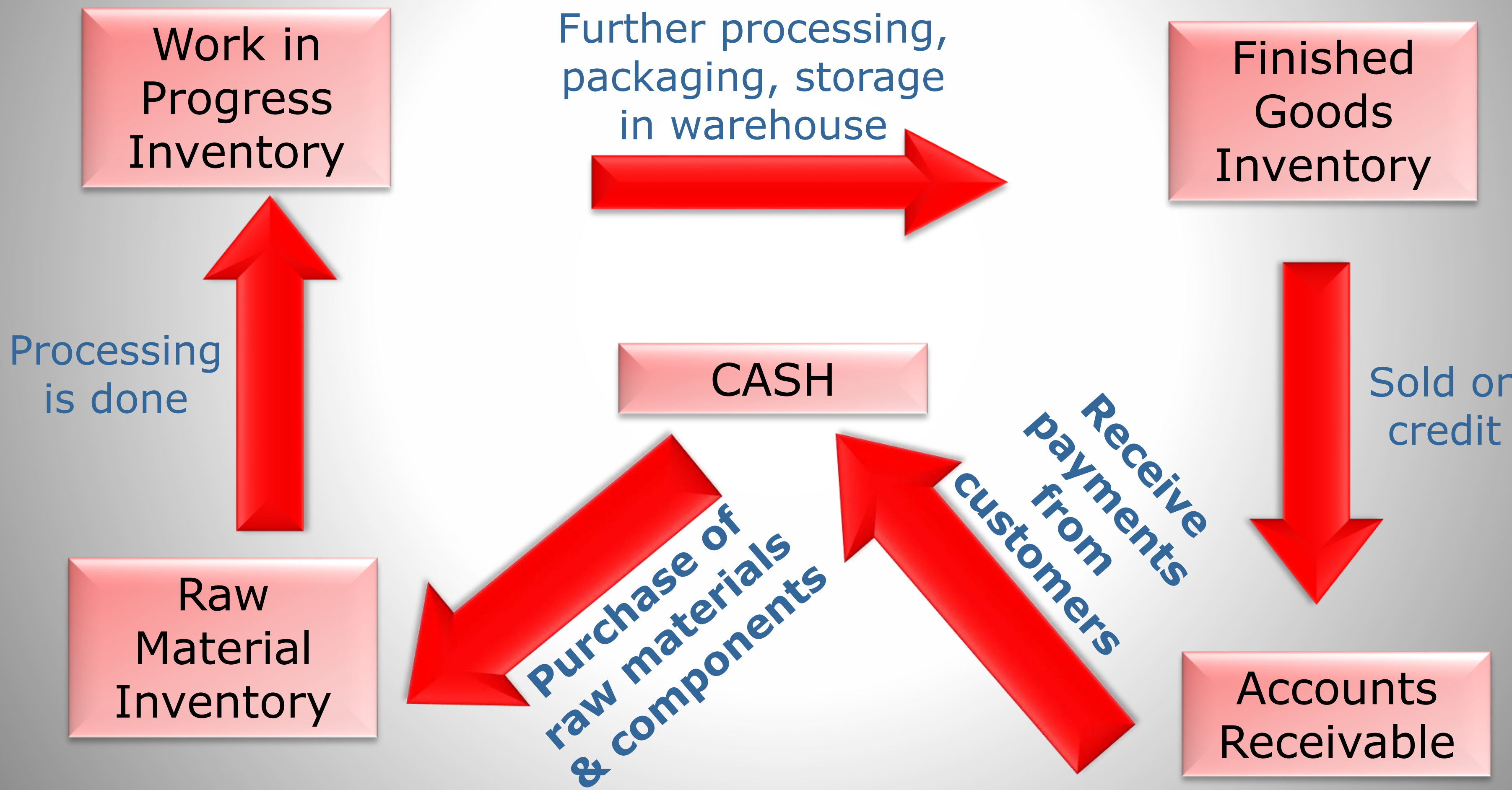
Classification of Assets

- Based on purpose in business:
  - Current Assets – Held for final transformation in to cash at the earliest opportunity during the normal course of business. Example: Inventory
  - Long Term/Fixed Assets – Held for use in the business. Sold only on liquidation. Example: Shop Premises
- Can same asset be classified in both categories!!.Example: an automobile dealership classify the inventory of cars for sale as current assets and the car used by the salesman for making sales call, as fixed asset
- Assets may also be classified as tangible or intangible

