

Chapter 1 - The Balance Sheet

The Purpose of the Balance Sheet

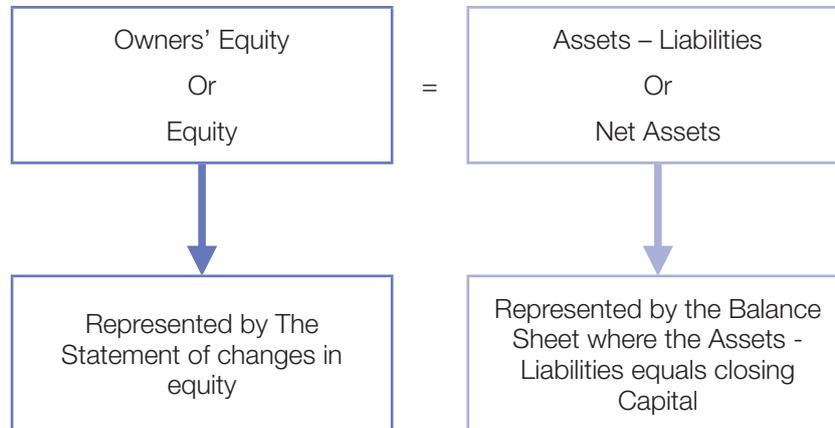
The Balance Sheet, or Statement of Financial Position, is a general-purpose report, which provides an outline of a business' asset and liabilities. It provides a snapshot of the business position at a point in time. The Balance Sheet reveals information about a firm's short term and long term financial risk in terms of liquidity and gearing.

Liquidity: The availability of liquid assets available to cover firms' short-term financial obligations.

Gearing: The relative proportions of debt and equity that a firm uses to fund its operations.

The Statement of Changes in Equity accompanies the Balance Sheet, which summaries movements in the equity accounts. The statement explains the changes in a business's capital, retained profits and drawings that occur during the reporting period. The statement essentially breaks down the changes in the owners' investment in the business over the accounting period.

The Balance Sheet and Statement of Changes in Equity is essentially an expression of the accounting equation.



Reading the Balance Sheet

Figure 1.1 presents an example Statement of changes in equity and Balance sheet. It is important that the information can be interpreted by general -purpose users, therefore it must be presented in a readable form, which follows accounting conventions.

Statement of Changes in Equity	
CTS Plastics	
For the year ending 30 June 2019	
	\$
Opening Capital	1,206,444
Profit/ loss	-407,600
Less drawings	<u>60,000</u>
Closing Capital	738,844

Balance Sheet		
CTS Plastics		
For the year ending 30 June 2019		
	\$	\$
<i>Current Assets</i>		
Debtors		<u>110,000</u>
		110,000
<i>Non-current Assets</i>		
Office Equipment	3,000	
Less Accumulated depreciation	<u>2,400</u>	
		600
Plant and Equipment	500,000	
Less Accumulated depreciation	<u>400,000</u>	
		100,000
Land		1,000,000
		<u>1,100,600</u>
Total Assets		1,210,600
<i>Current Liability</i>		
Overdraft		48,756
Creditors		<u>70,000</u>
		118,756
<i>Non-current liabilities</i>		
Secured loan		<u>353,000</u>
Total Liabilities		471,756
Net Assets		738,844

Owners' equity represents the owner's stake in the business after all Liabilities have been deducted from Assets.

It also represents internal sources of finance and the owner's contributions used to finance Asset purchases and cover costs of operations.

Current assets represent monetary assets or assets, which are liquid and will soon become monetary assets.

Non-current assets represents assets that have been bought to assist the business in generating income.

Liabilities represent external sources of finance.

Current liabilities are due to be repaid within the next 12 months or the next accounting period (which is typically 12 months).

Non-current liabilities refer to the financial obligations of a company that are not expected to be settled within one year

Net Assets are equal to closing capital. It represents the residual amount after Liabilities has been deducted from Assets. It represents the owners claim on the business Assets and therefore should equal closing capital.

Figure 1.1: Example Balance Sheet and Statement of Changes in Equity

Activity**1****Reading the Balance Sheet Activities**

1. Review the Balance Sheet and Statement of Changes in Equity in figure 1 and answer the following;

(a) Entity name:

.....

