

# Darlington Business Venture - Balance Sheet Basics

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## Balance sheets: the basics

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### Introduction

A balance sheet is a financial statement at a given point in time. It provides a snapshot summary of what a business owns or is owed - **assets** - and what it owes - **liabilities** - at a particular date.

The balance sheet shows how the business is being funded, and how those funds are being used.

The balance sheet is used in three ways:

- for reporting purposes as part of a limited company's annual accounts
- to help you and other interested parties such as investors, creditors or shareholders to assess the worth of your business at a given moment
- as a tool to help you analyse and improve the management of your business

This guide explains who needs to produce balance sheets and when, the different elements within them and how to use the information from a balance sheet to assess and manage business performance.

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### Balance sheet reporting - who, when and where?

**Limited companies** and **limited liability partnerships** must produce a balance sheet as part of their annual accounts for submission to:

- Companies House
- HM Revenue & Customs (HMRC)
- shareholders - unless agreed otherwise

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## Balance sheets: the basics

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As well as the balance sheet, annual accounts include the:

- profit and loss account
- auditor's reports - unless exemptions apply
- directors' report
- notes to the accounts - these should provide any information you think may be relevant, eg supplementary financial information or additional detail

Other parties who may wish to see the accounts - and therefore the balance sheet - are:

- potential lenders or investors
- potential purchasers of the business
- government departments carrying out inspections - for details see our guide on [enquiries and inspections](#)
- employees
- trade unions

There are strict **deadlines** for submitting annual accounts and returns with Companies House and HMRC - penalties will apply if they are received late. See our guides on how to [file accounts at Companies House](#) and [key filing dates](#).

However, if you choose to **file online**, you may be eligible for an extension to your deadline. Read our guide on how to [file returns online](#).

### Reporting requirements for other business structures

Self-employed people, partners and partnerships are not required to submit formal accounts and balance sheets on their

tax return. However, the returns do require the relevant financial details to be entered in a set format, so you may find it beneficial to prepare the figures in a balance-sheet format.

Other key benefits of producing a balance sheet:

- if you want to raise finance most lenders or investors will want to see three years' accounts
- if you want to bid for large contracts, including government contracts, the client will probably want to see audited accounts
- producing formal accounts - including a balance sheet - will help you monitor the performance of your business

For detailed information on reporting requirements see our guide on [key filing dates](#).

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## Contents of the balance sheet

A balance sheet shows:

- fixed assets - eg what the business owns
- current assets - eg what the business is owed
- current liabilities - eg what the business owes and must repay in the short term
- long-term liabilities - including owner or owners' capital

The balance sheet is so-called because the total value of the assets is always the same value as the total of the liabilities.

**Fixed assets** include:

- **tangible** assets - eg buildings, land, machinery, computers, fixtures and fittings - where relevant shown at their depreciated or resale value
- **intangible** assets - eg goodwill, intellectual property rights, patents, trademarks, website domain names, long-term investments

**Current assets** are short-term assets whose value can fluctuate from day to day, and can include:

- stock
- work-in-progress
- money owed by customers
- cash-in-hand or at the bank
- short-term investments
- pre-payments - eg advance rents

**Current liabilities** are amounts owing and due within one year. These include:

- money owed to suppliers
- short-term loans, overdrafts or other finance
- taxes due within the year - VAT, PAYE, National Insurance

**Long-term liabilities** include:

- creditors due after one year - the amounts due to be repaid in loans or financing after one year, eg bank or directors' loans, finance agreements
- capital and reserves - share capital and retained profits, after dividends

The balance sheet must by law include the elements shown above in bold. However, what each includes will vary from business

to business. The firm's external accountant will usually decide how to present the information, although if you have a qualified accountant on staff, they may make this decision.

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### Interpreting balance sheet figures

A balance sheet shows:

- how solvent the business is
- how liquid its assets are - ie how much is in the form of cash or can be easily converted into cash ie stocks and shares
- how the business is financed
- how much capital is being used

The individual figures can change dramatically in a short space of time but the net assets would only change dramatically if the business was making large profits or losses. For example:

- If you hold large inventories of finished products, a change in market conditions might mean their value is reduced. You may even need to sell at a loss.
- Customers sometimes have problems. If they are unable to pay, you may need to revalue your assets by making allowances for bad debts.

### Current liabilities - money you owe

This section might include money owed for goods or services received but not yet paid for.

### Debtors - money owed to you

This figure assumes that debtors will pay up on time. Where there are doubts about

being paid, a provision can be made to reduce the value of the debts in the business' accounts.

### Intangible assets

The value of goodwill can fluctuate with market trends, so the balance sheet value should be updated annually.