Current Assets

- Current literally means a *flow*, and in accounting it indicate the flow of assets through business
- Assets which will normally be converted into cash with in a fiscal year or within an '*operating cycle*'
  - The operating cycle is the duration of time taken by a unit of cash to circulate through the business operations and return back as cash
  - Example: in trading operation, we use cash to buy merchandise and sell it to recover cash

Operating Cycle Concept



Current Assets

- **Cash**
  - Includes cheques or any other instrument that circulates as cash
- **Marketable Securities**
  - Result of excess short-term cash; Valued at ‘lower of cost or market price’
- **Accounts Receivable**
  - Amounts owed to the company by ‘*debtors’,* for the purchase of goods and services. collection losses are called *bad debts*

Accounts Receivable	7,50,000
Less: Estimated collection loss (Reserve)	75,000
Net realizable value of accounts receivable	6,75,000

Current Assets…

- **Notes or Bills Receivable**
  - Arises out of credit sales. Often converted into negotiable instruments such as a ‘*Bill of Exchange*’
  - Negotiable instruments are written ‘*promises to pay’* or ‘*acceptance of an order to pay*’. Are transferable upon endorsement

Promissory Notes

Deman

U.S. $3,000

FOR VALUE RECEIVED, the
acknowledges itself indebted t
demand to or to the order of t
York, 12345, USA, or as othe
sum of $3,000 with interest th
monthly, not in advance, both
judgment until paid.

The Lender may assign all of
promissory note. All payment
the Borrower without any righ

Sample
Le

DATED:________________

Borrower

____

PROMISSORY NOTE

I, John Silver, of 36 Forecastle Place, Rumbottal, 3445,
do hereby promise to provide Barrister Eke with the following:

1. Honest and timely assistance in his endeavours.
2. Regular counselling advice on matters of propriety.
3. Suitable recompense for his assistance which should be expected to be at least 0.7% of the transaction amount and to be paid in Australian dollars.
4. Somewhere warm to sleep when visiting the antipodes.

All of the above I do promise, so help me God.

John Silver

John Silver, RAN (Ret).

Melbourne, April 29th, 2003.

Certified to be
true and correct.
....
J. Cosmo Newbery
Public Notary
29/4/2003

Current Assets

- **Prepaid Expenses**
  - Paid in advance such as rent, taxes, subscriptions and insurance
- **Merchandise Inventory**
  - Merchandise goods held for sale to customers in the ordinary course of business
- **Manufacturing Inventory**
  - Transformed into another product or assembled together into another product before being sold
  - Classified as raw material (steel for a car-making unit) and components (tyres)

Fixed Assets

- Are tangible, relatively long-lived items owned by the business
- To be used in the course of business
- Not possible to trace them in the value of the goods or services sold by the firm
- Benefit over several accounting periods to the extent of life of asset
  - Value of the asset is reduced proportionate to the expired life of the asset – depreciation

Example…

- A trader buys a delivery van for Rs. 100,000. Assume that the van will have to be discarded as junk as the end of five years. At the end of the first year it will be represented as:

Fixed Assets:	Rs.
Delivery Van - at cost	1,00,000
Less: Depreciation to date	20,000
Net	