(b) The Accounting period ends on:

.....

(c) Net Assets equals:

.....

(d) What financial information is represented on the Balance Sheet:

.....

(e) Can this business pay its immediate bills?

.....

(f) What are the immediate bills?

.....

(g) What can be used to pay them?

.....

(h) Is this a profitable business?

.....

(i) What other information might we need to assess the financial position of the business?

.....

.....

Stakeholders interested in the Balance Sheet

The Balance Sheet is referred to as a General Purpose Statement and may be used by several internal and external stakeholder to make crucial decisions. A stakeholder is anyone who is impacted by or has influence over the business. Figure 1.2 outlines common stakeholders, their needs and the accounting information that they require to make decisions.

Stakeholders	Stakeholder interests	Accounting information needs	Relevant information from the Balance sheet and Statement of Changes in Equity
Shareholders: Part owners in a company.	Shareholders invest in companies primarily to earn profits through dividends and capital growth through appreciation in their investment market value.	Information about the profitability, return, risk and stability of their investment.	Shareholders return on investment is calculated from the Statement of Changes in Equity. This statement also indicates profitability for the period. The Balance Sheet and Statement of Changes in Equity can be used to measure gearing; the portion liabilities to equity. This is an important indication of risk. Liquidity, the proportion of current assets to current liabilities, can also be an indication of risk and stability in the short term. The Balance sheet also indicates how assets has been financed and the business's overall reliance on external sources of finance.
Owner/partners: An Individual/group of people who own a business entity.	Similar to the needs of a shareholder, owners/partners invest in businesses to earn profits and capital growth through appreciation in the business' market value. Owners/partners are also interested in the efficiency and effectiveness of the firm in achieving its objectives, as well and the level of the risk of their investment.	Information about the profitability, return, liquidity, gearing, and stability of their investment. They also need information about how effectively assets have been used to generate profit.	The relevant information that owners/partners need to make decisions are very similar to that of a shareholder. Owners will also need information to assist in managing resources such as cash, inventory and debtors, and maximising the return on assets.
Managers: People responsible for planning, organising and controlling resources. Directing and leading staff.	Managers are interested in efficient allocation of resources. Ensuring that they have enough resources and expertise to successfully achieve the business's objectives. Overseeing the safety and well-being of their subordinates.	Information pertaining to the efficient use of assets and appropriate allocation of resources and staffing.	Profit information will indicate the effectiveness of managing resources and staff to generate profits. Expense ratios can be used to determine where efficiency can be improved. Return on Asset ratios will indicate how effectively assets have been used to generate revenue.
Employees: A person who performs work, under the direction and control of their employer, on an ongoing basis.	Employees are interested in stable ongoing employment, career progression opportunities and advancements in remuneration. Some employees may be entitled to profit sharing and performance based bonuses.	Information indicating profitability and stability of the firm.	The Balance Sheet and Statement of Changes in Equity will reflect the liquidity and gearing, which is a good indication of the firm's stability. Statement of changes in equity reflects overall profit. Increases in profit creates opportunities for increases in pay.
Lenders / Creditors: Lenders are institutions or firms who have lent the business money. Creditors are suppliers, which the business owes money to as a result of credit purchases, for example, inventory.	Lenders are interested in firms' ability to service loans and repay outstanding debts.	Lenders are interested in information about liquidity, gearing and credit history.	The Balance Sheet clearly identifies all current assets and liabilities. This can be used to determine working capital ratio and quick asset ratio, important measurements of liquidity. The Balance Sheet and Statement of Changes in Equity can be used to measure gearing. This will indicate the current proportion of debt to equity. Businesses with higher proportions of debt are at higher risk of default, and therefore lenders should extend finance to these entities with caution.

