

“Demystifying” the Balance Sheet

Presented by:

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Workshop Goals

- Define what the balance sheet is
- Understand how it integrates with the income statement
- Understand why it is the most important financial statement
- Work thru an example
- Tips for keeping your balance sheet up to date

What is a Balance Sheet?

- “Living Document” - snap shot of your business’ financial condition at a specific moment in time
 - Different from an income statement which shows you activity for a date range
- $\text{Assets} - \text{Liabilities} = \text{Equity (Net Worth)}$

Balance Sheet Definitions

- Assets
 - What you “Have”
 - Cash, Accounts Receivable, Investments, Fixed Assets
- Liabilities
 - What you “Owe”
 - Accounts Payable, Notes Payable, Taxes, Line of Credit
- Equity
 - What’s left for the “Owners”
 - Capital Contributed, Distributions/Draws, Cumulative Profits/Losses of the Company

Income Statement Overview

- Revenue
 - What you have “Received” or “Earned”
 - Sales, Interest Income
- Expenses
 - What you have “Spent”
 - Direct costs, Indirect costs, variable costs, fixed costs
- Track what you have received and spent during a period of time – such as a month or year.

How the Balance Sheet Integrates With the Income Statement

- The income statement captures activity for a year and then the “bottom line”, net income or loss, is “closed out” to retained earnings
- Retained earnings is an equity account on the balance sheet that represents all income or loss of the business since its inception.
- The income statement “feeds” the balance sheet this information
- The two statements should always be read together

Common Misconceptions

- Most business owners rely on the income statement for financial decisions
- Very few business owners and bookkeepers know how to prepare a proper balance sheet

Your Income Statement will be wrong if your Balance Sheet is wrong.

Balance Sheet Importance

- If your balance sheet is correct, then your income statement will be correct, in total
- Outside lenders rely on your balance sheet information when making loan decisions
- You will be able to make proper financial decisions quickly and confidently
- Analyze trends and compare to benchmarks in your industry to remain competitive

Working Thru The Example

- See examples 1 – 4 of the materials

Example 1 - Preliminary Income Statement - No review of Balance Sheet Done

ABC Company	
Income Statement	
For the year ended December 31, 2007	
(Accrual Basis)	
	Preliminary
Revenue	\$ 650,000
Cost of Goods Sold	275,000
Gross Profit	<u>375,000</u>
Operating Expenses:	
Advertising	8,600
Bank fees	225
Insurance	19,100
Office Supplies	3,500
Rent	48,000
Total Operating Expenses	<u>79,425</u>
Net Profit	<u><u>\$ 295,575</u></u>

Typical scenario of business owner printing profit and loss to see how the business is doing for the year.

This statement captures the income and expenses for specific time frame (January 1- December 31, 2007).

Example 2 - Preliminary Balance Sheet - Prior to Review

ABC Company	
Balance Sheet	
December 31, 2007	
(Accrual Basis)	
	Preliminary
ASSETS	
Current Assets	
Cash	\$ (5,785)
Accounts Receivable	125,721
Prepaid Insurance	-
Total current assets	119,936
Fixed Assets	
Motor Vehicles	20,000
Equipment	30,000
Accumulated Depreciation	-
	50,000
Non-Current Assets	
Deposits	2,000
TOTAL ASSETS	\$ 171,936
LIABILITIES AND EQUITY	
Current Liabilities	
Accounts Payable & Accrued Expense	2,500
Meals & Sales Taxes Payable	2,200
Income Taxes Payable	-
Bank Line of Credit	5,000
	9,700
Non-Current Liabilities	
Note Payable - Vehicle	18,800
	18,800
Total Liabilities	28,500
Equity	
Common Stock	100
Retained Earnings (Deficit)	(152,239)
Current Year Profit	295,575 A
Total Equity	143,436
TOTAL LIABILITIES AND EQUITY	\$ 171,936

Scenario of a bookkeeping system that does not review its balance sheet, reconcile cash, review accounts receivable or payables.

- A This amount matches the net income on Example 1. This is how the statements are integrated.

Example 3 - Information Gathered from Owner Regarding Balance Sheet Accounts

1 Cash

The owner does a bank reconciliation by hand each month. The reconciliation is summarized as follows:

Balance Per Bank, 12/31/07	15,086
Less Outstanding Checks in Transit	(11,408)
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Balance Per Book, 12/31/07	3,678
	<hr/> <hr/>
Compared to Balance Sheet at 12/31/07	(5,785)
	<hr/>
Error on Balance Sheet Related to Prior Year	9,463
	<hr/> <hr/>

2 Accounts Receivable

The owner keeps a file of unpaid invoices, at 12/31/07 this file contained \$5,015 in unpaid invoices from clients. The owner did not always post deposits from customers against their outstanding invoice, and instead posted them directly to Revenue.