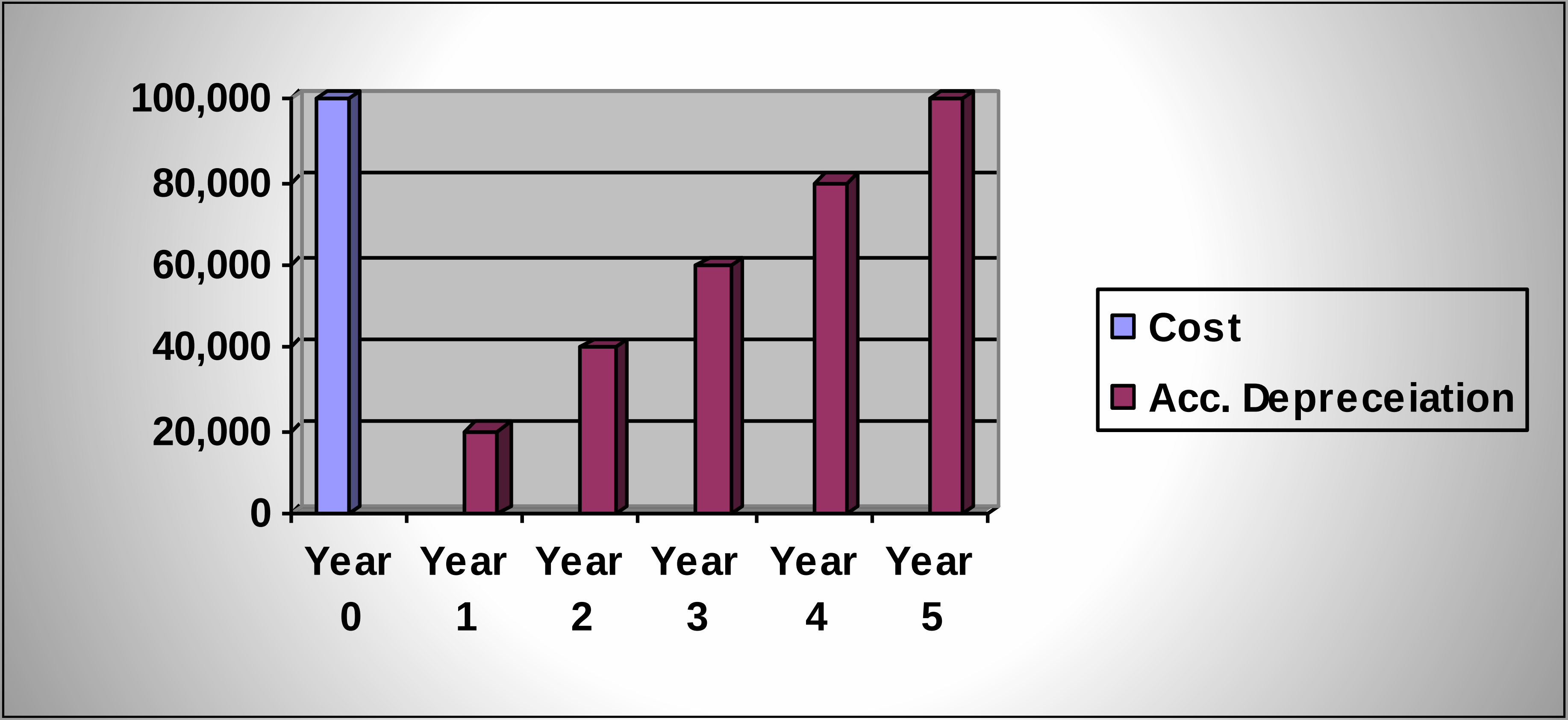
At the end o

Fixed Assets:	Rs.
Delivery Van - at cost	1,00,000
Less: Depreciation to date	40,000
Net	60,000

Example continued…

- At the end of five years the valuation of the asset will be zero
- The value of the assets at cost is usually referred to as '*Gross Fixed Assets*' or '*Gross Block*'
- The amount of depreciation to date (cumulative) as '*Accumulated Depreciation*'
- Net value of the fixed asset is usually referred to as '*Net Fixed Assets*' or '*Net Block*'.