Stakeholders	Stakeholder interests	Accounting information needs	Relevant information from the Balance sheet and Statement of Changes in Equity
<p>Government:</p> <p>State and federal government departments will be interested in the financial information about businesses and the performance of businesses in the economy</p> <p>The Australian Tax Office (ATO) is the Government's principle revenue collection agency and collects taxes from businesses.</p>	<p>Data will be collected to calculate indicators to assess the performance of the economy.</p> <p>The government is interested ensuring businesses and employees pay the correct level of tax and that any Goods and Services Tax (GST) is collected by businesses from sales.</p>	<p>Sales, inventory investment, profitability.</p> <p>The ATO requires a variety of information including details of profitability, collection of payment of Goods and Services Tax (GST), Employee taxes withheld and superannuation payments. In 2019 businesses began using Single Touch Payroll (STP) to report tax and superannuation information.</p>	<p>Income Statement and Balance Sheet data.</p> <p>The year-end profits will determine the tax that is owed to the ATO. This will be assessed through company and individual tax returns.</p> <p>The GST owing to the ATO is determined through the Business Activity Statement (BAS). This statement will also provide information about how much tax was withheld from employees pay, and the total amounts owed to the government.</p>
<p>Customers:</p> <p>A person who buys goods or services from the business.</p>	<p>Customers are interested in obtaining a consistent supply of good value products and services. They are also interested after sales support such as replacement parts and warranty claims.</p>	<p>Customers want information about the sustainability of the firm's operations and mark-up applied to products.</p>	<p>The Balance Sheet and Statement of Changes in Equity will reflect the liquidity and gearing, which is a good indication of the firm's sustainability.</p> <p>Gross profit margin will indicate the mark-up applied to the product, which customers may use to determine if they are being charged excessive prices.</p>
<p>General Public:</p> <p>Members of the local community. These people may be directly or indirectly impacted by the business' actions. Can include: journalists, business analysts, academics, activists and individuals.</p>	<p>Interested in analysing information and data for writing articles, academic papers and evaluating the business's financial performance against its social and environmental impact.</p>	<p>Information about employment, taxes paid, revenue generated for the local economy and business activity impacting the local community and environment.</p>	<p>The Balance Sheet will provide an overview of the financial position of the firm. This may not be enough to meet the financial information requirements of the general public. Businesses which also produce Corporate Social and Responsibility (CSR) Reports may better meet the needs of this group.</p>

Figure 1.2: Prominent Stakeholders

Activity

Stakeholder Activity

Statement of Changes in Equity		
CTS Plastics		
For the year ending 30 June 2019		
		\$
Opening Capital		1,206,444
Profit/ loss		-407,600
Less drawings		<u>60,000</u>
Closing Capital		738,844
Balance Sheet		
CTS Plastics		
For the year ending 30 June 2019		
	\$	\$
<i>Current Assets</i>		
Debtors		<u>110,000</u>
		110,000
<i>Non-current Assets</i>		
<i>Office Equipment</i>	3,000	
Less Accumulated depreciation	<u>2,400</u>	
		600
Plant and Equipment	500,000	
Less Accumulated depreciation	<u>400,000</u>	
		100,000
Land		1,000,000
		<u>1,100,600</u>
Total Assets		1,210,600
<i>Current Liability</i>		
Overdraft		48,756
Creditors		<u>70,000</u>
		118,756
<i>Non-current liabilities</i>		
Secured loan		<u>353,000</u>
Total Liabilities		471,756
Net Assets		738,844

Figure 1.3: CTS Plastics

The Accounting Equation

The Accounting Equation sets the foundation for all double-entry accounting and the fundamental elements of the Balance Sheet.

The Accounting Equation

$$\text{Total Assets} = \text{Total Liabilities} + \text{Owner's Equity}$$

This equation expresses the relationship between Total Assets and Total Equities (i.e. total assets, liabilities and owner's equity). The equation must always be in balance, i.e. Assets (A) = Liabilities (L) + Owner's Equity (OE).

The equation is usually expressed as:

- $A = L + OE$

However, it may be expressed as:

- $L = A - OE$

OR as

- $OE = A - L$

The Balance Sheet essentially expresses this equation in detail. Hence the use of the word 'Balance' in the title, referring to the balancing of the Accounting Equation.

Another way to view the accounting equation:

$$\text{Total Assets} = \text{Total Liabilities} + \text{Owner's Equity}$$

This side of the equation represents items which have been purchased.

