

LAP

Leadership, Attitude, Performance ...making learning pay!

Financial Analysis LAP 10 Performance Indicator: FI:093

The Right Balance

The Nature of Balance Sheets

**One
moment
in time**

**Your
greatest
assets**

**What's
it worth
to you?**

ACKNOWLEDGMENTS

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The Right Balance

A

The Nature of Balance Sheets

So What

If you're a typical high-school student, you have a lot of pictures—hundreds maybe!—stored on your phone or your computer. Take a look at a few of them. What do you see? Your best friend laughing at a joke? The star of the basketball team sinking a free throw? The sun dropping just below the horizon? Every photograph captures an exact moment in time. And, just like a photograph, a financial statement known as the balance sheet captures an exact moment in time—for a company's finances. Read on to learn more about what balance sheets are and why they're important.

Show Me the Money

The **balance sheet** is one of a business's key **financial statements**. It shows how much money a company has, how much money it owes, and how much belongs to its owners or stockholders. Sometimes called a statement of financial position, the balance sheet is usually described as a "snapshot" of the company's finances at a certain point in time. That certain point in time is typically the end of an accounting period—it could be the end of the month, the end of the quarter, the end of the year, etc.



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Objectives

- A Explain the purpose of balance sheets.
- B Describe the components of a balance sheet.

▲ You can check out any public corporation's latest balance sheet by visiting <https://www.google.com/finance>, searching for the company, and selecting "financials."

The accounting equation

Every balance sheet is based on the **accounting equation**. The accounting equation looks like this:

$$\text{Assets} = \text{Liabilities} + \text{Owners' Equity}$$

Don't worry! The accounting equation isn't as complicated as it looks, and we'll discuss the terms *assets*, *liabilities*, and *owners' equity* in more depth in Objective B. The equation simply means that all of a company's **assets** (items of value) have been obtained from two sources—**liabilities** (debts) or **owners' equity** (money that's been invested in the business). Here's an example:

McDonald's Corporation's latest balance sheet shows that it has \$35 billion in assets, \$20 billion in liabilities, and \$15 billion in owners' equity. This means that \$20 billion of the company's \$35 billion in assets has come from borrowing money, and \$15 billion of the company's \$35 billion in assets has come from investors.

A company's total assets always equal the amount it has borrowed plus the amount it has obtained from its owners or investors. If the multibillion-dollar corporate example doesn't quite cut it for you, we can make it a little more down-to-earth:

Grant has started his own lawn-mowing business to make money for college. Right now, he has about \$500 in total assets, including a lawnmower and other equipment. He put \$200 into the business from his own savings (owner's equity), and he borrowed \$300 from his parents (liability).

Sometimes, it's easier to consider the accounting equation when it's flipped another way:

$$\text{Assets} - \text{Liabilities} = \text{Owners' Equity}$$

Looking at the equation this way, you'll see that when you take McDonald's Corporation's assets (\$35 billion) and subtract its liabilities (\$20 billion), what's left is what belongs to its shareholders/investors (\$15 billion). And, when you take Grant's assets (\$500) and subtract his liabilities (\$300), what's left is what he has contributed to the business himself (\$200). No matter how you choose to look at it, the accounting equation should always add up on the balance sheet.




For more on the accounting equation, visit <http://www.quickmba.com/accounting/fin/equation/>.



A balance sheet shows:

- ✓ How much money a business has
- ✓ How much money a business owes
- ✓ How much belongs to its owners or stockholders

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Period Ending		Sept. 30, 20XX
Assets		
Current Assets		
Cash And Cash Equivalents		2,544,300
Short Term Investments		—
Net Receivables		1,285,300
Inventory		113,100
Other Current Assets		791,400
Total Current Assets		4,734,100
Long Term Investments		1,262,500
Property Plant and Equipment		25,081,500
Goodwill		2,853,800
Intangible Assets		—
Accumulated Amortization		—
Other Assets		1,619,400
Deferred Long Term Asset Charges		—
Total Assets		35,551,300
Liabilities		
Current Liabilities		
Accounts Payable		3,822,300
Short/Current Long Term Debt		—
Other Current Liabilities		—
Total Current Liabilities		3,822,300
Long Term Debt		13,487,800
Other Liabilities		1,556,000
Deferred Long Term Liability Charges		1,520,300
Minority Interest		—
Negative Goodwill		—
Total Liabilities		20,386,400
Stockholders' Equity		
Misc Stock Options Warrants		—
Redeemable Preferred Stock		—
Preferred Stock		—
Common Stock		16,600
Retained Earnings		40,354,600
Treasury Stock		(31,685,500)
Capital Surplus		5,962,600
Other Stockholder Equity		516,600
Total Stockholder Equity		15,164,900