Cost-Depreciation Relationship



Note: Depreciation is charged at the end of each accounting period

Depreciation

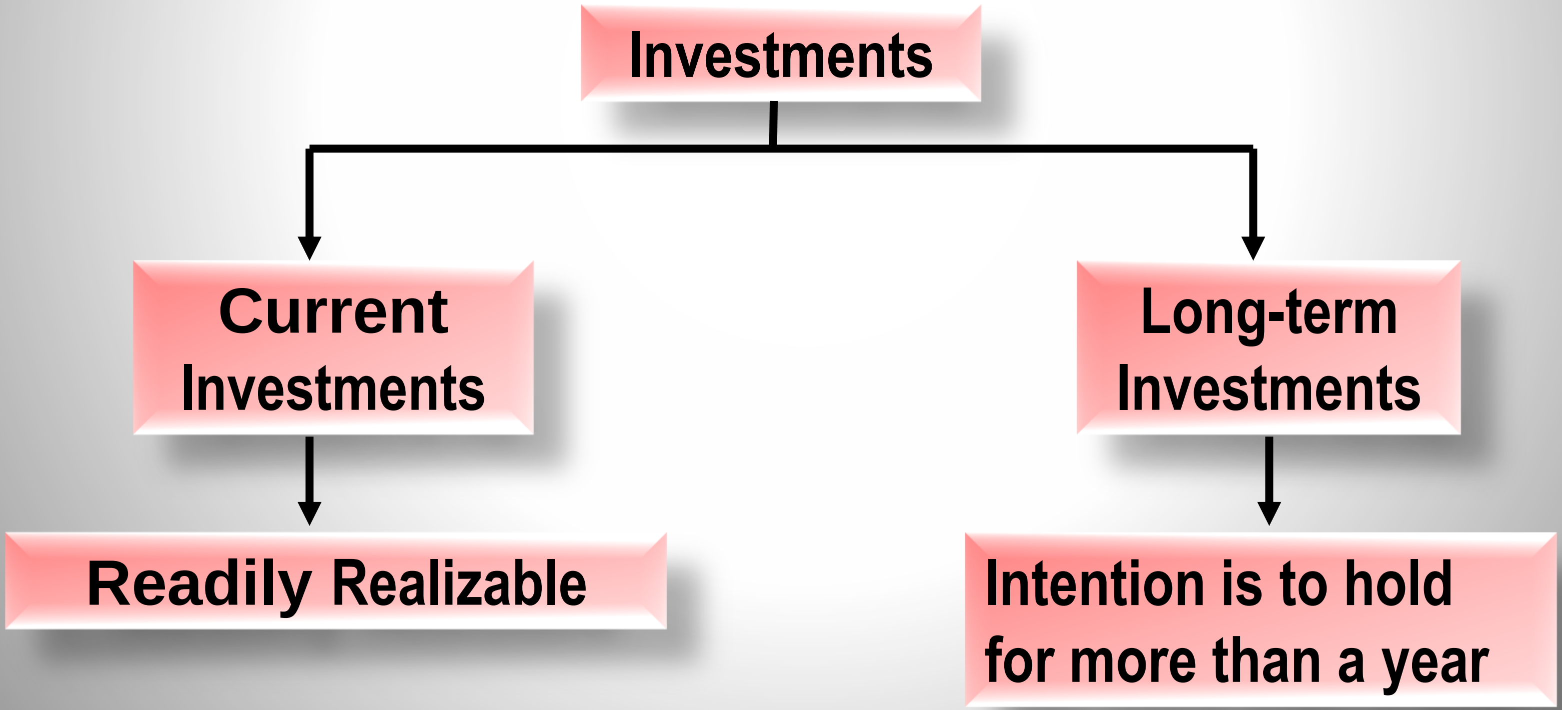
- Fixed assets are valued on the basis of cost of making the asset available and ‘ready for use’
- Others costs (such as installation costs) included are known as ‘*capitalized expenses*’ and included as part of gross fixed asset
- Land is not depreciated
  - Exception: Quarry or any similar extractive property involving depletion on usage