This side of the equation represent sources of finance which funded the purchases. Finance can be sourced through loans (Liabilities), Owners Contributions and profits (Owner's Equity)

The Accounting Equation relates to the concept of Duality.

Duality: Accountants see total assets as equal to total equities (liabilities + owner's equity).

Every transaction has at least two effects on the accounting equation.

Activities

Accounting Equation Activities

4. Using one of the versions of the Accounting Equation, calculate the missing figure;

(a) Assets \$80 000, Liabilities \$15 000, Owner's Equity?

.....
 (b) Liabilities \$40 000, Owners Equity \$75 000, Assets?

.....
 (c) Owner's Equity \$50 000, Assets \$95 000, Liabilities?

Classification Activities

5. Classify the following as either Assets (A), Liability (L) or Owners Equity (OE).

Account Name	Description	Classification
Overdraft	A deficit in a bank account caused by drawing more money than the account holds.	
Cash on hand	Cash kept on the premise.	
Accounts payable	Amounts owed to suppliers for unpaid inventory. Also known as Creditors.	
Plant and Equipment	The fixed assets used to produce goods for the firm.	
Premise	The property used by the business in their operations.	
Debtors	Amounts owed to the firm from customers as a result of a past credit sale. Also known as Accounts receivable.	
Creditors	Amounts that the firm owes its suppliers as a result of past credit purchase.	

6. Classify the following items as Assets (A), Liabilities (L) or Owners Equity (OE):

Description	Classification	Description	Classification
Creditors		Loan to J Jones	
Loan from bank (due 1 year)		Loan secured by mortgage	
Owner's interest in the business (Capital)		Motor vehicle	
Bank overdraft		Debtors	
Furniture		Inventories	
Loan from J Green		Premises	
Cash at Bank		Land	

7. Account names will vary, and often-different names can refer to items of the same nature.

Merchandise	Creditors	Bank	Inventory
Trade Creditors	Accounts Receivable	Cash	Trade Debtors
Accounts payable	Debtors	Cash at Bank	Stock
Payables	Receivables		

Identify the names of the accounts which describe the following;

(a) Amounts owed from customers as a result of credit sales

.....

(b) Asset held by the business with the intention of being resold

.....

(c) Money held in the businesses bank account.

.....

(d) Amounts the business owes to suppliers as a result of past credit purchases

.....

8. **Justify** why the following accounts are classified as either an Asset, Liability or Owner's Equity

(a) Cash at bank is classified as an Asset because :

.....

(b) Motor vehicles are classified as an Asset because

.....

(c) Creditors are classified as Liabilities because

.....

(d) Bank Loan is classified as an Liability because

.....

(e) Profit is classified as Equity because

.....

Preparing the Balance Sheet

9. Follow the steps below to prepare Balance Sheet and Statement of Changes in Owner's Equity for JJ House of Homewares as at 30 June 2021.

- (a) Label the Balance Sheet and Statement of Changes in Owner's Equity with the date and business name.
- (b) Transfer the account names and amounts into the appropriate sections of the Balance Sheet according to their classification.
- (c) Calculate and record totals next to the appropriate headings;
 - (i) Total Owners Equity (Opening Capital – Drawings+ Profit)
 - (ii) Total Assets
 - (iii) Total Liabilities
 - (iv) Net Assets (Total Assets – Total Liabilities)

Assets		Liabilities	
Bank	9,000	Creditors	4,000
Debtors	6,000	Loan	8,000
Inventory	10,000	Mortgage	65,000
Plant and equipment	56,000		
Furniture	16,000	Owners' Equity	
Premises	95,000	Capital	80,000
		Drawings	-30,000
		Profit	65,000

Statement of Changes in Equity

.....
for the year ended

\$

Opening Capital

Profit/ loss

Less drawings

Closing Capital

Total Owners Equity

Balance Sheet

.....
For the year ending

Assets

\$

\$

Total Assets

Liabilities

Total Liabilities

Net Assets

Full Classification

A fully classified Balance sheet further classifies Assets and Liabilities into current and non-current. Organising the Balance Sheet into these categories makes it easier to read and simpler for the user to extract the information. Furthermore, a fully classified Balance sheet assists in calculating ratios to analyse the business financial position. A fully classified Balance Sheet provides more information about liquidity and gearing. It also assists the reader to determine factors such as:

- Does the business have sufficient working capital
- Can the business pay their debts as they fall due
- What proportion of assets are income-producing

The full classifications are as follows:

Classification	Definition
Current Assets	The benefits of these assets will be gained within 12 months. This category includes cash-based assets. Examples include Cash at Bank, Debtors and Inventory.
Non-current Assets	The benefits associated with these assets will be gained over a period greater than 12 months. Examples include motor vehicles, buildings and land.
Current Liabilities	These are future sacrifices that will be made within the next accounting period, i.e. within 12 months. Examples include creditors and overdrafts.
Non-current Liabilities	These are future sacrifices of a long term nature, i.e. longer than 12 months. Examples include mortgage and loans, which are due after 12 months. Note: a loan can be split in to current and non-current liabilities, to recognise the payments due in the next 12 months, and the outstanding amounts due post 12 months.

Intangible Assets

Accountants also consider some intangible assets when valuing businesses. Intangible assets are not physical in nature and are often hard to measure. Intangible assets are often associated with intellectual property and include Goodwill, Trademarks, Patents and Copyright. These items are classified as Non-current Assets.

Goodwill	Goodwill is valued as an Asset on the Balance Sheet when a buyer acquires an existing business. The buyer of the business will pay a premium for the business over and above the valuation of its tangible assets, this premium is referred to as Goodwill. The elements that determine goodwill include a business' good reputation, customer loyalty or client base, brand identity and recognition, talented workforce, and proprietary technology.
Registered Trade marks	A recognisable symbol, design or phrase associated with a brand, which the business has exclusive use of.
Patents	Government patents are given to inventors to protect their intellectual property. Patents can protect any device, substance, method or process that is new, inventive and useful. A patent will restrict other businesses from using this intellectual property.
Copyright	A copyright grants the creator of an original creative work the exclusive legal right to ownership of their work. Copyrights enables creators to manage how their content is used and receive compensation for the distribution of their work.

The following balance sheet depicts a fully classified Balance Sheet.

Balance Sheet		
CTS Plastics		
For the year ending 30 June 2019		
	\$	\$
<i>Current Assets</i>		
Debtors		<u>110,000</u>
		110,000
<i>Non-current Assets</i>		
Office Equipment	3,000	
Less Accumulated depreciation	<u>2,400</u>	
		600
Plant and Equipment	500,000	
Less Accumulated depreciation	<u>400,000</u>	
		100,000
Land		1,000,000
		<u>1,100,600</u>
Total Assets		1,210,600
<i>Current Liability</i>		
Overdraft		48,756
Creditors		<u>70,000</u>
		118,756
<i>Non-current liabilities</i>		
Secured loan		<u>353,000</u>
Total Liabilities		471,756
Net Assets		738,844

Debtors are defined as a current asset because the business will receive cash for these debtors, probably within 30 days.

Overdraft is classified as a Current Liability, as the Bank can call in the liability for full repayment at any time.

Creditors are classified as Current Liabilities as they are generally due within 30 days.

Figure 1.4: Example of a Fully Classified Balance Sheet

Activities

Full Classification Activities

12. Classify the following items as: Current Assets (CA), Non-current Asset (NCA), Current Liabilities (CL), Non-current Liability (NCL) or Owners Equity (OE):

Description	Classification	Description	Classification
Creditors		Loan to J Jones (due 3 years)	
Loan from bank (due 1 year)		Loan secured by mortgage	
Register Trademark		Motor vehicle	
Owner's interest in the business (Capital)		Debtors	
Bank overdraft		Inventories	
Furniture		Premises	
Loan from J Green (due 2 years)		Land	
Cash at Bank		Goodwill	

13. In each of the following lists of business items, name the account and identify the assets (current and non-current), liabilities (current and non-current) and owner's equity.

