Lesson 3.

Financial position and balance sheet equation

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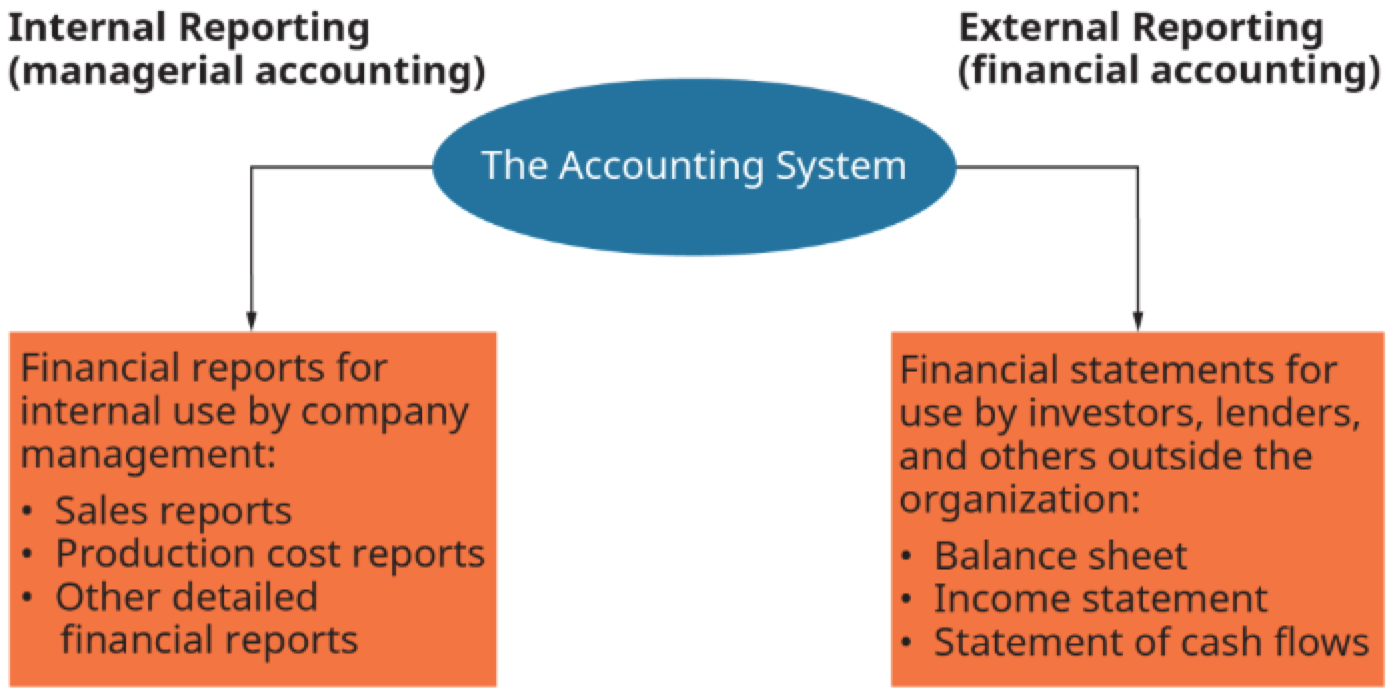
AGENDA

I. Accounting reports as a source of economic information

II. Main balance sheet levels

I. Accounting reports give a small business owner information about their operations, cash flow, net income, accounts receivable, accounts payable, and financial position. Understanding the data in these accounting reports helps a small business owner allocate resources better and make informed decisions.



Accounting Reports Explained

Accounting reports project the previous and current financial situation of the company. They give a compiled view of all the **financial information**. Hence, they are time-saving and allow for taking corrective measures. If there is no compilation of data, the comparison of current data with that of the previous year will become impossible.

The two major reasons for organizations to adopt financial or **management accounting reports** are as discussed below:

#1 – Every business needs to prepare its financial statements – By recording the everyday financial transactions, necessary business decisions occur. However, financial statements of a fiscal year are financial reports that highlight an organization's overall health.