### Fixed assets

These are shown at their depreciated rates. There are two main approaches to calculating depreciation of an asset:

- Write off the same charge over the calculated life of the asset. For example, you may decide that a computer bought for £5,000 has a useful life of five years and that you will write off 20 per cent of its value each year.
- Apply a steeper depreciation rate in the first few years of an asset's value. For example, you may decide to offset 30 per cent of the value of the same computer in the first two years, 20 per cent in the third year and 10 per cent in the final two years. This method may allow your business to keep pace with trends in the market value of the asset.

Depreciation costs must be realistic and you may wish to approach your accountant for further help.

You cannot offset the annual depreciation charge against taxable profits, but you can claim capital allowances, using rates fixed by HM Revenue & Customs. See our guide on [capital allowances: the basics](#).

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### sheet and profit & loss account

The Profit and Loss (P&L) account summarises a business' **trading transactions** - income, sales and expenditure - and the resulting profit or loss for a given period.

The balance sheet, by comparison, provides a **financial snapshot** at a given moment. It doesn't show day-to-day transactions or the current profitability of the business. However, many of its figures relate to or affect the state of play with P&L transactions on a given date.

Any profits not paid out as dividends are shown in the **retained profit** column on the balance sheet.

The amount shown as cash or at the bank under current assets on the balance sheet will be determined in part by the **income** and **spending** recorded in the P&L. For example, if sales income exceeds spending in the quarter preceding publication of the accounts, all other things being equal, current assets will be higher than if spending had outstripped income over the same period.

If the business takes out a **short-term loan**, this will be shown in the balance sheet under current liabilities, but the loan itself won't appear in the P&L. However, the P&L will include **interest payments** on that loan in its expenditure column - and these figures will affect its bottom line.

See our guide on how to [set up a simple profit and loss account for your business](#).

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## Relationship between balance

### Using balance sheet and P&L figures to assess performance

Many of the standard measures used to assess the financial health of a business involve comparing figures on the balance sheet with those on the P&L.

See the pages in this guide on how to [compare balance sheets to assess business performance](#) and how to [use accounting ratios to assess business performance](#).

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### Compare balance sheets to assess business performance

There are some simple balance sheet comparisons you can make to assess the strength or performance of your business against earlier periods, or against direct competitors. The figures you study will vary according to the nature of the business. Some comparisons draw on figures from the profit and loss (P&L) account.

#### Internal comparisons

If **inventory (stock) levels** are rising from one period to the next, but sales in your P&L are not, some of your stock might be out of date. You may also have a cashflow problem developing. See our guide on [cashflow management: the basics](#).

If the amount **trade debtors** owe you is growing faster than sales, it could indicate poor internal credit controls. Find out whether any of your customers are having problems with cashflow, which could pose a threat to your business.

A positive relationship with your **trade creditors** is essential. Key to this is

managing your cashflow well, so that payments can be made on time. For example, trade creditors are more likely to be flexible about extending terms of credit if you have built up a good payment record.

Making early payments may qualify you for a discount. However, early payment for the sake of it will have a negative impact on your cashflow. Good payment controls will help prevent imbalances in what you owe suppliers and levels of stock and inventory.

**Borrowing as a percentage of overall financing (gearing)** is important - the lower the figure, the stronger your business is financially. It's common for start-up businesses to have high borrowing requirements, but if the gearing figure reaches 50 per cent you may have difficulty getting further loans.

#### External comparisons

You can also compare the above balance sheet figures with those of direct or successful competitors to see how you measure up. This exercise will highlight weaknesses in your business operation that may need attention. It will also confirm strong business performance.

See the page in this guide on how to [use accounting ratios to assess business performance](#).

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### Use accounting ratios to assess business performance

Ratio analysis is a good way to evaluate the financial results of your business in order to gauge its performance. Ratios allow you to compare your business against different standards using the figures on your balance

sheet.

Accounting ratios can offer an invaluable insight into a business' performance. Ensure that the information used for comparison is accurate - otherwise the results will be misleading.

There are four main methods of ratio analysis - liquidity, solvency, efficiency and profitability.

### Liquidity ratios

There are three types of liquidity ratio:

- **Current ratio** - current assets divided by current liabilities. This assesses whether you have sufficient assets to cover your liabilities. A ratio of 2 shows you have twice as many current assets as current liabilities.
- **Quick or acid-test ratio** - current assets (excluding stock) divided by current liabilities. A ratio of 1 shows liquidity levels are high - an indication of solid financial health.
- **Defensive interval** - liquid assets divided by daily operating expenses. This measures how long your business could survive without cash coming in. This should be between 30 and 90 days.