Wilson Grocery

Item	Name	CA, NCA, CL, NCL&OE
(a) Amount Wilson invested to begin the business		
(b) Money in the business bank account		
(c) Building from which the store operates		
(d) Grocery items which will be sold to make a profit for the business		
(e) Amount of money Wilson has taken out of the business for his own use		
(f) Truck used to deliver goods to customers		
(g) Shelves in the shop		
(h) Computer and other office machinery		

Bencher's Cabinet Making

Transaction	Name	CA, NCA, CL, NCL&OE
(a) Tools and machines used in the manufacture of benches		
(b) Money the owner has invested into the bank account of the business		
(c) Loan made by the bank to this business to purchase premises		
(d) The building purchased with the borrowed funds.		
(e) Amounts owing by the business to other firms that have supplied materials		
(f) Amounts owing by customers who have purchased benches from the business.		
(g) Money that the owner has taken out of the business for personal use		
(h) Unsold benches		

Preparing fully Classified Balance Sheets

14. (a) Classify Halbert Traders accounts as Current Assets (CA), Non-current Assets (NCA), Current Liabilities (CL), Non-current Liabilities and Owner's Equity. The Profit, or loss, will need to be calculated (hint, Net Assets, Total Assets less Total Liabilities, should equal the total Owners' Equity, once profit, or /loss, has been added).

Overdraft	10,000		Vehicles	68 000	
Inventories	34,200		Office furniture	20,000	
Creditors	14,000		Goodwill	27,000	
Debtors	10,000		Petty cash	180	
Capital: J Halbert	377,000		Premises	290,000	
Machinery	210,000		Mortgage	280,000	
Investments (Maturity 3 years)	35,000		Drawings	26,000	
Loan from ANP (Due years)	50,000		Profit/ Loss	-10,620	

- (b) Use the account list provided in (a) to complete the Balance Sheet and Statement of Changes in Equity for Halbert Traders for the year ended 30 June 2021. Don't forget to label the Financial Reports and calculate all necessary totals.

Statement of Changes in Equity

Closing Capital

Balance Sheet

\$

\$

Current Assets

Total Current Assets

Non-current Assets

Total Non-current Assets

Total Assets

Current Liabilities

Total Current Liabilities

Non-current Liabilities

Total Non-current Liabilities

Total Liabilities

Net Assets

15. Use the following information to complete the Balance Sheet and Statement of Changes in Equity for Greens Nursery for the year ended 31 December 2021. Remember to calculate profit or loss. Profit is a divided split equally amongst the partners. Hint: the equity of each partners needs to be clearly indicated on the Statement of Changes in Equity. There is also a Balance Sheet template provided on the following page.

Bank	11,000
Inventories	74,020
Accounts Payable	13,550
Accounts Receivable	10,000
Capital: G Thumb	143,700
Machinery	210,000
Shares	5,035
Drawings; G Thumb	32,300

Delivery Vehicle	52,250
Office furniture	500
Premises	375,000
Mortgage	282,000
Drawings; T Green	27,000
Capital: T Green	143,700
Nursery Fixtures and Fittings	40,350
Loan From NNB (Due June 2022)	15,000

Statement of Changes in Equity

Opening Capital G Thumb
 Less Drawings
 Add Profit

Opening Capital T Green
 Less Drawings
 Add Profit
 Closing Capital

Total Closing Capital

Balance Sheet

<i>Current Assets</i>	\$	\$
-----------------------	----	----

Total Current Assets

Non-current Assets

Total Non-current Assets

Total Assets

Current Liability

Total Current Liabilities

Non-current liabilities

Total Non-current Liabilities

Total Liabilities

Net Assets

16. Use the following information to complete the Balance Sheet and Statement of Changes in Equity for Custom Prints for the year ended 30 June 2020. Remember to calculate profit or loss.

Recommend Approach: Prepare the Balance Sheet first. This will require you to calculate Net Assets, which will be equal to the closing Capital Figure that would use in your Statement of Changes in Equity.

Note: Don't forget to label Reports and Calculate all required totals.