- They provide information on the profitability of the daily operations, **cash flows** and total debt, etc. Accounting reports also talk about the performance of a particular business segment, like the total sales made in a quarter. Therefore, such reports bring into notice the **financial position of the entity.**
- The more accurately and correctly all the financial data is managed, the more convenient it is for the analyst to understand the company's position and the changes it requires.

#2 Accounting Reports help with the following –

Helps in crucial business decisions – Accounting reports are crucial for the management. They often examine different financial statements to figure out better ways to maximize profits. It also helps them make critical and non-financial decisions like going for capital structuring of debt and equity. An example of an accounting report is that of a bank. Before extending a loan, the lender examines the borrower's critical financial statements. This helps them understand whether they will be able to repay the debts or not.

- **Short-term decisions –** An example could be preparing budgets, which an entity arrives at by predicting the revenues or expenditures in advance. This preparation will be impossible without referring to the business data.
- **Investor analysis –** Investors analyze an entity's **financial model** before investing their hard-earned money, which becomes easier with financial reports.
- **Compliances Decisions –** They assist the entities in calculating the correct amount of due tax, keeping in mind the regulatory guidelines.
- **Goodwill/ Capital Reserve –** Business acquisitions require an examination of **valuation of goodwill** or **capital reserve** for which financial reports play a major role.

To understand the types, we need to dig deeper into bookkeeping. Accounting is documentation of financial data. In the beginning, accounting took place in a manual form. However, with the advent of technology, bookkeeping has become a computerized process. The most common types of accounting reports are **Cash flow statement**, **Balance Sheet** and **Profit & Loss Account**/ Income & Expenditure Accounts.

#1 – Balance Sheet

- A Balance Sheet gives us a tabular view of an organization's assets and liabilities on a particular date. A balance sheet components are **non-current assets**, **current assets**, **cash and cash equivalents**, **non-current liabilities**, **current liabilities**, and **share capital**.

#2 – Cash-Flow Statements

- A statement that shows inflows and outflows of cash for a set period is a cash flow statement. There are two ways to prepare it. One is a direct method that considers the inflow and outflow from everyday **operating activities**. The other is an indirect method that records the movement of cash occurring in operating, investing, and **financing activity**.

#3 – Profit & Loss Account

- It is a statement showing all the expenses incurred and revenues earned for a particular period.

II.

The main balance sheet levels, typically classified into three primary sections, are Assets, Liabilities, and Equity. Here's a detailed breakdown of each level:

1. Assets

- Assets represent what a company owns and are classified into current and non-current (long-term) assets.

a. Current Assets

- These are assets that are expected to be converted into cash or used up within one year.
- **Cash and Cash Equivalents**: Liquid assets like currency, bank deposits.
- **Accounts Receivable**: Money owed by customers for sales made on credit.
- **Inventory**: Goods available for sale.
- **Prepaid Expenses**: Payments made in advance for goods or services to be received in the future.
- **Short-term Investments**: Investments that can be easily converted into cash within a year.

b. Non-Current Assets

- These are assets that are expected to provide economic benefits over a period longer than one year.
- **Property, Plant, and Equipment (PP&E)**: Long-term assets used in business operations like buildings, machinery, and equipment.
- **Intangible Assets**: Non-physical assets like patents, trademarks, and goodwill, franchise
- **Long-term Investments**: Investments intended to be held for more than one year.
- **Deferred Tax Assets**: Tax reductions available in future periods.

2. **Liabilities**

A liability is something that a person or company owes, usually a sum of money. Liabilities are settled over time through the transfer of economic benefits including money, goods, or services. They're recorded on the right side of the balance sheet and include loans, accounts payable, mortgages, deferred revenues, bonds, warranties, and accrued expenses.

Liabilities are the opposite of assets. They refer to things that you owe or have borrowed. Assets are things that you own or are owed.

