

ZIONS BANK[®] BUSINESS BUILDER 2

HOW TO PREPARE AND ANALYZE A BALANCE SHEET



how to prepare and analyze a balance sheet

Examine the concepts of assets, liabilities, and net worth in a way that will help you relate them to your business. Learn how to create a balance sheet for your company and how to use it to analyze your business' liquidity and leverage.

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what to expect

This Business Builder will introduce you to accounting terminology and examine the concepts of assets, liabilities and net worth in a way that will help you relate them to your business. It will guide you through a step-by-step process to create a balance sheet for your company and explain how to use a balance sheet to analyze your business' liquidity and leverage.

what you should know before getting started

The Purpose of Financial Statements

The purpose of financial statements is to communicate. Financial statements tell you and others the state of your business. The three most commonly prepared financial statements for a small business are a balance sheet, an income statement, and a cash flow statement.

A **balance sheet** (also known as a statement of financial position) is a formal document that follows a standard accounting format showing the same categories of assets and liabilities regardless of the size or nature of the business. The balance sheet you prepare will be in the same format as IBM's or General Motors'. Accounting is considered the language of business because its concepts are time-tested and standardized. Even if you do not utilize the services of a certified public accountant, you or your bookkeeper can adopt certain generally accepted accounting principles (**GAAP**) to develop financial statements.

To help you get a grip on accounting terminology, terms are defined as they are introduced and a glossary is included for reference.

The strength of GAAP is the reliability of company data from one accounting period to another and the ability to compare the financial statements of different companies. The standardization introduced by commonly defined terms is responsible for this reliability. To help you get a grip on accounting terminology, terms are defined as they are introduced and a glossary is included for reference.

Garbage-in, garbage-out. The integrity of any financial statement is directly related to the information that goes into its construction. You may want to consider revamping your record-keeping, if necessary, before you begin compiling financial statements.

This Business Builder will explain what data is necessary for accurate financial statements, but answering the following questions might be a good place to start:

- Are the financial records for all (or most) of the company's **assets** (equipment, inventory, furniture) and **liabilities** (personal loans, bank loans) in one place?
- Is there a record of the amounts and sources of cash expended to begin the business and acquire inventory?
- Do you know what is currently owed to the bank, creditors, or others?
- Do you know how much of what is owed is due in the next 12 months?
- Can you estimate what percentage of accounts receivable may not be received?

Why Create a Balance Sheet?

A balance sheet provides a snapshot of a business' health at a point in time. It is a summary of what the business owns (assets) and owes (liabilities). Balance sheets are usually prepared at the close of an accounting period such as month-end, quarter-end, or year-end. New business owners should not wait until the end of 12 months or the end of an operating cycle to complete a balance sheet. Savvy business owners see a balance sheet as an important decision-making tool.

Over time, a comparison of balance sheets can give a good picture of the financial health of a business. In conjunction with other financial statements, it forms the basis for more sophisticated analysis of the business. The balance sheet is also a tool to evaluate a company's flexibility and liquidity.

how to prepare a balance sheet

A balance sheet is a statement of a firm's assets, liabilities and net worth. The key to understanding a balance sheet is the simple formula:

$$\text{Assets} = \text{Liabilities} + \text{Net Worth}$$

All balance sheets follow the same format: If it is in two columns, assets are on the left, liabilities are on the right, and net worth is beneath liabilities. If it is in one column, assets are listed first, followed by liabilities and net worth.

Here is a sample balance sheet for the Doodads Company.