Creditors	20,000
Accounts Receivable	3,000
Bank	50,000
Capital: J Dance	143,700
Petty Cash	40
Stock	20,000
Office Equipment	1,200

Office furniture	1,500
Loan From NNB (Due June 2025)	40,000
Drawings; J Dance	27,000
Term deposit (Maturity December 2020)	7,000
Stock of Stationery	300
Delivery Vehicle	52,250
Machinery	62,000

1

Closing Capital		
	\$	\$
<i>Current Assets</i>		
<i>Total Current Assets</i>		
<i>Non-current Assets</i>		
<i>Total Non-current Assets</i>		
Total Assets		
<i>Current Liability</i>		
<i>Total Current Liabilities</i>		
<i>Non-current Liabilities</i>		
<i>Total Non-current Liabilities</i>		
Total Liabilities		
Net Assets		

Analysing a Fully Classified Balance Sheet

Preparing a Fully Classified Balance Sheet involves classifying Current and Non-current Assets and Liabilities on the Balance Sheet. This provides the reader with information which will allow assessment of the firm's liquidity, gearing and long term stability.

Users of accounting information often use financial ratios to assist in the evaluation of a firm's financial performance and position. Financial ratios express relationships between financial statement items. Financial ratios can provide awareness into what is happening within a business, insights that are not always apparent upon review of the financial statements alone. Ratios express financial information in a way that makes it easy to compare the financial results across periods and to like organisations.

Analysis, which compares items vertically down financial statements, is referred to as **vertical analysis**. The following section will outline ratios, which are used to perform vertical analysis in the Balance Sheet and Statement of changes in Equity.

Balance Sheet		
CTS Plastics		
For the year ending 30 June 2019		
	\$	\$
<i>Current Assets</i>		
Debtors		<u>110,000</u>
		110,000
<i>Non-current Assets</i>		
Office Equipment	3,000	
Less Accumulated depreciation	<u>2,400</u>	
		600
Plant and Equipment	500,000	
Less Accumulated depreciation	<u>400,000</u>	
		100,000
Land		1,000,000
		<u>1,100,600</u>
Total Assets		1,210,600
<i>Current Liability</i>		
Overdraft		48,756
Creditors		<u>70,000</u>
		118,756
<i>Non-current liabilities</i>		
Secured loan		<u>353,000</u>
Total Liabilities		471,756
Net Assets		738,844

Vertical Analysis compare items down the statement.
e.g. compares current assets to current liability.

Vertical Analysis - A method of analysing financial statements which compares figures within an accounting period.

Liquidity

Liquidity refers to a firm's ability to pay its debts, which are due, in the short-term. When assessing a firm's liquidity, Accountants compare the current assets to current liabilities. The following ratio equations are often used to help analyse an entity's liquidity;

Liquidity - Refers to how quickly an asset can be turned into cash. Also refers to a firm's ability to meet short term financial commitments.

- **Working Capital = Current Assets – Current Liabilities**
 - The Working Capital measures, in monetary form, the amount of excess current assets the firm has after covering its Current Liabilities.
- **Working Capital Ratio = $\frac{\text{Current Assets}}{\text{Current Liabilities}}$ expressed as a ratio e.g. 2:1**
 - The Working Capital Ratio (current ratio) measures the proportion of current assets to current liabilities. It is used to assess the firm's liquidity within the next 12 months.
 - For most industries, the ratio is recommended to be between 1.5:1 and 2:1
- **Quick Asset Ratio = $\frac{\text{Cash Assets} + \text{Receivables}}{\text{Current Liabilities}}$ expressed as a ratio**
 - The Quick Asset Ratio (acid test) measures the firm's immediate liquidity, which is its ability to cover debts in the next 90 days.
 - For most industries, the ratio is recommended to be between 1.1:1 and 1.5:1

Please note that in some textbooks instruct students to deduct bank overdrafts from current liabilities when calculating this ratio. Please **DO NOT USE THIS METHOD**.

Summary

The Working Capital and Quick Asset ratio can be used to analyse a firm's liquidity.

- A result of < 1:1 indicates insufficient current assets to cover the firm's short-term financial obligations.

Activity

Liquidity Activity

17. Refer to the balance sheet on page 23 to perform the following calculations to aid you in analysing the firm's liquidity. Make sure you show all your workings.