Making a statement

To better understand the balance sheet, it's important to consider its relationship with the company's other financial statements, particularly the income statement. The **income statement** shows how much money a company makes and spends during a specific accounting period. And, every dollar a company makes or spends changes the numbers on the balance sheet.

For example, whenever a company brings in money, it's recorded on the income statement. The income will likely increase the business's assets, and those assets are then recorded on the balance sheet. Let's say that Grant makes \$150 mowing lawns this month. He'll record that money on his income statement under sales revenue, and on his balance sheet, his assets will grow from \$500 to \$650.

On the flip side, whenever a company spends money, it's recorded on the income statement as well. The expenditures will likely increase the business's liabilities, and those liabilities are then recorded on the balance sheet. If Grant borrows an additional \$50 from his parents this month to cover gas and other expenses, he'll record the \$50 on his income statement under operating costs. Then, on his balance sheet, liabilities will grow from \$300 to \$350.

To learn more about the relationship between the balance sheet and the income statement, see John A. Tracy's article "Connecting the Income Statement and the Balance Sheet" at <http://www.dummies.com/how-to/content/connecting-the-income-statement-and-balance-sheet.html>.

Who needs it?

Like most financial statements, balance sheets are useful to a number of different people for a number of different purposes. Investors look at them to see how much a company is really worth and to determine whether or not it's a good investment. For instance, a company with a lot of cash on its balance sheet is often attractive to investors because it indicates strong growth.

Banks and vendors also look at balance sheets to determine how much credit they'll extend to a company. Let's say a retailer wants to purchase 10,000 tires from a manufacturer to resell in its store. The retailer wants to purchase the tires on credit instead of paying the full balance upfront. The tire manufacturer will likely study the retailer's latest balance sheet as part of its efforts to determine the retailer's creditworthiness.

Of course, businesses rely on balance sheets for internal purposes as well. Managers may look at the balance sheet to get a quick handle on the company's strengths and capabilities or study a series of past balance sheets to identify and analyze financial trends within the company. For example, if the past year's monthly balance sheets all show a steady decrease in assets and increase in liabilities, managers will certainly want to address this trend!

For a more in-depth look at how companies use their balance sheets, check out public accountant Maria Yanuaria's article "What is the Use of the Balance Sheet?" at <http://mpm.ph/what-is-the-use-of-the-balance-sheet/>.

Summary

The balance sheet is one of a business's key financial statements. It shows how much money a company has, how much money it owes, and how much belongs to its owners or stockholders. It is usually described as a "snapshot" of the company's finances at a certain point in time. The balance sheet is based on the accounting equation, which states that a business's assets are equal to its liabilities plus owners' equity. Another way to look at it is that the owners' equity is equal to assets minus liabilities. The balance sheet is related to a company's other financial statements—for instance, every change in the income statement affects the numbers on the balance sheet. Balance sheets are important to investors, banks, creditors, and businesses.



- ▲ Balance sheets provide valuable information to investors, banks, vendors, and business managers about the business's strengths and capabilities.

TOTAL RECALL

1. What is a balance sheet?
2. What is the accounting equation?
3. Describe the relationship between the balance sheet and the income statement.
4. Who uses balance sheets?

THE GRAY ZONE

Businesses want their balance sheets to show more assets than liabilities. When a business has few debts, it's viewed as financially healthy—a good investment, a low credit risk, etc. Sometimes, to avoid showing liabilities on its balance sheet, a business will participate in what's known as off-balance-sheet financing.