DOODADS CO. BALANCE SHEET AS OF DEC 31, 20XX

Assets	\$\$
Current Assets	
Cash On Hand	\$ 300
Cash in Bank	\$ 2,200
Accounts Receivable	\$ 1,600
Merchandise Inventory	\$ 5,500
Prepaid Expenses	
Rent	\$ 1,200
Total Current Assets	\$10,800
Fixed Assets	
Equipment and Fixtures (less Depreciation)	\$ 1,200
Total Assets	\$12,000
Liabilities	\$\$
Current Liabilities	
Accounts Payable	\$ 1,100
Notes Payable, Bank	\$ 2,200
Accrued Payroll Expenses	\$ 500
Total Current Liabilities	\$ 3,800
Long-Term Liabilities	
Notes Payable, 1998	\$ 5,500
Total Liabilities	\$ 9,300
Net Worth*	\$ 2,700
Total Liabilities and Net Worth	\$12,000

*Assets = Liabilities + Net Worth

Assets

In this section, each type of asset is explained. A worksheet is provided for your use in assembling a balance sheet for your business on Page 9.

All balance sheets show the same categories of assets: current, long-term (fixed) assets, and other assets. Assets are arranged in order of how quickly they can be turned into cash. Turning assets into cash is called **liquidity**.

Current assets include cash, stocks and bonds, **accounts receivable, inventory, prepaid expenses** and anything else that can be converted into cash within one year or during the normal course of business. These are the categories you will use to group your current assets. This Business Builder focuses on the current assets most commonly used by small businesses: cash, accounts receivable, inventory and prepaid expenses.

Assets are arranged in order of how quickly they can be turned into cash.

Cash is relatively easy to figure out. It includes cash on hand, in the bank and in petty cash.

Accounts receivable is what you are owed by customers. The easy availability of this information is important. Fast action on slow paying accounts may be the difference between success and failure for a small business. To make this number more realistic, you should deduct an amount from accounts receivable as an **allowance for bad debts**.

Inventory may be your largest current asset. On a balance sheet, the value of inventory is the cost to replace it. If your inventory were destroyed, lost or damaged, how much would it cost you to replace or reproduce it? Inventory includes goods ready for sale, as well as raw material and partially completed products that will be for sale when they are completed.

Prepaid expenses are listed as a current asset because they represent an item or service that has been paid for but has not been used or consumed. An example of a prepaid expense is the last month of rent of a lease that you may have prepaid as a security deposit. It will be carried as an asset until it is used. Prepaid insurance premiums are another example of a prepaid expense. Sometimes, prepaid expenses are also referred to as unexpired expenses.

On a balance sheet, current assets are totaled and this total is shown as the line item: Total Current Assets.

Step 1: Complete the Current Asset Section of the worksheet.

Fixed Assets are also known as long-term assets. Fixed assets are the assets that produce revenues. They are distinguished from current assets by their longevity. They are not for resale. Many small businesses may not own a large amount of fixed assets. This is because most small businesses are started with a minimum of capital. Of course, fixed assets will vary considerably and depend on the business type (such as service or manufacturing), size and market.

Fixed assets include furniture and fixtures, motor vehicles, buildings, land, building improvements (or leasehold improvements, if you rent), production machinery, equipment and any other items with an expected business life that can be measured in years.

All fixed assets (except land) are shown on the balance sheet at original (or historic) cost less any depreciation. Subtracting depreciation is a conservative accounting practice to reduce the possibility of overvaluation. **Depreciation** subtracts a specified amount from the original purchase price for the wear and tear on the asset. It is important to remember that original cost may be more than the asset's invoice price. It can include shipping, installation, and any associated expenses necessary for readying the asset for service.

This Business Builder assumes that you are familiar with depreciation, have already selected a depreciation method and are comfortable with its application. If you are not familiar with depreciation, you can still prepare a balance sheet. It will provide you with similar benefits, but it will not be in conformance with GAAP.

This section concentrates on the categories of fixed assets common to most small businesses: furniture and fixtures, motor vehicles, and machinery and equipment.

- *Furniture and fixtures* is a line item that includes office furniture, display shelves, counters, work tables, storage bins and other similar items. On the balance sheet, these items are listed at cost (plus related expenses) minus depreciation.
- *Motor vehicles* is a line item to list the original value (less depreciation) of any motor vehicle, such as a delivery truck, that is owned by your business.
- *Machinery and equipment* are vital to many businesses. If you are a manufacturing firm, this could be your largest fixed asset. Like the other fixed assets on the balance sheet, machinery and equipment will be valued at the original cost minus depreciation.
- *Other assets* is a fourth category of fixed assets. Other assets are generally intangible assets such as patents, royalty arrangements and copyrights.

