Unit 01 The Financial statements

Section I Balance Sheet

A balance sheet, also called the statement of condition or statement of financial position, provides a wealth of valuable information about a business firm, particularly when examined over a period of several years and evaluated in relation to the other financial statement. A prerequisite to learning what the balance sheet can teach us, however, is a fundamental understanding of the accounts in the statement and the relationship of each account to the financial statements as a whole.

The balance sheet shows the financial condition or financial position of a company on a particular date. The statement is a summary of what the firm owns (assets) and what the firm owes to outsiders (liabilities) and to internal owners (stockholder's equity). By definition, the account balances on a balance sheet must balance; that is, the total of all assets must equal the sum of liabilities and stockholders' equity. The balancing equation is expressed as:

Assets = Liabilities + Stockholders' equity

Assets are segregated on balance sheet according to how they are utilized. Current assets include cash or those assets expected to be converted into cash within one year or operating cycle, whichever is longer. The operating cycle is the time required to purchase or manufacture inventory, sell the product, and collect the cash. For most companies, the operating cycle is less than one year, but in some industries, it is longer. The designation "current" refers essentially to those assets that are continually used up and replenished in the ongoing operation s of the business. The term working capital or net working capital is used to designate the amount by which current assets exceed current liabilities.

The cash account is exactly cash in any form – cash awaiting deposit or in a bank account. Marketable securities are cash substitutes, cash that is not needed immediately in the business and is temporarily invested to earn a return. These investments are in instruments with short-term maturities (less than one year) to minimize the risk of interest rate fluctuation. They must be relatively riskless securities and highly liquid so that funds can be readily withdrawn as needed. Instruments used for such purposes include U.S treasury bills, certificates, notes, and bonds, negotiable certificates of deposit at financial institutions; and commercial paper.

Accounts receivable are customer balances outstanding on credit sales and are reported on the balance sheet at their net realizable value, that is, the actual amount of the account less an allowance for doubtful accounts. Management must estimate – based on such factors as past experience, knowledge of customer quality, the state of the economy, and the firm's collection policies. Actual losses are written off against the allowance account, which is adjusted at the end of each accounting period.