Module 3 – The Balance Sheet

Assets can be described as:

1. the untransformed means of production like land, buildings, plant and machinery and raw materials; and
2. the transformed means of production like work-in-progress and finished goods which have not yet been released into the profit and loss account. when released these costs become ‘expenses’; no further benefit is anticipated from these costs.

**3.3 Fixed Assets**

Fixed assets are those assets that a company keeps for a substantial period of time, not for resale, but to use in the course of business. It is the intention of management as to the use of the asset, rather than the physical characteristics that are important – e.g. a car in one business may be a fixed asset but in a car dealership the cars are current assets. Maintenance expense and depreciation of fixed assets are both charged to the P&L but the former is charged against profits in the period of outlay whereas the latter is the allocation of previously incurred cost.

* Land – not usually depreciated. The costs involved in buying land (legal fees etc.) may be capitalized and made part of the fixed asset or written off in the P&L. The latter is usually the case, unless the costs are clearly related to the accusation and the asset cannot be made operational without incurring the cost. As land increase in value, the market value is either put in parenthesis or the land is revalued from time to time and the increase added to the owners equity (doesn’t effect P&L)
* Buildings – slow depreciation applies
* Plant & Equipment
* Fixed Asset not owned by company

Why use leasing?

* avoids substantial outflow of cash
* spreads the cash outflow into relative small amounts over the years of the assets life
* Company can replace the leased asset with a more up to date model without having to record a loss or gain for the sale of the old model
* Maintenance costs are usually covered by the lease agreement
* Lease payments are an allowable charge against profits before the calculation of taxes

A finance lease is one in which the ownership of the asset reverts to the lessee (rather than the lessor) – in this case the asset appears in the balance sheet under fixed assets and the future lease payments under ‘Creditors’. The interest charged per year does appear in the P&L, while the capital portion is deducted from the lease obligation in the balance sheet.

An operating lease is one in which ownership remains with the lessor, in that case the lease is not capitalized but the yearly lease payments (capital & interest) appear in the P&L.

**3.4 Current Assets**

Current Asset are those that are expected to be sold or consumed during the normal operating cycle of a company – usually one year.

* Inventories:
* the valuation of inventories is based on the ‘lower of cost or market value’ rule
* ‘Cost’ is usually defined as direct manufacturing cost plus a share of manufacturing overhead. Period costs (like administration overhead) are not normally allocated to inventory.
* the level of reported profit can be influenced by changing the basis of valuation for inventories
* Debtors – due to the convention of conservatism, accountants want to write some debt off as being unrecoverable. Rather than writing debt off in the period in which it becomes unrecoverable (matching convention doesn’t allow for this), accountants make a provision for bad dents during each period.

The P&L is charged with an initial provision, in succeeding periods, only the incremental adjustment is entered into the P&L account. Note: the provision is then subtracted from the debtors figure in the balance sheet.

Bad debt provision is based upon:

1. the risks attached to each particular customer
2. the severity with which the company will pursue recalcitrant debtors
3. the general economic environment e.g. interest rate changes

Example:

|  |  |  |  |
| --- | --- | --- | --- |
| Year One Debtors | 100,000 | Year Two Debtors | 122,000 |
| Policy: bad debts provision set at 5% |  | Same policy |  |
|  |  | Specific bad debt arising in Year 2 to be written off | 2,000 |
| Entry in P&L |  | Entry in P&L |  |
| Charge for bad debts provision | 5000 | Bad debt written off | 2,000 |
|  |  | Top Up provision to 5% (5% of 120K – 5000, its 120K because 122k minus 2k bad debts) | 1000 |
|  |  |  |  |
| Entry in balance sheet |  | Entry in Balance Sheet |  |
| Debtors less provision | 95,000 | Debtors | $120,000 |
|  |  | Less Provision ($6000) | $114,000 |

* Cash – obviously handy to have

**3.5 Current Liabilities**

These are those debts that the company expects to pay in the next 12 months. Examples include creditors, bank overdraft, taxes payable on previously recorded profits, dividends payable on previously recorded profits, accruals and deferred revenue (revenue received by the company in advance of providing the goods or service).

Example: One year subscription = $75, Three year = $ 210. In 1996 there were 3000 one year and 2000 three year subscriptions:

|  |  |  |  |
| --- | --- | --- | --- |
| Balance Sheets | **1996** | **1997** | **1998** |
| Cash | 645000 | - | - |
| Owners Equity | $X | $X | $X |
| Deferred Revenue | 280,000 | 140,000 | - |
|  |  |  |  |
| **Profit and Loss Account** |  |  |  |
| Subscription Revenue: |  |  |  |
| One Year | 225,000 | - | - |
| Three Years | 140,000 | 140,000 | 140,000 |
| Total | 365,000 | 140,000 | 140,000 |
|  |  |  |  |
|  |  |  |  |

**3.6 Net Current Assets and Net Assets**

Net current Assets = Current Assets – Current Liabilities

**3.6.1 Financing Net Assets**

Internally generated sources for the acquisition of net assets include original equity and operations which produced a profit which was not distributed to the owner. The combined some of these internally generated funds is called ownership equity.

An external source of funds could be a long term loan. The amount of interest must be charged as an expense against profits before shareholders become entitled to any dividends. The relationship between shareholder funding (owners equity) and loans is called *gearing* or *leverage*.

Gearing = (Long term Debts/Owners Equity)

In years of healthy profits, shareholders receive a better return on their equity with a highly geared company. The opposite is true in years of low profits.

Return on Owners Equity = (Profit after interest on loan/Equity) x 1000

**3.7 Why does Balance Sheet always balance?**

P&L acts as a balancer.

For example: a change from LIFO to FIFO in inflationary times.

FIFO means higher cost of closing stock (first in would be lower price, so closing stock would be made up of higher priced items), which means lower cost of sales which means higher gross profit.

In the balance sheet, this higher profit is reported as an increase in owners equity, but is balanced by the increase in current assets (higher closing stock valuation).

Review Questions:

1. b
2. d
3. False
4. b
5. d
6. a
7. b
8. c
9. c
10. c
11. a
12. b
13. d
14. c

15.

1995 – Debtors: 150k, provision = 6000.

1996 – Debtors: 180k, 4% of that = 7200, [Note: it says that bad debts have already been written off during each year – presume that is written off the debtors figure]

Ans: a

16.1997: Debtors = 210k, 4% = 8400, Now take away the provision in 1996: 8400 – 7200 = 1200 top up.

5700 (actual bad debts) +1200 (provision for 1998) = 6900 Ans: b

17. 4% of 210k = 8400, 210k – 8400 = $201,600 Ans: d

Note: in the balance sheet the provision is a straight 4% of debtors, no top up bullshit.

18. b

19. c

20. d (must include annual lease payments and annual loan stock repayments)

21. remaining loan stock = 30,000; remaining lease payments = 6000, Ans: a

22. b

23. True

24. c

25. Return on Owners Equity = (Profit after Interest/Equity)x100

25 = ((36,000 – x)/100,000)\*100 ; where x is the interest

.25 (100,000) = 36000 – x

x=36,000 – 25,000 = 11,000

At 10% interest, the loan stock would need to be 110,000 Ans: a

26. Gearing Ration = (long terms debts/Owners Equity)

x/(100,000+x) = 37.5% ; where x = long term debt

## Note: Equity includes the long term loan, hence 100000+x

x = .375(100,000 + x)

x = 37,500 + .375x

.625x = 37,500

x = 60,000

Ans: b