Liabilities represent what a company owes and are classified into current and non-current (long-term) liabilities.

a. **Current (Near-Term) Liabilities**
b. **Non-Current (Long-Term) Liabilities**

Current (Near-Term) Liabilities

Analysts ideally want to see that a company can pay current liabilities that are due within a year with cash. Some examples of short-term liabilities include payroll expenses and accounts payable which can include money owed to vendors, monthly utilities, and similar expenses. Other examples include:

- **Wages payable**: This is the total amount of accrued income that employees have earned but haven't yet received. Many companies pay their employees every two weeks so this liability changes often.
- **Interest payable**: Companies often use credit to purchase goods and services. This represents the interest on those short-term credit purchases that must be paid.
- **Dividends payable**: This represents the amount owed to shareholders after a dividend was declared for companies that have issued stock to investors and pay dividends.
- **Unearned revenues**: This is a company's liability to deliver goods and/or services at a future date after being paid in advance. The amount will be reduced in the future with an offsetting entry when the product or service is delivered.
- **Liabilities of discontinued operations**: This is a unique liability. Companies are required to account for the financial impact of an operation, division, or entity that's currently being held for sale or has been recently sold. This also includes the financial impact of a product line that has recently been shut down.

Non-Current (Long-Term) Liabilities

Any liability that's not near-term falls under non-current liabilities that are expected to be paid in 12 months or more. Long-term debt is also known as bonds payable and it's usually the largest liability and at the top of the list.

Analysts want to see that long-term liabilities can be paid with assets derived from future earnings or financing transactions. Bonds and loans aren't the only long-term liabilities that companies incur. Items like rent, deferred taxes, payroll, and pension obligations can also be listed as long-term liabilities.

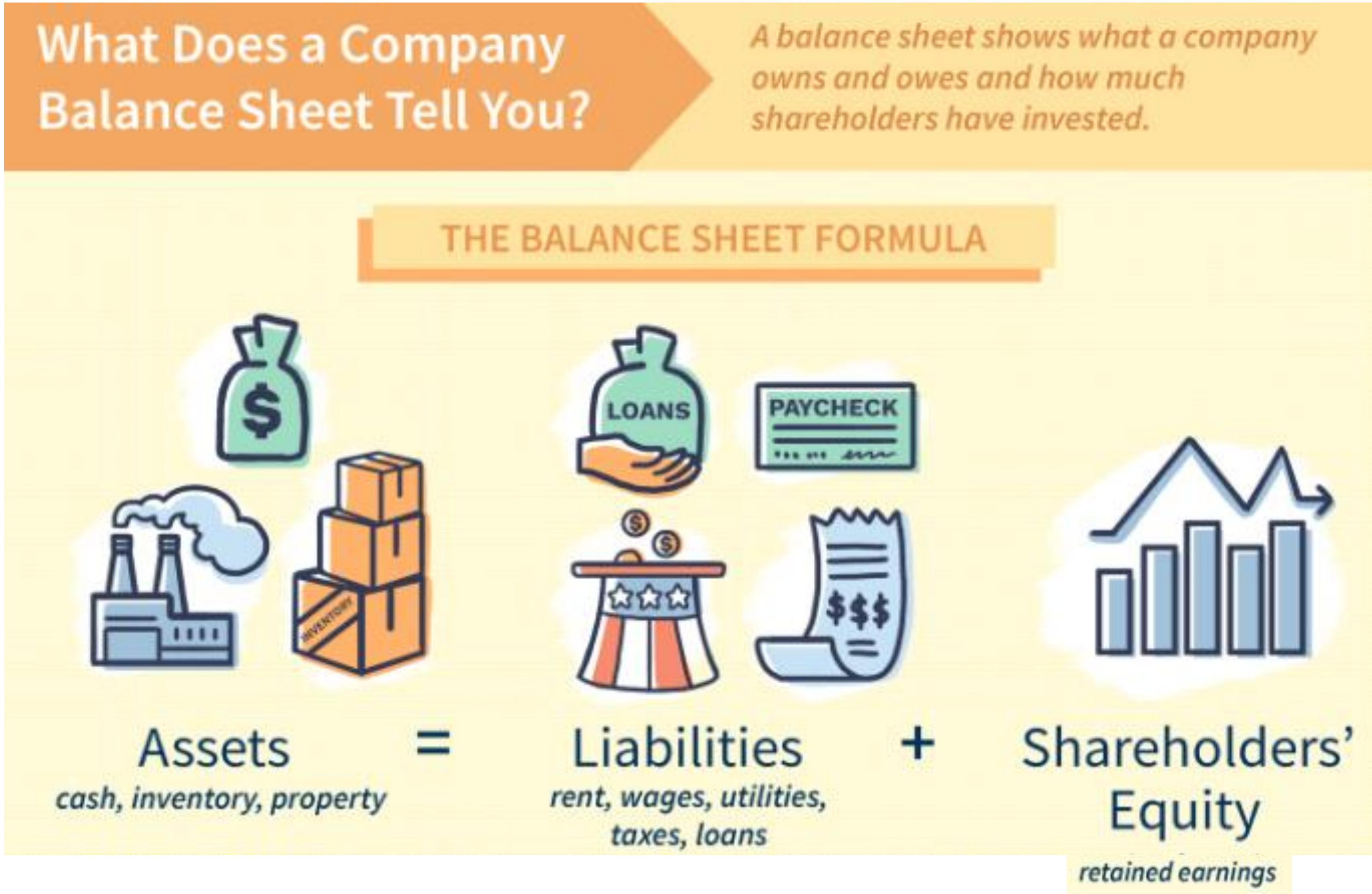
Other examples include:

