Understanding Balance Sheets

In order to make an informed investment decision, you should review a company's balance sheet. Let's look at what a balance sheet entails.

The balance sheet is one of the most important financial statements of a company. It is reported to investors at least once per year. It may also be presented quarterly, semiannually or monthly. The balance sheet provides information on what the company owns (its assets), what it owes (its liabilities), and the value of the business to its stockholders (the shareholders' equity). The name, balance sheet, is derived from the fact that these accounts must always be in balance. Assets must always equal the sum of liabilities and shareholders' equity.

Why Should the Balance Sheet Be Important to You?

The balance sheet is the fundamental report of a company's possessions, debts and capital invested. Before investing in any company, an investor can use the balance sheet to examine the following:

- Can the firm meet its financial obligations?
- How much money has already been invested in this company?
- Is the company overly indebted?
- What kind of assets has the company purchased with its financing?

These are just a few of the many relevant questions you can answer by studying the balance sheet. The balance sheet provides a diligent investor with many clues to a firm's future performance. In this section, you will learn the basic building blocks necessary to do such analysis. Once you completely understand the balance sheet, making informed investment decisions should be much easier for you.

The Basic Concept Behind a Balance Sheet

The concept behind the balance sheet is very simple. In order to acquire assets, a firm must pay for them with either debt (liabilities) or with the owners' capital (shareholders' equity). Therefore, the following equation must hold true:

Assets = Liabilities + Shareholders' Equity

Total Liabilities	$30,000
Shareholders' Equity	$50,000
Total Assets	$80,000

What Are Assets?

Assets are economic resources that are expected to produce economic benefits for its owners. Assets can be buildings and machinery used to manufacture products. They can be patents or copyrights that provide financial advantages for their holder. Let us begin with a look at a few of the important types of assets that exist.

Current assets are assets that are usually converted to cash within one year. Bondholders and other creditors closely monitor a firm's current assets since interest payments are generally made from current assets. They include several forms of current assets:

- **Cash** is known and loved by all. It is the most basic current asset. In addition to currency, bank accounts without restrictions, checks and drafts are also considered cash due to the ease in which one can turn these instruments into currency.
- **Cash equivalents** are not cash but can be converted into cash so easily that they are considered equal to cash. Cash equivalents are generally highly liquid, short-term investments such as U.S. government securities and money market funds.
- **Accounts receivable** represent money clients owe to the firm. As more and more business is being done today with credit instead of cash, this item is a significant component of the balance sheet.
- A firm's **inventory** is the stock of materials used to manufacture their products and the products themselves before they are sold. A manufacturing entity will often have three

different types of inventory: raw materials, works-in-process, and finished goods. A retail firm's inventory generally will consist only of products purchased that have not been sold yet.

Now that we have looked at some of the most important short-term assets, let us move forward to examine long-term assets.

Long-Term Assets

Long-term assets are grouped into several categories. The following are some of the common terms you may encounter:

Fixed assets are those tangible assets with a useful life greater than one year. Generally, fixed assets refer to items such as equipment, buildings, production plants and property. On the balance sheet, these are valued at their cost. Depreciation is subtracted from all except land. Fixed assets are very important to a company because they represent long-term illiquid investments that a company expects will help it generate profits.

Depreciation is the process of allocating the original purchase price of a fixed asset over the course of its useful life. It appears in the balance sheet as a deduction from the original value of the fixed assets.

Intangible assets are non-physical assets such as copyrights, franchises and patents. To estimate their value is very difficult because they are intangible. Often there is no ready market for them. Nevertheless, for some companies, an intangible asset can be the most valuable asset it possesses.

Remember that every company will have different assets depending on its industry. However, it is important to know and understand the major accounts that will appear on most balance sheets. Now, we will talk about what the company owes to others: its liabilities.

What Are Liabilities?

Liabilities are obligations a company owes to outside parties. They represent rights of others to money or services of the company. Examples include bank loans, debts to suppliers and debts to employees. On the balance sheet, liabilities are generally broken down into current liabilities and long-term liabilities.

Current liabilities are those obligations that are usually paid within the year, such as accounts payable, interest on long-term debts, taxes payable, and dividends payable. Because current liabilities are usually paid with current assets, as an investor it is important to examine the degree to which current assets exceed current liabilities.

The most pervasive item in the current liability section of the balance sheet is accounts payable.

Accounts payable are debts owed to suppliers for the purchase of goods and services on an open account. Almost all firms buy some or all of their goods on account. Therefore, you will often see accounts payable on most balance sheets.

Long-term debt is a liability of a period greater than one year. It usually refers to loans a company takes out. These debts are often paid in installments. If this is the case, the portion to be paid off in the current year is considered a current liability.

That wraps up our short review of liabilities. You only have one piece left of the balance sheet left to learn - shareholders' equity. Remember that:

assets minus liabilities equals shareholders' equity

What Is Shareholders' Equity?

Shareholders' equity is the value of a business to its owners after all of its obligations have been met. This net worth belongs to the owners. Shareholders' equity generally reflects the amount of capital the owners invested plus any profits that the company generates that are subsequently reinvested in the company. This reinvested income is called **retained earnings**.

Now that we understand the major components, let us move forward to examine a sample balance sheet.

Example of a Balance Sheet

The most important lesson to learn in viewing this example is that the basic balance sheet equation (the most basic and fundamental of all accounting equations) holds true:

Assets = Liabilities + Shareholders' Equity

The following balance sheet is arranged vertically starting with assets and then proceeding to detail liabilities and shareholders' equity. Note that the balance sheet gives a snapshot of the assets, liabilities and equity for a given day. In our case, that is December 31. Often a balance sheet shows information for two successive periods as the one below. This gives the investor a better perspective of the company's operations by showing areas of growth.

Pete's Potato & Pasta, Inc.
Balance Sheet Ending December 31st

	1998	**1999**
ASSETS		
Current Assets		
Cash and cash equivalents	$10,000	10,000
Accounts receivable	35,000	30,000
Inventory	25,000	20,000
Total Current Assets	**70,000**	**60,000**
Fixed Assets		
Plant and machinery	$20,000	20,000
Less depreciation	-12,000	-10,000
Land	8,000	8,000
Intangible Assets	2,000	1,500
TOTAL ASSETS	**88,000**	**79,500**
LIABILITIES AND SHAREHOLDERS' EQUITY		
Liabilities		
Accounts payable	$ 20,000	15,500
Taxes payable	5,000	4,000
Long-term bonds issued	15,000	10,000
TOTAL LIABILITIES	**40,000**	**29,500**
SHAREHOLDERS' EQUITY		
Common stock	$ 40,000	40,000
Retained earnings	8,000	10,000
TOTAL SHAREHOLDERS' EQUITY	**48,000**	**50,000**
LIABILITIES & SHAREHOLDERS' EQUITY	**$ 88,000**	**79,500**

As you can see, total liabilities and shareholders' equity equals total assets.

Tying It All Together

You have now learned the basic construction of a balance sheet and should have a clearer understanding of its importance. The basic financial statement reveals what a company owns, what a company owes to others, and the investments its owners made. It details how a company finances its operations and what assets the company has acquired with this financing.

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