Sophia

The Balance Sheet

by Sophia

WHAT'S COVERED

In this lesson, you will learn about the parts of the balance sheet and the information communicated within them. Specifically, this lesson will cover:

1. The Balance Sheet

A standard company **balance sheet** has three parts: assets, liabilities and ownership equity. The main categories of assets are usually listed first, and typically in order of liquidity.

Balance Sheet

ABC Company Inc.

		Dec. 31, 201X
Assets		
Current Assets		
	Cash	7,314
	Accounts receivable	
	Inventory	5,560
	Prepaid expenses	
	Short-term investments	
	Total current assets	12,874
Fixed (Long-Term) Assets		
	Long-term investments	2,310
	Property, plant, and equipment	14,442
	(Less accumulated depreciation)	(2,200)
	Intangible assets	
	Total fixed assets	14,552
Other Assets		
	Deferred income tax	
	Other	
	Total Other Assets	-
Total Assets		**27,426**
Liabilities and Owner's Equity		
Current Liabilities		
	Accounts payable	9,060
	Short-term loans	
	Income taxes payable	3,349
	Accrued salaries and wages	
	Unearned revenue	
	Current portion of long-term debt	
	Total current liabilities	12,409
Long-Term Liabilities		
	Long-term debt	3,450
	Deferred income tax	
	Other	
	Total long-term liabilities	3,450
Owner's Equity		
	Owner's investment	6,000
	Retained earnings	5,567
	Other	
	Total owner's equity	11,567
Total Liabilities and Owner's Equity		**27,426**

TERM TO KNOW

Balance Sheet

A summary of a person's or organization's assets, liabilities and equity as of a specific date.

2. Assets

The first part of the balance sheet comprises assets. In finance, **assets** are any resource owned by a business. On the left side of a balance sheet, assets will typically be classified into current assets and non-current (long-term) assets.

TERM TO KNOW

Assets

Something or someone of any value; economic resources that represent value of ownership that can be converted into cash.

2a. Current Assets

A current asset on the balance sheet is an asset that can either be converted to cash or used to pay current liabilities within 12 months. Typical current assets include cash and cash equivalents, short-term investments, accounts receivable, inventories and the portion of prepaid liabilities which will be paid within a year.

The most liquid financial assets are arranged at the top of the balance sheet. This begins with cash and cash equivalents. **Cash equivalents** are those assets that can be quickly and easily converted into cash. These are differentiated from other types of investments by their short-term nature. These must mature within 3 months. Other short-term investments typically mature in 12 months.

Accounts receivable (AR) is an account representing funds owed to the organization by other entities through the sale of goods and services on the nature of credit. This is typically denoted by the creation of an invoice which will then include terms of payment.

Most manufacturing organizations usually divide their inventory into:

- raw materials, which are materials and components scheduled for use in making a product,
- work in progress (WIP), which are materials and components that have begun their transformation to finished goods,
- finished goods, referring to goods ready for sale to customers, and
- goods for resale, which are returned goods that are salable.

As an additional classification, deferred expenses represent an asset that consists of a cash payment to an entity for goods to be utilized during a later accounting period.

TERM TO KNOW

Cash Equivalents

A deferred expense or prepayment, prepaid expense, plural often prepaids, is an asset representing cash paid out to a counterpart for goods or services to be received in a later accounting period.

2b. Non-current Assets

A non-current asset is a term used in accounting for assets and property which cannot easily be converted into cash. This can be compared with current assets such as cash or bank accounts, which are described as liquid assets.

Non-current assets include:

- Property, plant and equipment (PPE)
- Investment property (such as real estate held for investment purposes)
- Intangible assets
- Long-term financial assets
- Investments accounted for by using the equity method
- Biological assets, which are living plants or animals

The property, plant, and equipment category normally includes items such as land and buildings, motor vehicles, furniture, office equipment, computers, fixtures and fittings, and plant and machinery. These often

receive favorable tax treatment (depreciation allowance) over short-term assets.
Intangible assets are defined as identifiable, non-monetary assets that cannot be seen, touched or physically measured. They are created through time and effort, and are identifiable as a separate asset. There are two primary forms of intangibles: legal intangibles, such as trade secrets (e. g., customer lists), copyrights, patents, and trademarks; and competitive intangibles, such as knowledge activities (know-how, knowledge), collaboration activities, leverage activities, and structural activities. The intangible asset ”goodwill” reflects the difference between the firm’s net assets and its market value; the amount is first recorded at the time of acquisition. The additional value of the firm in excess of its net assets usually reflects the company’s reputation, talent pool, and other attributes that separate it from the competition. Goodwill must be tested for impairment on an annual basis and adjusted if the firm’s market value has changed.

Investments accounted for by using the equity method are 20-50% stake investments in other companies. The investor keeps such equities as an asset on the balance sheet. The investor’s proportional share of the associate company’s net income increases the investment (and a net loss decreases the investment), and the proportional payment of dividends decreases it. In the investor’s income statement, the proportional share of the investee’s net income or net loss is reported as a single line item.