(a) Calculate the Working Capital. (The answer must be presented in monetary form)

.....

(b) Calculate the Working Capital Ratio. (The answer must be presented as a ratio)

.....

(c) Calculate the Quick Asset Ratio. (The answer must be presented as a ratio)

.....

(d) Comment on what your answers to a-c indicate about the firm's liquidity.

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(e) Use the Balance Sheet on Page 23 to investigate the factors contributing to the firm's liquidity.

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(f) Suggest actions that the owners' of CTS Plastics could take to improve the firm's liquidity.

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(g) Thinking about the broader external environment, discuss other possible factors, which could have directly or indirectly influence the liquidity of CTS Plastics.

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Gearing

Gearing compares the level of funding from owners capital as opposed to external debt funding. The debt to equity ratio indicates the level of gearing. It indicates if the business has relied on external debt finance or internal equity finance to fund its activities.

Debt to Equity Ratio = $\left(\frac{\text{Total Liabilities}}{\text{Total Equities}} \right) \times 100$

This ratio is always presented as a percentage.

A business which has proportionally high levels of equity funding, in relation to Liabilities, is described as lowly geared and will have a debt to equity ratio of lower than 100%. Lowly geared businesses source the majority of their finance from the owners and thus is deemed to be a lower risk of bankruptcy. This is because equity finance does not require principle or interest payments, and therefore, the business has fewer payment obligations. It also has less exposure to the risk of interest rate increases.

A business with proportionally higher levels of liabilities in relation to equity is described as highly geared or leveraged. Highly geared businesses will have a debt to equity ratio of higher than 100%. This result indicates that the business has sourced a large amount of its finance from external debt sources. The sources require repayment with interest and thus are at high risk of bankruptcy.

Summary

The Debt to Equity ratio can be used to assist in analysing a firm's gearing.

- The results are presented as a percentage
- A result of < 100% indicates low gearing levels

A result of > 100% indicates higher gearing levels.

Debt ratio = $\left(\frac{\text{Total Liabilities}}{\text{Total Assets}} \right) \times 100$

This ratio is always presented as a percentage.

Debt ratio: Similar to debt to equity ratio, the debt ratio measures extent of a firms leveraging. It expresses the proportion of the firms assets financed by debt. A ratio greater than 100% reflects a high portion of leveraging.

Activities

Gearing/Solvency activities

Statement of Changes in Equity		
CTS Plastics		
For the year ending 30 June 2019		
		\$
Opening Capital		1,206,444
Profit/ loss		-407,600
Less drawings		<u>60,000</u>
Closing Capital		738,844
Balance Sheet		
CTS Plastics		
For the year ending 30 June 2019		
	\$	\$
<i>Current Assets</i>		
Debtors		<u>110,000</u>
		110,000
<i>Non-current Assets</i>		
<i>Office Equipment</i>	3,000	
Less Accumulated depreciation	<u>2,400</u>	
		600
Plant and Equipment	500,000	
Less Accumulated depreciation	<u>400,000</u>	
		100,000
Land		1,000,000
		<u>1,100,600</u>
Total Assets		1,210,600
<i>Current Liability</i>		
Overdraft		48,756
Creditors		<u>70,000</u>
		118,756
<i>Non-current liabilities</i>		
Secured loan		<u>353,000</u>
Total Liabilities		471,756
Net Assets		738,844

18. (a) Review at the Balance Sheet and Statement of Changes in Equity on page 26. What information would you use to assess the firms gearing?

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(b) Refer to CTS plastics Balance Sheet and Statement of Changes in Equity above

(i) Calculate the Debt to Equity Ratio

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(ii) Comment on the firm's gearing.

(c) What actions can the owner of CTS plastics take to change the firm's gearing level? What actions would you recommend?

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Activity – Sources of Finance

19. Investigate the advantages and disadvantages of using capital and debt financing and summarise your findings in the space provided. Use the following websites in your investigation:

(a) <https://www.business.qld.gov.au/starting-business/costs-finance-banking/funding-business/debt>

(b) <https://www.business.qld.gov.au/starting-business/costs-finance-banking/funding-business/equity>