Off-balance-sheet financing allows a company to keep certain liabilities from showing up in its financial statements. For example, a company can lease or rent an expensive piece of equipment instead of buying it. That way, the business needs only to record the rent as an operating expense on its income statement—*not* as a liability on its balance sheet.

Off-balance-sheet financing isn't illegal, but some individuals think it's unethical because it "hides" some of a business's liabilities from people reading the balance sheet. What do you think?

A Closer Look: Components of the Balance Sheet



Though every company's balance sheet is unique, all balance sheets should include the same basic components—assets, liabilities, owners' equity, and notes. Let's take a closer look at each.

Assets

Any valuable items a business owns are considered **assets**. Assets may be **tangible** (having a physical presence) or **intangible** (not having a physical presence). Here are a few examples of a business's assets:

- Cash
- **Copyrights, trademarks, and patents**
- Buildings and land
- Equipment
- Vehicles
- Inventory
- Materials and supplies
- Prepaid advertising, legal fees, insurance, etc.
- **Accounts receivable** (money owed to the business)
- Stocks and bonds



Which of these examples are tangible? Which are intangible?

▲ Tangible assets come in many shapes and sizes—including something as small as a paper clip or as large as a skyscraper!

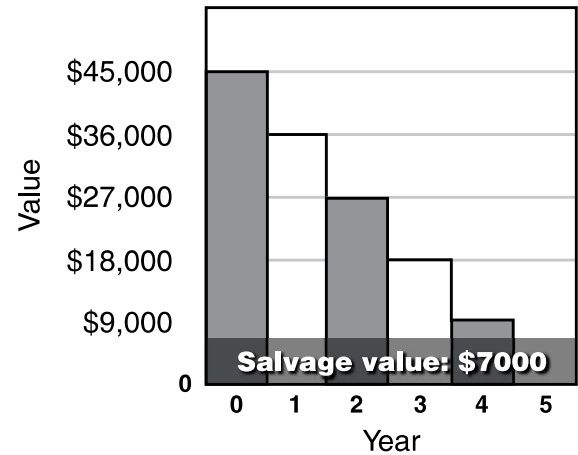
Depending on an asset's **liquidity** (ability to be converted into cash), it is classified on the balance sheet as either a current asset or a fixed asset. **Current assets** are liquid and can be converted into cash in one year or less. Examples of current assets include checking accounts and accounts receivable. You see, a business can easily access the money it has in a checking account, and it will likely collect the balances of any outstanding bills within a year as well. Can you think of any more examples of current assets?

Fixed assets are not as liquid as current assets. They usually cannot be converted into cash within a year. Examples of fixed assets include land and machinery. Items such as these are generally purchased for the business's long-term use and are not intended to be sold. As a matter of fact, fixed assets are often referred to as **PPE** (property, plant, and equipment) on the balance sheet. Can you think of any other examples of assets that would be considered fixed assets?

There's another important concept to learn when it comes to fixed assets, and that's **depreciation** (loss of value). As you know, after a few years, the items you purchase aren't worth as much as they originally were. Consider cellphones, laptops, and cars. It's no different for the items that a business owns. Let's say that a catering company purchases a delivery vehicle for \$45,000. Accounting standards dictate that vehicles depreciate over a period of five years. This means that, every year for the next five years, one-fifth of the vehicle's value will be subtracted from the balance sheet. After year one, the vehicle will be valued at \$36,000; after year two, \$27,000, and so on. Make sense? All fixed assets depreciate over time, with the exception of land.

Because the depreciation of fixed assets also affects a business's taxes, the Internal Revenue Service has specific rules for how businesses should handle depreciation. These guidelines also influence how the business creates its balance sheets. You can browse the information at <http://www.irs.gov/pub/irs-pdf/p946.pdf>.

Delivery Van Depreciation



▲ On balance sheets, business vehicles such as delivery vans depreciate, or drop in value, over a period of five years.



