



Conquering the Balance Sheet: Figuring Out What it Actually Says

WHAT CAN THE BALANCE SHEET TELL US AND WHAT can't it tell us? Unlike the income statement, which shows the results of operations over a period of time, the balance sheet is a snapshot of the financial position—assets, liabilities and equity—of the company at a single point in time.

The snapshot is accurate and detailed. However, the information it provides is somewhat limited and the situation can change dramatically with time. As a result, it is common to show two-year comparative figures on the balance sheet to help identify and analyze trends.

Assets

An asset is something the company has which will benefit it in the future. Assets can be current or non-current—current assets are ones that will be converted to cash within one year. The most familiar examples of current assets are cash and accounts receivable and the most common non-current asset is equipment. Let's examine each of these and see what they tell us.

Cash : Cash is a very nice thing to have! The cash on the balance sheet is generally the reconciled balance in the company bank account at the balance sheet date. If the account is overdrawn, cash will show as a liability. If the cash balance is quite high (maybe wishful thinking) the question arises, "What is the cash for?" Rather than just sitting there, perhaps it should be used to buy equipment or be paid out as a dividend to you, the shareholder.

Accounts receivable : In some industries, collecting accounts receivable can be problematic. However, I believe that most consultants deal with large companies and agencies that pay within a reasonable time.

You can get a general feel for how long it takes on average to collect by calculating the average collection period. To do this, divide the revenue from the income statement by the accounts receivable balance to get the yearly turnover. Then divide that into 365 to get the average number of days it takes to collect. The trend of this number from year to year can be interesting.

Equipment : Equipment is recorded at its original cost and not adjusted to its market value each year. Instead, the original cost is spread out over the life of the asset through the process of depreciation also called amortization. If the equipment has an estimated ten-year life, for instance, one-tenth of its cost will appear on the income statement as depreciation expense each year for ten years. You will see the total amount of the depreciation expense from all past years on the balance sheet, as accumulated depreciation.

Receivables: One other item that could appear as an asset on the corporation balance sheet is a receivable from the shareholder. If you, as the owner and shareholder, draw money out of the corporation bank account for your own use, it will appear as a shareholder loan or receivable from shareholder. Care must be taken in this case loans like these must be repaid within a certain short period of time. If they aren't, the Canada Revenue Agency (CRA) can deem them to be salaries, subject to the various withholding taxes and possibly penalties. If you plan to draw funds from the corporation, check with your accountant to make sure you stay on side with the CRA rules.

Liabilities

Now, let's look at liabilities. A liability is a form of debt. Like assets, liabilities can be current or non-current. The most common current liabilities (which must be paid within one year) are accounts payable and short-term loans. Non-current liabilities are usually in the form of long-term loans from the bank or the shareholders.

Solvency

A glance at a balance sheet can tell us about the general solvency of the business. Which is greater, the current assets or the current liabilities? If the current liabilities are greater, the question arises, "Where will the money come to pay these liabilities within a year, if the current assets aren't sufficient?" This situation doesn't necessarily mean serious trouble. However, it does point to a concern; namely, is there enough short-term funding available to cover a shortfall if it develops?

Balance Sheet

Assets

Cash

Marketable Securities

Accounts Receivable

Less Allowance for Bad Debts

Accounts Payable

Liquidity

Quick Ratio

Current Ratio

Days Accounts Payable

Days Accounts Receivable

Days Working Capital

Days Inventory

Accounts Payable

Accounts Receivable

Current Liabilities

Current Assets

Dividing the total current assets by the total current liabilities gives the current ratio. This ratio can be valuable in comparing the situation over time. The current ratio will be greater than one if the current assets are larger than the current liabilities. This indicates a comfortable position. You can calculate the current ratio over several years to see the trend. It should be stable or increasing for comfort.

Equity

Finally, let's look at equity. Equity is the residual ownership in the business after total liabilities are subtracted from total assets. Equity for a corporation appears on the balance sheet as shares and retained earnings.

Shares: Shares are established when you set up the corporation. As owner, you invest a nominal amount to purchase the shares initially. That number won't change over time, unless you decide to issue more shares. Maybe someone wants to buy into your company and share in its profits?

Retained Earnings: Retained earnings consist of all of the earnings of the corporation since its inception, less the total amount of any dividends paid out over the years.

The balance sheet isn't a great predictor of the future. However, it's helpful to understand what it is telling us, to ensure the success of the business. For specific help on this and other financial information, have a discussion with your accountant. 🍷

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is Your Advantage





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