### Solvency ratios

**Gearing** is found by dividing loans and bank overdraft by equity, long-term loans and bank overdraft. This is expressed as a percentage and is a sign of solvency.

The higher the gearing, the more vulnerable the company is to increasing interest rates. Most lenders will refuse further finance

where gearing exceeds 50 per cent.

### Efficiency ratios

There are three types of efficiency ratio:

- **Debtors' turnover** - average of credit sales divided by the average level of debtors. This shows how long it takes to collect payments. A low ratio may mean payment terms need tightening up.
- **Creditors' turnover** - average cost of sales divided by the average amount of credit that is taken from suppliers. This shows how long your business takes to pay suppliers. Suppliers may withdraw credit if you regularly pay late.
- **Stock turnover** - average cost of sales divided by the average value of stock. This ratio indicates how long you hold stock before selling. A lower stock turnover may mean lower profits.

### Profitability ratios

Divide net profit before income tax, by the total value of capital employed to see how good your return on the capital used in your business is. This can then be compared to what the same amount of money (loans and shares) would have earned on deposit or in the stock market.

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## Accounting periods

A balance sheet normally reflects a business' position on its **Accounting Reference Date** (ARD), which is the last day of its accounting reference period. The accounting reference period, also known as the financial year, is usually 12 months. However, it can be longer or shorter in the

first year of trading, or if the ARD is subsequently changed for some reason.

Companies House automatically sets the first ARD. Thus the end of the first financial year is the first anniversary of the last day of the month in which the company was formed. If you decide to change this, you will need to notify Companies House.

**Find out about ARDs on the Companies House website.**

You should also notify HM Revenue & Customs (HMRC) if you change your ARD.

For further information on filing deadlines, see the page in this guide on **balance sheet reporting - who, when and where?** Also, see our guides on **key filing dates** and how to **change your accounting date**.

### Internal accounts

Your business may decide to draw up accounts as frequently as monthly, to help you monitor business performance. In this case the figures - often known as management accounts - are for internal use only. You do not need to file them with Companies House or HMRC.

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Here's how a good balance sheet helped me to improve my business

**Sandeep Sud**

**Sanco**

**Sandeep's top tips:**

- "Pay your creditors - especially

suppliers - as soon as possible, not only does it help your balance sheet but it improves your bargaining position."

- "Consider off-balance sheet financing if appropriate eg for leased vehicles - this will improve the asset side of your balance sheet."
- "Never have too much cash in hand. If you are cash rich this will show on your balance sheet and you should move this money to a high-interest bank account."

Sandeep Sud is a qualified solicitor who also runs a school uniform business based in Hounslow, in partnership with his parents. The company, which has four full-time employees, uses its balance sheet to gauge how the business is progressing. It's also been a key factor in securing a bank loan for the improvement and expansion of the company premises.

**What I did**

**Kept an eye on changing figures**

"As a partnership we produce a balance sheet as part of our annual accounts and as an internal management exercise.

"A balance sheet gives a snapshot of how the business is doing at a particular time. This is useful, but you have to remember that it could change overnight. For example, if you were in debt on April 30 when you did your year-end accounts, but paid this off on May 1, you would get a completely different picture of the strength of the business."

**Looked at our profit and loss figures**

"The balance sheet is useful when looked at alongside the profit and loss figures

because then you get the whole picture. For example, if you borrowed lots in one particular year, but had made a profit, the profit would show on your profit and loss accounts, but what you owed would only be apparent on the balance sheet. It's important to be aware of both sets of numbers."

### Used the balance sheet to secure a loan

"Having a strong balance sheet helped when it came to borrowing. When we first applied for a refurbishment loan we couldn't provide up-to-date accounts to the bank manager. This could have been a problem, but we quickly got our accounts in order and the loan was approved straight away. Because our balance sheet was strong, the bank thought we were a good risk. Although we decided not to draw down on the loan - because we used cashflow instead - it did open our eyes to the importance of a strong balance sheet."

### What I'd do differently

"I would have taken the bank loan to drive expansion. In the past we've taken a cautious view of our balance sheet and so never taken the full amount of money available to us, when really the decision to borrow should be based on the risks and rewards of the project. Your balance sheet is essential, but don't let it rule your decision making."

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## Helplines

### Companies House Contact Centre

0870 33 33 636

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## Balance sheets: the basics

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**Read the guide on accounts and accounting reference dates on the Companies House website**

**Read guidance on late filing penalties and appeals at the Companies House website**

**Read information on financial ratio analysis at the Biz/ed website**

**Find out about ARDs on the Companies House website**