Intangible and Other Assets

- A non-physical resource or a legal right that represents an advantage to a company's position in the marketplace.
- Example – '*goodwill*'. It reflects the ability of a firm to earn profits in excess of normal return
- Process of expiration of the cost of intangible asset (like patents) is called '*amortization*'
- "Other Assets" are assets which are not normally classified as current, fixed and intangible

Investments

- A ‘financial security’ is a piece of paper that proves ownership of equity, loan, and other similar investments
- Usually carried at cost price



Deferred Tax Asset

- Sometimes business entities prepay their tax and adjust it in later years (like '*prepaid expenses*')
- **Deferred expenditure**
  - Special case of intangible assets
  - Benefit of these expenses are expected over several future periods and these expenses are deferred over a period of time; considered as expenses in the normal course of business
  - Example: Restructuring expenses

Current Liabilities

- Liabilities that are due within an accounting period or the operating cycle of the business
- **Accounts Payable**
  - Arises in the normal course of business as a result of acquisition of goods or services on credit
  - Contracted for the purchase of raw material, components or services necessary for the production or provision of the goods and services
- **Acceptance**
  - *'Bills of exchange'* accepted by the firm usually for goods purchased

Current Liabilities

- **Promissory Notes Payable**
  - Written promises to pay the debt at a specified future date

- **Accrued Liabilities**
  - Expenses or obligations incurred in the previous accounting period but the payment would be made in the next period. Examples: Salaries due but not paid

Current Liabilities

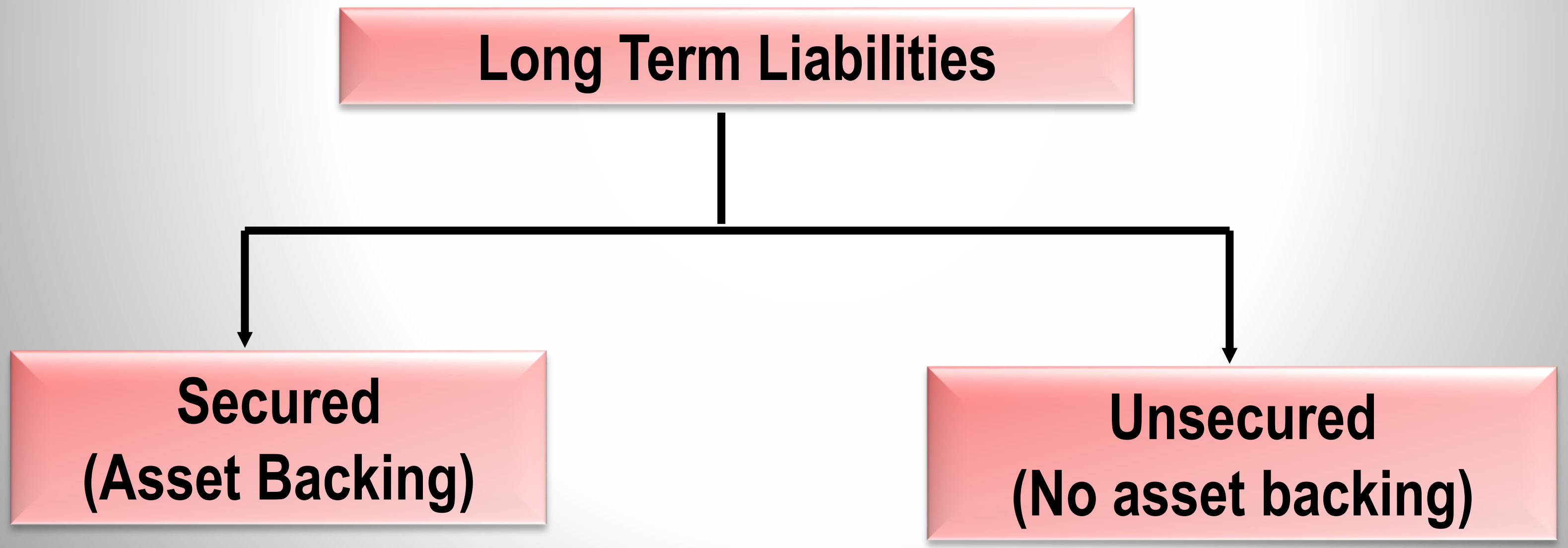
- **Estimated Liabilities or Provisions**
  - Liabilities are known but the amounts cannot be precisely determined
  - The principle of conservatism
  - Example: Income taxes payable
- **Bank Overdraft**
  - Short-term borrowing – ‘current account’ with the bank with a contract to permit overdrawing these accounts up to a limit
  - Flexible borrowing