Step 2: Complete the Fixed Assets Section and the Other Assets Section of the worksheet and compute the total assets of your business.

Liabilities

In this section, two types of liabilities will be explained. You will continue to use the worksheet at the end of this section. Liabilities are claims of creditors against the assets of the business. They are debts owed by the business.

There are two types of liabilities: current liabilities and long-term liabilities. Liabilities are arranged on the balance sheet in order of how soon they must be repaid. For example, accounts payable will appear first as they are generally paid within 30 days. Notes payable are generally due within 90 days and are the second liability to appear on the balance sheet.

Current liabilities are accounts payable, notes payable to banks (or others), accrued expenses (such as wages and salaries), taxes payable, the current due within one year portion of long-term debt and any other obligations to creditors due within one year from the date of the balance sheet. The current liabilities of most small

Liabilities are arranged on the balance sheet in order of how soon they must be repaid.

businesses include accounts payable, notes payable to banks and accrued payroll taxes.

- **Accounts payable** is the amount you may owe any suppliers or other creditors for services or goods that you have received but not yet paid for.
- **Notes payable** refers to any money due on a loan during the next 12 months.
- **Accrued payroll taxes** would be any compensation to employees who have worked, but have not been paid, at the time the balance sheet is created.

Long-term liabilities are any debts that must be repaid by your business more than one year from the date of the balance sheet. This may include startup financing from relatives, banks, finance companies or others.

Step 3: Complete the Liabilities Section of the worksheet. Compute Total Liabilities.

Net Worth

The formula that defines the balance sheet is:

$$\text{Assets} = \text{Liabilities} + \text{Net Worth}$$

The formula can be transposed to yield a definition of net worth:

$$\text{Net Worth} = \text{Assets} - \text{Liabilities}$$

Net worth is what is left over after liabilities have been subtracted from the assets of the business. In a sole proprietorship, it is also known as owner's equity. This equity is the investment by the owner plus any profits or minus any losses that have accumulated in the business.

Step 4: Complete the Net Worth Section of the worksheet. When this is done, you should have a completed balance sheet for your business.

BALANCE SHEET WORKSHEET		
Enter your Company Name here: _____		
ASSETS	BEGINNING: _____	PROJECTED: _____
<u>Current Assets</u>		
Cash in bank	\$ _____	\$ _____
Accounts receivable	\$ _____	\$ _____
Inventory	\$ _____	\$ _____
Prepaid expenses	\$ _____	\$ _____
Other current assets	\$ _____	\$ _____
Total Current Assets	\$ _____	\$ _____
<u>Fixed Assets</u>		
Machinery & equipment	\$ _____	\$ _____
Furniture & fixtures	\$ _____	\$ _____
Leasehold improvements	\$ _____	\$ _____
Land & buildings	\$ _____	\$ _____
Other fixed assets	\$ _____	\$ _____
(LESS accumulated depreciation on all fixed assets)		
Total Fixed Assets (net of depreciation)	\$ _____	\$ _____

<u>Other Assets</u>		
Intangibles	\$ _____	\$ _____
Deposits	\$ _____	\$ _____
Goodwill	\$ _____	\$ _____
Other	\$ _____	\$ _____
Total Other Assets	\$ _____	\$ _____
TOTAL ASSETS	\$ _____	\$ _____
LIABILITIES AND EQUITY		
<u>Current Liabilities</u>		
Accounts payable	\$ _____	\$ _____
Interest payable	\$ _____	\$ _____
Taxes payable	\$ _____	\$ _____
Notes payable, short-term (due within 12 months)	\$ _____	\$ _____
Current part, long-term debt	\$ _____	\$ _____
Other current liabilities	\$ _____	\$ _____
Total Current Liabilities	\$ _____	\$ _____
<u>Long-term Debt</u>		
Bank loans payable	\$ _____	\$ _____
Notes payable to stockholders	\$ _____	\$ _____
LESS: Short-term portion	\$ _____	\$ _____
Other long-term debt	\$ _____	\$ _____
Total Long-term Debt	\$ _____	\$ _____
TOTAL LIABILITIES	\$ _____	\$ _____
<u>Net Worth</u>	\$ _____	\$ _____
TOTAL LIABILITIES & NET WORTH	\$ _____	\$ _____

In the next section, four simple formulas will be introduced to enhance the information contained on the balance sheet.

