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Understanding Financial Statements: The Balance Sheet

By Adrian Lawrence

The balance sheet is important to business operations in general. It provides a snapshot of what the company owns and what they owe to outside sources. The balance sheet is also known as a profit and loss account. By either name, this special form of financial statement provides great insight into an organization's holdings.

Breaking Down the Balance Sheet

To clarify, a balance sheet shows how much money the organization has, how much property they own, and most importantly, how much money they owe. This is beneficial for outside sources to view - bankers, investors, and even potential creditors.

The balance sheet is broken down into several sections. Each section is grouped by liquidity - that is, how easily the particular asset can be converted into cash. The first section is short term assets. Within this category, cash is listed first, followed by near cash assets. Near cash assets are assets that can be easily converted into cash. Accounts receivable, money that people owe the organization, is also listed in this category.

The next category is the long term assets. These would include equipment, property, and buildings, along with long term accounts receivable. Generally, long term assets are assets that cannot be easily converted to cash within a year's time.

After long term assets comes the liabilities category. This category is also divided into short and long term - that is, short and long term liabilities. In this case, time is generally defined in years - less than a year for short term, and more than a year for long term.

Short term liabilities would include items such as mortgage payments for the next year, along with utilities and equipment leases. In addition, short term liabilities include employee wages, usually listed as wages payable. Long term liabilities would include items such as the remainder of the mortgage for future years, along with equipment leases. Items here overlap, as time is the separator, not the specific item.

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Uses of the Balance Sheet

The balance sheet is used internally to gain insight into what the company has available at a certain point in time. Potential creditors use a company's balance sheet to determine the cash to debt ratio, which would in turn inform them how much risk is involved in lending. Investors can use a company's balance sheet to judge risk as well. For example, if a company is cash heavy or cash light, this could be an indicator of problems within the company. Size of the balance sheet is also an important factor in determining corporate health. If the balance sheet is large, this is an indicator of lots of activity, which may indicate positive growth. On the other hand, if the balance sheet is small, it may mean that the company is growing stagnant.

Flow and Format of Balance Sheets

The balance sheet is laid out in a specific order for a number of reasons. The first reason is GAAP, or Generally Acceptable Accounting Practices. It is a guideline used by all accountants to formalize the statements and keep communication standardized. If the company is also publicly traded, then the format of the balance sheet is required by the SEC, the Securities and Exchange Commission. The last reason relates to Sarbanes - Oxley, a set of accounting regulation regarding internal controls designed to minimize fraud. Due to recent corporate scandals, such as Enron and WorldCom, regulations have been stricter, requiring more detail.

In short, balance sheets provide insight into a company's holdings for all to see. Balance sheets are a highly informative tool, often open for public viewing if the company is traded publicly. Without balance sheets, it becomes difficult to gain a clear insight into the health of the company.

Adrian Lawrence is the webmaster of Finance Alley the best place to find financial articles

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covering topics such as accounting, money and loans and all aspects of finance.

Why Financial Statements Are Important: A Beginner's Guide

By Adrian Lawrence

Accounting is considered to be one of those complicated yet necessary chores that keep people's financial affairs relatively clean. For the beginner who is just getting started, the process may not be the first obstacle. Often, it is understanding the special language used by accountants and those that work around them. In other words, one must wade through the jargon in order to understand what's going on. The first step in gaining understanding of accounting is to break concepts down to one fundamental point: financial statements.

Understanding Financial Statements: The Balance Sheet

Corporations are extremely fond of financial statements - after all, they are required to have them. Financial statements are, in a broader sense, just timely statements of the financial situation of an organization. They hold companies accountable for how money is earned and spent, down to the very last detail. Financial statements are often audited by external auditors to ensure that the company is handling records properly. This also confirms to third parties that the company is displaying a fair and balanced view of the organization's position. These are also called "cash flow statements". Like most financial concepts, financial statements can be broken down into several smaller concepts. They are: balance sheets, cash flow statements, and profit and loss accounts.

Cash flow statements is another term for financial statements, but a little more specific. This statement shows exactly where the money goes - how it was made, where it was made, and most importantly, how was it spent. A business, after all, has many areas where money flows in and out: operating activities, investing activities, financing activities.

To clarify, operating activities are the daily internal business a company relies on to survive. This may include, but is not limited to: collecting money from customers, paying employees and vendors, interest and taxes, or even revenue from interest payouts. Investing activities are generally investments made by the company to fund purchases of equipment. Finally, financing activities are those that affect the flow of money directly, such as the sale of common stock or adjustments in long or short-term loans.

These calculations are then used to find the total increase (or decrease) in cash and investments. Fluctuations in operations, investing, or financing affect cash flow. This is called the "net change" in cash and marketable securities. From here, these calculations are checked against the balance sheet.

Wait, a balance sheet? Isn't that what we just did, balance?

No. A balance sheet sums up a company's assets, liabilities, and value at a certain point in time. Investors look to the balance sheet to determine a company's value based on what the company owns and what they owe to external sources. The amount of money invested by the shareholders affects company value in this way as well. The balance sheet follows a specific formula, where assets equal liabilities plus shareholder's equity. It is called a balance sheet because the two sides must balance out; after all, a company must pay for assets by either borrowing the money directly, or through shareholders. The balance sheet is clearly a great source of financial information on a company.

The last line of defense, the profit and loss account, shows the activities of a company during a period of time. This differs from the balance sheet in that a profit and loss account serves as a log of a

company's activities over a period of time, while the balance sheet is just the financial position at a specific moment in time. Some value the profit and loss account over the balance sheet, as it marks a longer stretch of time than the balance sheet does.

Once broken down into parts, financial statements are not such a hard topic to handle, even for a beginner. Financial statements expose the practices of a company - while one does not get a specific blueprint of how a company makes or loses money, the end results are clearly displayed for people to see.

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