Balance sheet

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Introduction

The balance sheet shows the resources that the company has under its control at a certain point in time. The balance sheet consists of three major parts which are, the assets, liabilities, and the owners equity.[1]

In this paper I will focus on the company's assets. How the company value their assets. The deprecations of the assets. How and why the company writes down the values of the assets, and finally when the company gets the opportunity to write up value of the assets.

Balance sheet

Assets	Liabilities
Current assets	**Long time depts.**
Cash	Bank loans
accounts receivable	**Short time depts.**
Raw materials	Accounts payable
Fixed assets	**Share holders equity**
Land	Common stock
Equipment	Retained earnings
Real estates	

Simplified example of the Balance sheet.

Assets

The assets in the balance sheet are divided in to "Current assets" and "Fixed assets". There are also some assets that are intangible, and these are very hard to value and are therefore not included in the company's balance sheet. Unless the accountant is able to identify and give the asset a proper and correct valuation. A few examples of intangible assets are patents, skilled employees, and goodwill[2].

[1] http://library.eb.co.uk/eb/article-9471830?query=balance%20sheet&ct=

[2] Principles of Corporate Finance 9:th edition p. 789

The current assets are the assets that most likely will be turned into cash in the near future such as receivables, work in progress, raw materials, and of course plain cash.

The fixed assets are the long term non-liquid assets like industry buildings, real estates, and factories. The balance sheet will not show up to date market values on these assets. Instead the accountant will record the amount that the asset cost when the company purchased the asset. Then as in most cases, like equipment for an example, the accountant will deduct the annual amount for deprecation[3].

The financial asset does not have to be physical like land or equipment. The values of these types of assets are normally driven by a contractual claim, like the expected return on a bond, stocks or perhaps a plain bank deposit[4]. One important presumption when valuing the financial asset to market value is that all assets can be valued by the same method, for example the stock value on the open market place[5].

Valuation

The general rule when valuation the company's assets is that the asset is valued to the purchase price minus the deprecation[6].

The valuation is important because the financial reports need to be as reliable as possible. There are several methods being used while valuating assets for the financial reports. Many of those methods are governed by rules and regulations. One method is as simple as the price for purchasing the asset, for example the real estate[7].

The financial assets are normally valued to fair value. The faire value is the price paid for the financial instrument on the market at a certain point of time[8].

Deprecation

The deprecation is not a cash expense. Deprecation is important because deprecation reduces the taxable income. This reduction in taxable income will provide the company with a tax shield which is ”equal to the product of deprecation and the marginal tax rate”[9].
The deprecation also covers the deterioration that comes with use, age, and exposure to wind and weather. It also covers the

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[3] Ibid. P 788
[4] http://www.investopedia.com/terms/f/financialasset.asp
[5] http://www.anlaggningsregister.se/vardering-tillgangar.htm
[6] Externredovisning, Bonniers förlag, Malmö 2004, P170
[7] http://www.investopedia.com/terms/a/accounting-valuation.asp
[8] http://www.anlaggningsregister.se/vardering-tillgangar.htm
[9] http://library.eb.co.uk/eb/article-9029985?query=depreication&ct=eb

obsolescence that might occur when more efficient equipment that serves the same purpose develops and becomes available. Deprecation does not cover unexpected costs that occur in case of an accident or other sudden occurrence[10].
Deprecation can be applied to assets like machines, buildings and equipment as well as it can be applied on intangible assets with a limited economic lifespan, such as patent and copyrights. There are several annuity methods to calculate depreciation, there are two more common ones, the “Straight-line” and the fixed percentage[11].

The fixed percentage is also known as declining – charge deprecation. These means that the deprecation will be recognized as higher in the early years of the assets life time, and lower in the later years when the economical value are expected to be less.

> Example: The Company purchases a machine for $1 million, that is supposed to have five years of economical value and will therefore have a 20% deprecation each year.
>
> The deprecation will be:

Year 1	20%*1 000 000= 200,000
Year 2	20%*800 000= 160,000
Year 3	20%*640 000= 128,000
Year 4	20%*512 000= 102,400
Year 5	102,400

In the straight line method the deprecation will be the same each year until the asset reaches zero economic value12.

> Example: The company purchases a machine for $1 million. The machine is estimated to have 5 years of life, but will have a salvage value estimated to 200 000$.
>
> The deprecation will be:
>
> Year 1 (1000 000-200 000)/5=160 000
> Year 2 (1000 000-200 000)/5=160 000
> Year 3 (1000 000-200 000)/5=160 000
> Year 4 (1000 000-200 000)/5=160 000
> Year 5 (1000 000-200 000)/5=160 000

[10] Ibid.
[11] http://library.eb.co.uk/eb/article-9029985?query=depreication&ct=eb
[12] http://library.eb.co.uk/eb/article-252929#306363.hook

Write down

Sometimes an external accountant (auditor) might find that the deprecation is not based on reasonable formulas and can therefore decide that the asset should be written down[13].

Write down means that the company reduces the book value of the asset because its overvalued compared to the market value of the asset[14]. The write down is a non cash expense just like deprecation and is therefore shown in the income statement with a net income loss as a result.

The company is obligated to write down the value of the asset if it has decreased in value (in contrast to write up). This rule goes for all kinds of assets except financial assets[15] .

Writing <u>Up</u>

Some times the value of an asset increases in value and can therefore be valued to a higher value than what is recognized in the books. Real estate is one example of such assets. This is only possible if the increased value is permanent. A writing up is a single event and is a voluntary action (in contrast to Write down), perhaps to give the readers of the annual report a more true image of the assets value[16].

[13] http://library.eb.co.uk/eb/article-9029985?query=depreication&ct=eb
[14] http://www.investopedia.com/terms/w/writedown.asp
[15] Externredovisning, Bonniers förlag, Malmö 2004, P170
[16] Externredovisning, Bonniers förlag, Malmö 2004, P170