Accounts Receivable per owner 12/31/07	5,015
Accounts Receivable per Balance Sheet 12/31/07	125,721
	<hr/>
Error on Balance Sheet for Current Year Income	(120,706)
	<hr/> <hr/>

3 Prepaid Insurance

The owner always pays their insurance policy in full when they receive the bill. The policy runs from 4/1/07-3/31/08 and the premium is \$19,100. As of 12/31/07, 3 months or 25% of the policy is a 2008 expense that has been prepaid.

Prepaid Insurance should be 25% of Premium	4,775
Prepaid Insurance per Balance Sheet 12/31/07	-
	<hr/>
Error on Balance Sheet for Current Year Expense	4,775
	<hr/> <hr/>

4 Accumulated Depreciation

The owner bought equipment and vehicles this year totaling \$50,000 which were properly recorded as a fixed asset on the balance sheet. But, the owner does not know how to book depreciation and did not record any.

Accum Depreciation should be	(14,000)
Accum Depreciation per Balance Sheet 12/31/07	-
	<hr/>
Error on Balance Sheet for Depreciation Mission	(14,000)
	<hr/> <hr/>

5 Accounts Payable & Accrued Expense

The owner reviewed the payments they made to vendors in January 2008 and found \$48,755 of payments that were related to expenses incurred in 2007. These payments to vendors were not included in accounts payable at 12/31/07

Accounts Payable should be (\$2,500+\$48,755)	51,255
Accounts Payable per Balance Sheet 12/31/07	2,500
	<hr/>
Error on Balance Sheet for Missing Accruals	48,755
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6 Income Taxes Payable

The accountant estimated the business will have to pay \$10,000 for income taxes related to 2007.

Income Taxes Payable should be	10,000
Income Taxes Payable per Balance Sheet 12/31/07	-
	<hr/>
Error on Balance Sheet for Current Year Taxes	10,000
	<hr/> <hr/>

7 Bank Line of Credit

The owner mistakenly posted advances they received on the line of credit against Revenue. These advances should have been posted against the liability account. The total balance outstanding on the line of credit is \$45,000.

Line of Credit balance per Bank 12/31/07	45,000
Line of Credit balance per Balance Sheet 12/31/07	5,000
	<hr/>
Error on Balance Sheet for Misposted Advances	40,000
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Example 4 - Adjustments to Preliminary Financials

**ABC Company
Balance Sheet
December 31, 2007
(Accrual Basis)**

	Preliminary	Adjustments	Final
ASSETS			
Current Assets			
Cash	\$ (5,785)	1 9,463	\$ 3,678
Accounts Receivable	125,721	2 (120,706)	5,015
Prepaid Insurance	-	3 4,775	4,775
Total current assets	119,936		13,468
Fixed Assets			
Motor Vehicles	20,000		20,000
Equipment	30,000		30,000
Accumulated Depreciation		4 (14,000)	(14,000)
Total fixed assets	50,000		36,000
Non-Current Assets			
Deposits	2,000		2,000
TOTAL ASSETS	\$ 171,936		\$ 51,468
LIABILITIES AND EQUITY			
Current Liabilities			
Accounts Payable	2,500	5 48,755	51,255
Meals & Sales Taxes Payable	2,200		2,200
Income Taxes Payable	-	6 10,000	10,000
Bank Line of Credit	5,000	7 40,000	45,000
Total current liabilities	9,700		108,455
Non-Current Liabilities			
Note Payable - Vehicle	18,800	-	18,800
Total Liabilities	28,500		127,255
Equity			
Common Stock	100		100
Retained Earnings (Deficit)	(152,239)	1 9,463	(142,776)
Current Year Profit	295,575	A	66,889 B
Total Equity	143,436		(75,787)
TOTAL LIABILITIES AND EQUITY	\$ 171,936		\$ 51,468

**ABC Company
Income Statement
For the year ended December 31, 2007
(Accrual Basis)**

	Preliminary	Adjustments	Final
Revenue	\$ 650,000	2 (120,706)	\$ 489,294
		7 (40,000)	
Cost of Goods Sold	275,000	5 48,755	323,755
Gross Profit	375,000		165,539
Operating Expenses:			
Advertising	8,600		8,600
Bank fees	225		225
Depreciation	-	4 14,000	14,000
Income Taxes	-	6 10,000	10,000
Insurance	19,100	3 (4,775)	14,325
Office Supplies	3,500	-	3,500
Rent	48,000	-	48,000
Total Operating Expenses	79,425		98,650
Net Profit	\$ 295,575	A	\$ 66,889 B

Tips for Closing Your Balance Sheet

- Go thru each account and understand what the balance represents
- Create workpapers to support your balance sheet accounts at the close of each year
- Ask your accountant what you can do better
- See enclosed article for tips to review your balance sheet and how to interview an accountant

Questions?



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