

FINANCE AT A GLANCE

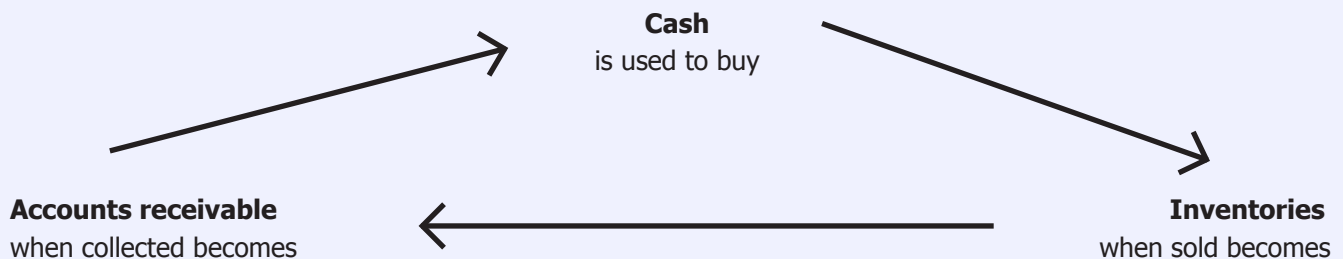
How ASSETS are presented

Lesson 05

In this lesson, we shall look at how assets are presented in the balance sheet, as well as well as elaborate on the types of assets.

Operating cycle

Before we go into the aforementioned, we have an important concept to clarify: the concept of operating cycle. In simplified terms, operating cycle refers to that cycle whereby cash gets converted into inventories of merchandise, which then get sold, thus giving rise to receivables. The receivables then revert into cash once collected. This cycle is shown by the following diagram:



The above diagram holds true for a trading business (that is, one that buys and sells goods). For a service business or a manufacturing business, we need to modify the diagram a bit.

For a service business, cash is used to perform or deliver a service. Upon completion of the service, a receivable is generated, which upon collection becomes cash.

For a manufacturing business, cash is used to buy inventories of raw materials, which are then converted into inventories of finished products. Once the finished products are sold, receivables are generated, which upon collection become cash.

In most cases, the operating cycle lasts for a period that is less than one year. However, businesses like those in aircraft manufacture or infrastructural construction have operating cycles that extend for periods longer than a year. It takes much more than one year for them to deliver their end-product.

It is important to know the length of time it takes to complete a business' operating cycle, because this length or period of time determines which assets will be presented under one of the major categories under which assets are presented.

Presentation of assets in the balance sheet

Presentation of assets varies from country to country. However the following asset categories are generally used.

1. Current assets

Since most businesses have cycles shorter than a year, the period of one year is used a basis by most businesses for putting assets under the current assets category. For them, current assets are those that are expected to be converted into cash, sold or consumed within the year. (For businesses whose operating cycle is longer than a year, their current assets are those that are expected to be converted to cash, sold or consumed within the duration of their operating cycle.)

The major items under current assets are:

Cash and cash equivalents - These include currencies, deposit accounts and negotiable instruments (such as cheque payment from clients, bank drafts, etc.)

Short-term investments - These include securities bought and held for sale in the short term. Instead of keeping excess funds as bank deposits (that earn minimal interest), a company buys securities and hopes to make a profit on the difference between the selling and acquisition prices of the securities.

Accounts receivable - This represents the business' right to collect money from a customer to whom it has sold products or rendered services on credit.

Inventories - These include:

raw materials - unprocessed materials that will be used in manufacturing products

work-in-process - partially finished products in the process of being manufactured

finished goods - completed products ready for delivery to customers

Prepaid expenses - These are payments the business has made for services it has not yet received. Prepaid expenses may be in the form of prepaid insurance, prepayment of rent, deposits paid to utility companies, salary advances etc. These items are classified as current not because they will be converted to cash, but because the expenses that were prepaid will eventually become due within a year (or within the business' operating cycle, if such a cycle is longer than year), and once they become due, the prepayment is said to be "consumed". (Recall that assets expected to be consumed within one year or within the operating cycle, whichever is longer, are considered as current assets.)

The other assets categories are:

2. Long-term investments

3. Fixed assets

4. Intangible assets

5. Other assets

We shall discuss them in our next e-lesson. Until then

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