

FAST FACTS 3: UNDERSTANDING THE BALANCE SHEET

The balance sheet sets out your assets and liabilities to show the net worth of your business. Assets owned less liability owed equals the net worth of your business. By arranging the items in a balance sheet into different groupings, it is possible to understand a great deal about your own business and how it compares with similar businesses.

The groupings you will see in a balance sheet are:

Current assets

These are cash and other assets that are regularly turned into cash or consumed during the normal operating cycle of the business. You use cash to buy materials, make the product, sell the product for gain, and return to cash.

Non current or fixed assets

These are held by the business in order to carry out the revenue earning activities. They are intended primarily for use, rather than trading. Examples are vehicles, plant and equipment, as well as the premises that the business operates from (Note: These assets must be purchased by the business).

Current liabilities

These are amounts owed to outside creditors that have to be met in the ordinary course of business, either on demand or within a period not exceeding one year.

Non current or deferred liabilities

These are amounts owed to outside creditors of a relatively long term nature, such as loans.

Proprietorship equity

This is made up of monies put into the business, which is called capital, and the accumulated surplus (or deficit) from business trading.

Ratio analysis of your balance sheet

The following ratios are the more common ones used by accountants and banks to measure whether your business, as reflected by the figures in the balance sheet, has improved, compared with earlier and forecasted figures.

Working capital (or current asset) ratio

This measures the liquidity of your business by showing how many dollars of current assets are available to meet each one dollar of current liability. Using the example balance sheet attached, the figures are calculated as follows:

	30/6/07	30/6/08
Current assets	$\frac{107\ 000}{\$2.54} =$	$\frac{112\ 000}{\$2.03} =$
Current liabilities	42 000	55 000

In the above example the ratio has deteriorated, however ratios generally greater than 1.5 times will have enough coverage.

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Turnover of book debts

This ratio is used to show how quickly the outstanding debtors of the business are collected. It is determined by dividing the average sales into the amount of debtors.

	30/6/07	30/6/08
Debtors	$\frac{40\,000}{30 \text{ days}} =$	$\frac{45\,000}{28 \text{ days}} =$
Average daily sales*	1333	1607

* Total sales income from profit and loss statement divided by 365.

The example shows that the collection of debtors has actually improved and will vary for the type of business products and services.

The rate of inventory turnover

The rate of inventory turnover is calculated by dividing the cost of sales (cost of goods sold on the profit and loss statement) for a period of time, by the cost of the average inventory held during the period (stock on hand at the start of the period, plus by the stock on hand at the end of the period divided by two).

	30/6/07	30/6/08
Cost of Goods Sold	$\frac{450\,000}{7.5 \text{ times}} =$	$\frac{500\,000}{8.2 \text{ times}} =$
Average Inventory	60 000	61 000

The above shows an increase in the turnover of inventory – this is a positive sign. The rate will vary for the type of business.

Return on capital

This ratio shows if you may be better off putting your capital into Government Bonds and working for someone else. If the ratio shows a return substantially in excess of Government Bonds, then you had better stay with your business. The ratio looks at the profits made against the amount of capital invested in your business. It is calculated by taking the profit for the period from your profit and loss statement and dividing by the average of the start and end capital amounts.

	30/6/07	30/6/08
Profit x 100	$\frac{5000 \times 100}{14\,000} =$ 35.7%	$\frac{6000 \times 100}{17\,500} =$ 34.3%
Capital	14 000	17 500

Summary

This business is good because of the high profit return on capital, where generally a return greater than 15 per cent is considered good. However, check that falling return on capital is not the beginning of a deteriorating trend. The problem the business has is that the owner has weakened the working capital by drawing too much cash out of the business.

Need more help?

Your accountant is best placed to help you to analyse your financial statements. For more information visit www.nt.gov.au/business

For an example balance sheet see over page.

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Example only

Mr and Mrs Bill Smith Balance Sheet as at 30 June 2008

30 June 2007		30 June 2008
Owners equity		
\$ 15 000	Capital	\$ 20 000
<u>\$ 10 000</u>	Accumulated surplus (deficit)	<u>\$ 6 000</u>
\$ 25 000	Total Owners Equity	\$ 26 000
These funds are represented by:		
Current assets		
\$ 1 000	Cash at bank	\$ 2 000
\$ 40 000	Debtors	\$ 45 000
\$ 4 000	Prepayments	\$ 5 000
<u>\$ 62 000</u>	Stock on hand	<u>\$ 60 000</u>
<u>\$107 000</u>	Total current assets	<u>\$112 000</u>
Fixed assets		
\$ 15 000	Plant and equipment	\$ 20 000
(\$ 3 000)	Less provision for depreciation	(\$ 4 000)
<u>\$ 12 000</u>	Total Fixed Assets	<u>\$ 16 000</u>
<u>\$119 000</u>	TOTAL ASSETS	<u>\$128 000</u>
Current liabilities		
\$ 30 000	Creditors	\$ 40 000
<u>\$ 12 000</u>	Accrued expenses	<u>\$ 15 000</u>
<u>\$ 42 000</u>	Total current liabilities	<u>\$ 55 000</u>
Non current liabilities		
\$ 30 000	Bank loan	\$ 27 000
\$ 22 000	Loan from J Smith	\$ 20 000
<u>\$ 52 000</u>	Total non current liabilities	<u>\$ 47 000</u>
<u>\$ 94 000</u>	TOTAL LIABILITIES	<u>\$102 000</u>
\$ 25 000	Surplus of assets over liabilities	\$ 26 000

For more information refer to other Fast Facts in this series, or contact:

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