3. Liabilities and Equity

The balance sheet contains details on company liabilities and owner’s equity. In financial accounting, a **liability** is defined as an obligation of an entity arising from past transactions or events, the settlement of which may result in the transfer or use of assets, provision of services or other yielding of economic benefits in the future.

A liability is defined by the following characteristics:

- Any type of borrowing from persons or banks for improving a business or personal income that is payable during the short or long term;
- A duty or responsibility to others that entails settlement by future transfer or use of assets, provision of services, or other transaction yielding an economic benefit, at a specified or determinable date, on occurrence of a specified event, or on demand;
- A duty or responsibility that obligates the entity to another, leaving it little or no discretion to avoid settlement; and
- A transaction or event obligating the entity that has already occurred.

The **accounting equation** is the mathematical structure of the balance sheet and relates assets, liabilities, and owner’s equity.

FORMULA TO KNOW

Accounting Equation

Assets = Liabilities + Owner's Equity

In accounting and finance, **equity** is the residual claim or interest of the most junior class of investors in assets, after all liabilities are paid. If liability exceeds assets, negative equity exists. In an accounting context, shareholders' equity (or stockholders' equity, shareholders' funds, shareholders' capital, or similar terms) represents the remaining interest in assets of a company, spread among individual shareholders of common or **preferred stock**.

At the start of a business, owners put some funding into the business to finance operations. This creates a liability on the business in the shape of capital, as the business is a separate entity from its owners. Businesses can be considered, for accounting purposes, sums of liabilities and assets: this is the accounting equation. After liabilities have been accounted for, the positive remainder is deemed the owner's interest in the business.

In financial accounting, owner's equity consists of the net assets of an entity. Net assets are the difference between the total assets of the entity and all its liabilities. Equity appears on the balance sheet, one of the four primary financial statements.

The assets of an entity include both tangible and intangible items, such as brand names and reputation or goodwill. The types of accounts and their descriptions that comprise the owner's equity depend on the nature of the entity and may include: common stock, preferred stock, capital surplus, retained earnings, treasury stock, stock options, and reserve.

The total changes to equity are calculated as follows:

FORMULA TO KNOW

Total Changes to Equity

Ending Equity = Beginning Equity +/- changes to common or preferred stock and capital surplus +/- net income/loss (net profit/loss earned during the period) − dividends

Dividends are typically cash distributions of earnings to stockholders on hand and they are recorded as a reduction to the retained earnings account reported in the equity section.

TERMS TO KNOW

Liability

An obligation, debt or responsibility owed to someone.

Equity

The residual claim or interest to investors in assets after all liabilities are paid.

Preferred Stock

Stock with a dividend, usually fixed, that is paid out of profits before any dividend can be paid on common stock. It also has priority to common stock in liquidation.

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4. Working Capital

Working capital is the representation of the liquidity that the organization currently has. In addition to **fixed assets** such as PPE, this metric is also held to be a component of operating capital as well.

Net working capital is calculated as current assets minus current liabilities. It is a derivation of working capital that is commonly used in valuation techniques such as discounted cash flows (DCFs). If current assets are less than current liabilities, an entity has a working capital deficiency, also called a working capital **deficit**. A rise in working capital typically shows that a business has either had a rise in current assets, or experienced a decrease in current liabilities - which could consist of paying down short-term liabilities.

Current assets and current liabilities include three accounts which are of special importance. These accounts represent the areas of the business where managers have the most direct impact: accounts receivable (current asset), inventories (current assets), and accounts payable (current liability). The current portion of debt (payable within 12 months) is critical because it represents a short-term claim to current assets and is often secured by long-term assets. Common types of short-term debt are bank loans and lines of credit.

On the surface, it can easily appear that a company has a ready supply of assets and overall profitability. However, if these assets are difficult to convert to cash, it can lead to complications. It is these types of decisions that make up the task of working capital management. These decisions help to manage a firm's short-term assets and short-term liabilities. The end goal is for the firm to be able to adequately satisfy short-term debt obligations and sustain its day-to-day operational expenses. This creates the need for effective management of a number of accounts, including inventory, cash, accounts receivable, and accounts payable.

TERMS TO KNOW

Fixed Assets

Assets and property that cannot easily be converted into cash. This can be compared with current assets, such as cash or bank accounts, which are described as liquid assets. In most cases, only tangible assets are referred to as fixed.

Deficit

The amount by which spending exceeds revenue.

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5. Liquidity

In accounting, **liquidity** is a measure of the ability of a debtor to pay his debts when they fall due. A standard company balance sheet has three parts: assets, liabilities and ownership equity. The main categories of assets are usually listed first, and typically in order of liquidity. Money, or cash, is the most liquid asset and can be used immediately to perform economic actions like buying, selling, or paying debt, and meeting immediate wants and needs. Next are cash equivalents, short-term investments, inventories, and prepaid expenses.

Liquidity also refers both to a business's ability to meet its payment obligations, in terms of possessing sufficient liquid assets and to such assets themselves. For assets themselves, liquidity is an asset's ability to be sold without causing a significant movement in the price and with minimum loss of value.