The information in the preceding section will help you develop a balance sheet of your own.

how to analyze a balance sheet

Now that you have created a balance sheet for your business, there are some easy calculations that you can perform that will give you a better understanding of your company. Using data from your balance sheet, you can calculate liquidity and leverage ratios.

These financial ratios turn the raw financial data from the balance sheet into information that will help you manage your business and make knowledgeable decisions. A ratio shows the relationship between two numbers. It is defined as the relative size of two quantities expressed as the quotient of one divided by the other. Financial ratio analysis is important because it is one method loan officers use to evaluate the credit worthiness of potential borrowers. Ratio analysis is a tool to uncover trends in a business as well as allow the comparison between one business and another.

In the following section, four financial ratios that can be computed from a balance sheet are examined:

- Current Ratio
- Quick Ratio
- Working Capital
- Debt/Worth Ratio

Current Ratio

The current ratio (or liquidity ratio) is a measure of financial strength. The number of times current assets exceed current liabilities is a valuable expression of a business' solvency. Here is the formula to compute the current ratio:

$$\text{Current Ratio} = \frac{\text{Total Current Assets}}{\text{Total Current Liabilities}}$$

The **current ratio** answers the question, "Does my business have enough current assets to meet the payment schedule of current liabilities with a margin of safety?" A rule-of-thumb puts a strong current ratio at two. Of course, the adequacy of a current ratio will depend on the nature of the small business and the character of the current assets and current liabilities. While there is usually little doubt about debts that are due, there can be considerable doubt about the quality of accounts receivable or the cash value of inventory.

A current ratio can be improved by either increasing current assets or decreasing current liabilities. This can take the form of the following:

- Paying down debt.
- Acquiring a loan (payable in more than one year's time).
- Selling a fixed asset.
- Putting profits back into the business.

A high current ratio may mean that cash is not being utilized in an optimal way. That is, the cash might better be invested in equipment.

Quick Ratio

The quick ratio is also called the “acid test” ratio. It is a measure of a company’s liquidity. The quick ratio looks only at a company’s most liquid assets and divides them by current liabilities. Here is the formula for the quick ratio:

$$\text{Quick Ratio} = \frac{\text{Current Assets} - \text{Inventory}}{\text{Current Liabilities}}$$

The assets considered to be “quick” assets are cash, stocks and bonds, and accounts receivable (all of the current assets on the balance sheet, except inventory). The **quick ratio** is an acid test of whether or not a business can meet its obligations if adverse conditions occur. Generally, quick ratios between .50 and 1 are considered satisfactory as long as the collection of receivables is not expected to slow.

Working Capital

Working capital should always be a positive number. It is used by lenders to evaluate a company’s ability to weather hard times. Often, loan agreements specify a level of working capital that the borrower must maintain.

$$\text{Working Capital} = \text{Total Current Assets} - \text{Total Current Liabilities}$$

The current ratio, quick ratio and **working capital** are all measures of a company’s liquidity. In general, the higher these ratios are, the better for the business and the higher degree of liquidity.

Debt/Worth Ratio

The debt/worth ratio (or leverage ratio) is an indicator of a business’ solvency. It is a measure of how dependent a company is on debt financing (or borrowings) as compared to owner’s equity. It shows how much of a business is owned and how much is owed.