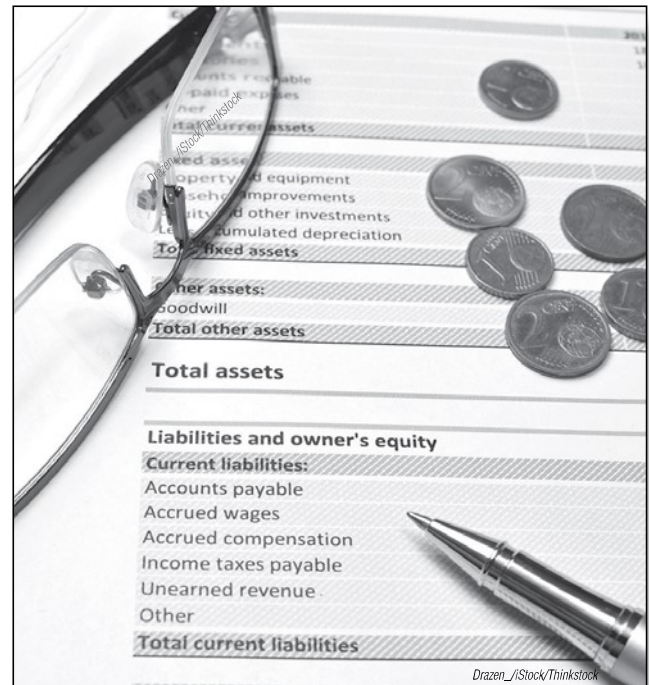
Assets are usually listed on the right side of the balance sheet.

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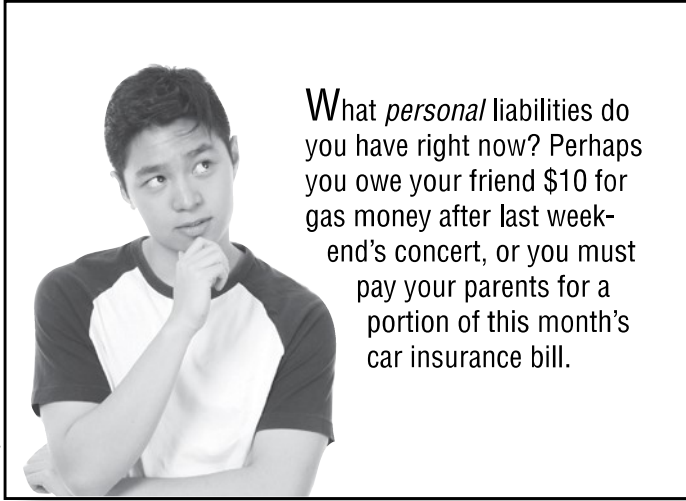
Liabilities

Any money that the business owes is a **liability**. Another way of looking at liabilities is as claims that creditors have against the business's assets. Examples of a business's liabilities may include:

- **Accounts payable** (outstanding bills the company needs to pay)
- Wages and salaries
- Mortgage(s)
- Interest
- Outstanding loans
- Taxes (sales, income, payroll, property, etc.)
- Customer deposits (goods or services that have been paid for but not yet delivered by the company)



▲ Current (short-term) liabilities are due within one year. Long-term liabilities, on the other hand, take longer than a year to pay off.



Owners' equity

Whatever value—positive or negative—is left in a business after liabilities have been subtracted from assets is **owners' equity**. For **public companies** (companies with shares traded on the stock market), this value is called **stockholders' equity**. Potential investors might also call this the company's **net worth** or **book value**.

It's important to note that owners' equity is *not* the same as the company's actual worth. Book value and **fair market value** are two different things. You see, on the balance sheet, assets are not necessarily listed at their fair market value. It's just the way accounting works. Some assets, such as land or equipment, are listed at their value at the time of purchase—even less than that value due to depreciation. Here are a couple of examples:

Example 1: Griffin's Dairy Farm bought 80 acres of land in 1989 for \$96,000. On the balance sheet, this asset is still listed at \$96,000, even though its fair market value is now over \$550,000. Therefore, the business has nearly \$450,000 in additional land assets that don't show up on the balance sheet or in owners' equity.

Example 2: Sew-Rite Tailor Shop purchased a professional sewing machine several years ago for \$2,000. Even though its value on the balance sheet has depreciated to \$0, the machine is still an asset to the business because it still works perfectly and helps the business to make money. In addition, the machine could still be sold for at least \$1,000 at fair market value. This is another example of an asset that doesn't show up on the balance sheet.