TERM TO KNOW

Liquidity

Availability of cash over short term: ability to service short-term debt.

6. Debt to Equity

The ratio known as debt to equity is used to indicate the relationship between instruments used to finance the assets of a company. It compares the degree to which both debt and equity are used for this purpose. The most efficient manner of deriving this information is through the firm's balance sheet.

Financial analysts and stock market quotes will generally not include other types of liabilities, such as accounts payable, although some will make adjustments to include or exclude certain items from the formal financial statements. Adjustments are sometimes also made, for example, to exclude intangible assets, and this will affect the formal equity; debt to equity (dequity) will therefore also be affected.

7. Market Value vs. Book Value

When considering the differences between book value and market value, it is important to keep in mind that the market value is the price that can be obtained in a competitive setting, such as an auction or live sale. Market value is also considered to be the price that an asset would be valued at, given a willing buyer and seller, engaging in a transaction without being compelled to do so.

Book value, otherwise thought of as accounting value, is the worth of an asset based on the original cost, less applicable depreciation, **amortization**, or impairment costs related to that asset.

The book value is different from market value, as it can be higher or lower depending on the asset in question and the accounting practices that affect book value, such as depreciation, amortization, and impairment. In many cases, the **carrying value** of an asset and its market value will differ greatly. If the asset is valued on the balance at market value, then its book value is equal to the market value.

Ways of measuring the value of assets on the balance sheet include historical cost, market value or lower of cost or market. Historical cost is typically the purchase price of the asset or the sum of certain costs expended to put the asset into use. Market value is the asset's worth if it were to be exchanged in the open market in an arm's length transaction; it can also be derived based on the asset's present value of the expected cash flows it will generate. Certain assets are disclosed at lower of cost or market in order to conform to accounting's conservatism principle, which stresses that assets should never be overstated.

Book value is the price paid for a particular asset, while market value is the price at which you could presently sell the same asset.

TERMS TO KNOW

Amortization

The distribution of the cost of an intangible asset, such as an intellectual property right, over the projected useful life of the asset.

Carrying Value

Also known as book value; the value of an asset according to its balance sheet account balance. For assets, the value is based on the original cost of the asset less any depreciation, amortization or impairment costs made against the asset.

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8. Limitations of the Balance Sheet

In financial accounting, a balance sheet or statement of financial position is a summary of the financial balances of a sole proprietorship, business partnership, corporation, or other business organization, such as an LLC or an LLP. Assets, liabilities, and ownership equity are listed as of a specific date, such as the end of its financial year. A balance sheet is often described as a “snapshot of a company’s financial condition.” Of the four basic financial statements, the balance sheet is the only statement which applies to a single point in time of a business’s calendar year. There are three primary limitations to balance sheets, including the fact that they are recorded at historical cost, the use of estimates, and the omission of valuable things, such as intelligence.

Fixed assets are shown in the balance sheet at historical cost less depreciation up to date. Depreciation affects the carrying value of an asset on the balance sheet. The historical cost will equal the carrying value only if there has been no change recorded in the value of the asset since acquisition. Therefore, the balance sheet does not show true value of assets. Historical cost is criticized for its inaccuracy since it may not reflect current market valuation.

Some of the current assets are valued on an estimated basis, so the balance sheet is not in a position to reflect the true financial position of the business. Intangible assets like goodwill are shown in the balance sheet at imaginary figures, which may bear no relationship to the market value. The International Accounting Standards Board (IASB) offers some guidance (IAS 38) as to how intangible assets should be accounted for in financial statements. In general, legal intangibles that are developed internally are not recognized, and legal intangibles that are purchased from third parties are recognized. Therefore, there is a disconnect–goodwill from acquisitions can be booked, since it is derived from a market or purchase valuation. However, similar internal spending cannot be booked, although it will be recognized by investors who compare a company’s market value with its book value.

Finally, the balance sheet cannot reflect those assets which cannot be expressed in monetary terms, such as skill, intelligence, honesty, and loyalty of workers.

SUMMARY

In this lesson, you learned about the financial information conveyed by **the balance sheet**. The balance sheet is divided into three parts: **Assets**, which is subdivided into **current assets** and **noncurrent** assets; **Liabilities**; and **Equity**. These three categories are related to one another through the accounting equation (assets is equal to liabilities plus owner’s equity). The balance sheet contains information about a company’s **working capital**, which is a representation of its **liquidity**, or its ability to pay off short-term debts. The balance sheet also provides information about a company’s **debt to equity ratio**, which compares how assets are financed and is useful to financial analysts.

As you have learned about financial statements in general, the balance sheet has limitations. For example, balance sheets reflect an asset's **book value rather than market value**. Other **limitations** include their use of estimated values, and their failure to account for certain intangible assets such as workforce loyalty.

Best of luck in your learning!

TERMS TO KNOW

Amortization
The distribution of the cost of an intangible asset, such as an intellectual property right, over the projected useful life of the asset.

Assets
Something or someone of any value; economic resources that represent value of ownership that can be converted into cash.

Balance Sheet
A summary of a person's or organization's assets, liabilities and equity as of a specific date.

Carrying Value
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