- **Warranty liability**
- **Contingent liability evaluation**
- **Deferred credits**: This is a broad category that can be recorded as current or non-current depending on the specifics of the transaction. These credits are revenue collected before it's recorded as earned on the income statement.
- **Post-employment benefits**: These are benefits that an employee or family member may receive upon their retirement. They're carried as long-term liabilities as they accrue.
- **Unamortized investment tax credits (UITC)**: This represents the net between an asset's historical cost and the amount that's already been depreciated. The unamortized portion is a liability but it's only a rough estimate of the asset's fair market value. This provides an analyst with some details regarding how aggressive or conservative a company is with its depreciation methods.

3. Equity

Equity represents the owners' residual interest in the assets of the company after deducting liabilities.

- Common shares
- Preferred shares
- Other capital
- Retained earnings
- additional paid-in capita
- reserve capital


What Does a Company Balance Sheet Tell You?
A balance sheet shows what a company owns and owes and how much shareholders have invested.
THE BALANCE SHEET FORMULA
LOANS
PAYCHECK
INVENTORY
Assets = Liabilities + Shareholders' Equity
cash, inventory, property
rent, wages, utilities, taxes, loans
retained earnings

QUESTIONS

1. What are accounting reports and why are they important for businesses?
2. List at least three types of information a small business owner can get from accounting reports.
3. How do accounting reports help business owners make better decisions?
4. Explain the two major reasons organizations adopt financial or management accounting reports.
5. Give three examples of how investors use accounting reports.
6. Name the three most common types of accounting reports.
7. What is a balance sheet and what does it show?
8. What is a cash flow statement and what does it measure?
9. Explain the difference between the direct and indirect methods of preparing a cash flow statement.
10. What does a Profit & Loss Account (Income Statement) show?
11. Name the three primary sections of a balance sheet.
12. What is the difference between current assets and non-current assets?
13. Give three examples of current assets.
14. Give three examples of non-current (long-term) assets.
15. Explain what “accounts receivable” means.
16. Define liabilities and give at least three examples.
17. What is the difference between current liabilities and non-current liabilities?
18. Give three examples of current (near-term) liabilities.
19. Give three examples of non-current (long-term) liabilities.
20. Explain what “unearned revenues” are and why they are a liability.
21. Define equity in the context of a balance sheet.
22. Name at least four components of equity listed in the presentation.
23. Why is equity considered the owners’ “residual interest”?
24. Why do analysts want to see that a company can pay its current liabilities with cash?
25. How do the three sections of the balance sheet (assets, liabilities, and equity) relate to each other in the balance sheet equation?

Thanks for your attention !