Liabilities …

- **Contingent Liabilities**
  - These are no liabilities as of now as *neither* ‘the amount’ *nor* ‘the liability’ is *certain*
  - They become liabilities only on the happening of a certain event
  - Example: A claim against the company *contested* in a law court
  - Shown as part of ‘*notes’* to the balance sheet

Long-Term Liabilities

- Are usually for more than one year
- Cover almost all the liabilities not included in the current liabilities and provisions



Long-Term Liabilities

- **Debentures and Bonds**
  - Special instruments of borrowing used by registered companies under the State Companies Act
  - Designated into standard units and one or more of those units are issued to lenders
  - Have standard form and legal backing, enabling them to be traded on stock exchange as debt instruments
  - Technically, there is no difference between debentures or bonds, they may have an explicit coupon rate

Owners Equity

- **Capital**
  - Assets = Liabilities + Owners Equity
  - In the Ramsons Illustration:

Total assets	10,000,000
Liabilities	6,000,000
Owners equity	4,000,000

- Owners Equity = Contributed Capital + Retained Earnings
- Share Premium paid by stockholders is an example of capital reserve

Illustration

- A Company has an authorized share capital of Rs. 2,00,000; divided into 15,000 ordinary shares of Rs. 10 each and 500, 10% preference shares of Rs. 100 each

- The portion of the authorized capital, which is raised, is referred to as 'issued capital'. If the Company offered to the public 7,500 ordinary shares and 500 preference shares for cash.

Issued capital	**Rs.**
7,500 ordinary shares of Rs. 10 each	75,000
500, 10% cumulative preference shares of Rs. 100 each	50,000
Total	1,25,000

Continued…

Subscribed, Called up and Paid up Capital	
7,500 ordinary shares of Rs.10 each	75,000
500, 10% cumulative preference shares of Rs.100 each	50,000
Total	1,25,000

- The company needed only part of the capital and hence chose to issue only one half of the total authorized ordinary shares
- The implication of authorized capital is that it is maximum amount of capital a company may raise without altering the deed of registration

Ordinary and Preference Shares

- **Preference Shares**
  - Have some preference over ordinary shares
  - In case of liquidation the assets remaining after payments to creditors are distributed to preference shareholders first
  - Are first paid their '*prefixed*' dividend
- Usually redeemable after a specified period
- **Ordinary Shares**
  - Have residual claim against all the assets
  - No preferential or fixed rights in either repayment of capital or profit distribution

Reserve and Surplus

- These are surpluses earned by the firm (not distributed as dividends)
- Retained earnings normally arise out of profitable operations
- They are '*earned capital*' for the firm
- Limit of dividend is retained earnings

Formats of Balance Sheet

- Standard Format
- Report Format
- Vertical Format

Thank You