Now you can see why owners' equity is not the same as fair market value. Just because a company's balance sheet lists owners' equity at \$1 million, for example, it doesn't mean that \$1 million would be enough to purchase that business. Make sense?

Depending on the size of the debt involved, liabilities are generally classified on the balance sheet as either short term or long term. **Short-term liabilities** are those that will be paid within one year. Examples of short-term liabilities include accounts payable and most taxes. These are obligations that companies usually pay regularly and quickly. **Long-term liabilities**, on the other hand, are those that will take longer than a year to pay. These might include mortgages or other bank loans. Many mortgages, for example, are set up to be paid over 15 or even 30 years.



Liabilities are usually listed on the left side of the balance sheet.

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So, what about *potential* liabilities? You know, obligations the company may or may not have to pay? These are also included on the balance sheet as **contingent liabilities**. Perhaps the company is being sued for \$500,000 by a customer or a former employee. If it's likely that the company will have to pay, the \$500,000 is listed as a liability. If it's unlikely that the company will have to pay, the \$500,000 is mentioned in the "notes" section of the balance sheet (more on notes in just a bit).



Owners' equity is usually listed on the left side of the balance sheet, under liabilities.

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For a more in-depth look at liabilities on the balance sheet, read Michael Schmidt's article "Reviewing Liabilities on the Balance Sheet." You can find it here— <http://www.investopedia.com/articles/investing/100313/reviewing-liabilities-balance-sheet.asp>.

Of course, businesses and investors hope for owners' equity to be a positive number. If owners' equity is a negative number, liabilities are greater than assets, and that can certainly be a sign that the company is not in good financial health. You can learn more about the causes of negative owners' equity here—<http://www.accountingtools.com/questions-and-answers/what-does-negative-stockholders-equity-mean.html>.



On a balance sheet, all numbers are rounded to the nearest dollar.

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Notes

Like most financial statements, balance sheets often have additional data attached in the form of **footnotes**. These notes may include such information as what types of accounting policies were used when creating the balance sheet, disclosure of any upcoming financial commitments the company has, potential costs involved with **warranties** or **guarantees**, etc. The notes section of a balance sheet might be quite long—10–20 pages is not uncommon. For more on the importance of financial-statement footnotes, visit <http://www.investopedia.com/articles/02/050102.asp>.

Summary

The four main components of a balance sheet are assets, liabilities, owners' equity, and notes. Assets are items of value the company owns. They may be current or fixed. Fixed assets (except land) depreciate over time. Liabilities are obligations the company has to pay. They may be short term or long term. Owners' equity is what's leftover when liabilities are subtracted from assets—it is also known as the company's net worth or book value. It is not, however, the same as the company's fair market value. The notes section includes extra information that is relevant to the balance sheet.

EDELWEISS CORPORATION

Balance Sheet

December 31, 20XX

Assets	
Cash	\$ 35,000
Accounts receivable	45,000
Inventories	35,000
Land	125,000
Building	400,000
Equipment	280,000
Other assets	10,000
Total assets	\$ 930,000

Liabilities	
Accounts payable	\$ 50,000
Loans payable	155,000
Total liabilities	\$ 205,000

Stockholders' equity	
Capital stock	\$ 120,000
Retained earnings	605,000
Total stockholders' equity	725,000
Total liabilities and equity	\$ 930,000

▲ Remember: A business's total liabilities and equity must equal its total assets. That's why this financial statement is called the balance sheet!

TOTAL RECALL

1. What are assets?
2. What is the difference between current assets and fixed assets?
3. What is depreciation?
4. What are liabilities?
5. What is the difference between short-term liabilities and long-term liabilities?
6. What is owners' equity?
7. What is the difference between a company's book value and its fair market value?
8. Describe the "notes" section of the balance sheet.

Make It Pay!

Consider your current place of employment. If you're not working right now, think about one of your favorite local businesses. What are some of its assets? Are the assets you've thought of tangible or intangible? Current or fixed? Now, try to determine what some of the business's short-term and long-term liabilities might be. Is this a business you would want to invest in?