The **debt/worth ratio** is computed as follows:

$$\text{Debt/Worth Ratio} = \frac{\text{Total Liabilities}}{\text{Net Worth}}$$

Step 5: Compute the current ratio, quick ratio, working capital, and debt/worth ratio for your company.

conclusion

Since balance sheets present the health of a company as of one point in time, valuable information will be lost if managers do not take the opportunity to compare the progress and trend of a business by regularly evaluating and comparing balance sheets of past time periods. Information is power. The information that can be gleaned from the preparation and analysis of a balance sheet is one financial management tool that may mean the difference between success and failure.

checklist

Assets

- Have you included all current assets?
- Did you adjust accounts receivable for bad debts?
- Is inventory valued at replacement cost?
- Did you include all appropriate prepaid expenses?
- Did you include any installation or delivery costs for fixed assets?

Liabilities and Net Worth

- Have all liabilities, both current and long term, been included?
- Did you include all startup expenses payable in more than one year in long-term liabilities?
- Do assets minus liabilities equal net worth?

Financial Ratio Analysis

- Did you compute a current ratio, quick ratio, working capital and debt/worth ratio for your business?
- Is your current ratio greater than or equal to two? If not, do you know what adjustments might be made?

glossary

Allowance for Bad Debts - Amount of estimated debt to the business that is not expected to be repaid and is subtracted from accounts receivable on the balance sheet. Also known as an allowance for doubtful accounts.

Assets - Anything that a business owns that has monetary value.

Accounts Payable - Debts of the business, often to suppliers, and generally payable within 30 days.

Accounts Receivable - An amount owed to the business, usually by one of its customers, as result of the extension of credit.

Accrued Payroll Taxes - Taxes payable for employee services received, but for which payment has not yet been made.

Balance Sheet - A financial statement showing the assets, liabilities, and net worth of a business as of a specific date.

Current Assets - Cash and other assets readily converted into cash. Includes accounts receivable, inventory, and prepaid expenses.

Current Liabilities - The debts of a company which are due and payable within the next 12 months.

Current Ratio - Current assets divided by current liabilities.

Debt/Worth Ratio - Total Liabilities divided by Net Worth.

Depreciation - An accounting convention to take into account the physical deterioration of an asset. It is a systematic method to allocate the historical cost of the asset over its useful life.

Fixed Assets - Also called long-term assets with a relatively long life that are used in the production of goods and services, rather than being for resale.

GAAP - Abbreviation of Generally Accepted Accounting Principles. Conventions, rules, and procedures that define accepted accounting practice.

Inventory - Goods held for sale, raw material and partially finished products which will be sold when they are finished.

Liabilities - Debts of the business.

Liquidity - The ability to produce cash from assets in a short period of time.

Long-Term Liabilities - Debts of a company due after a period of 12 months or longer.

Net Worth - The business owner's equity in a company as represented by the difference between assets and liabilities.

Owners' Equity - See Net Worth.

Quick Ratio - Current Assets minus Inventory, divided by Current Liabilities. Also known as the acid test.

Working Capital - Current Assets minus Current Liabilities.

resources

Books

Accounting Principles and Applications by Horace R. Brock (McGraw Hill, 1990).

Analysis and Use of Financial Statements by Gerald I. White, Ashwinpaul C. Sondhi and Dov Fried (John Wiley & Sons, 1997).

Corporate Controller's Handbook of Financial Management 2nd ed. by Joel G. Siegel, Jae K. Shim and Nicky A. Dauber (Prentice Hall, 1997).

Handbook of Budgeting 4th ed. by Robert Rachlin (Wiley, 2000).

Winning Business: How to Use Financial Analysis and Benchmarks to Outscore Your Competition (with CD-ROM) by Rich Gildersleeve (Gulf Publishing, 1999).

Magazines

Journal of Accountancy

Templates

Templates in this booklet are used courtesy of SCORE. Download Excel files of these templates at: <http://www.score.org> then select Business Toolbox in the left navigation pane and Template Gallery.

Templates can also be found at:

<http://www.resources.zionsbank.com> then select Business Tools in the left navigation pane.

Writer: E. Bond

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Zions Business Resource Center

Utah

resources@zionsbank.com

Idaho

idresources@zionsbank.com