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Balance Sheet

In what terms does the balance sheet describe the financial condition of an organization?

The **balance sheet**, one of three financial statements generated from the accounting system, summarizes a firm's financial position at a specific point in time. It reports the resources of a company (assets), the company's obligations (liabilities), and the difference between what is owned (assets) and what is owed (liabilities), or owners' equity.

Balance sheets, like all financial statements, will have minor differences between organizations and industries. However, there are several "buckets" and line items that are almost always included in common balance sheets.

The assets are listed in order of their **liquidity**, the speed with which they can be converted to cash. The most liquid assets come first, and the least liquid are last. Because cash is the most liquid asset, it is listed first. Buildings, on the other hand, have to be sold to be converted to cash, so they are listed after cash. Liabilities are arranged similarly: liabilities due in the short term are listed before those due in the long term.

We briefly go through commonly found line items under Current Assets, Long-Term Assets, Current Liabilities, Long-term Liabilities, and Equity.

Current Assets

- **Cash and Equivalents**

The most liquid of all assets, cash, appears on the first line of the balance sheet. Cash Equivalents are also lumped under this line item and include assets that have short-term maturities under three months or assets that the company can liquidate on short notice, such as marketable securities. Companies will generally disclose what equivalents it includes in the footnotes to the balance sheet.

- **Accounts Receivable**

This account includes the balance of all sales revenue still on credit, net of any allowances for doubtful accounts (which generates a bad debt expense). As companies recover accounts receivables, this account decreases, and cash increases by the same amount.account

- **Inventory**

Inventory includes amounts for raw materials, work-in-progress goods, and finished goods. The company uses this account when it reports sales of goods, generally under cost of goods sold in the income statement.

Non-Current Assets

- **Plant, Property, and Equipment (PP&E)**

Property, Plant, and Equipment (also known as PP&E) capture the company's tangible fixed assets. The line item is noted net of accumulated depreciation. Some companies will class out their PP&E by the different types of assets, such as Land, Building, and various types of Equipment. All PP&E is depreciable except for Land.

- **Intangible Assets**

This line item includes all of the company's intangible fixed assets, which may or may not be identifiable. Identifiable intangible assets include patents, licenses, and secret formulas. Unidentifiable intangible assets include brand and goodwill.

Current Liabilities

- **Accounts Payable**

Accounts Payables, or AP, is the amount a company owes suppliers for items or services purchased on credit. As the company pays off its AP, it decreases along with an equal amount decrease to the cash account.

- **Current Debt/Notes Payable**

Includes non-AP obligations that are due within one year's time or within one operating cycle for the company (whichever is longest). Notes payable may also have a long-term version, which includes notes with a maturity of more than one year.

- **Current Portion of Long-Term Debt**

This account may or may not be lumped together with the above account, Current Debt. While they may seem similar, the current portion of long-term debt is specifically the portion due within this year of a piece of debt that has a maturity of more than one year. For example, if a company takes on a bank loan to be paid off in 5-years, this account will include the portion of that loan due in the next year.

Non-Current Liabilities

- **Bonds Payable**

This account includes the amortized amount of any bonds the company has issued.

- **Long-Term Debt**

This account includes the total amount of long-term debt (excluding the current portion, if that account is present under current liabilities). This account is derived from the debt schedule, which outlines all of the company's outstanding debt, the interest expense, and the principal repayment for every period.

Shareholders' Equity

- **Share Capital**

This is the value of funds that shareholders have invested in the company. When a company is first formed, shareholders will typically put in cash. For example, an investor starts a company and seeds it with \$10M. Cash (an asset) rises by \$10M, and Share Capital (an equity account) rises by \$10M, balancing out the balance sheet.

- **Retained Earnings**

This is the total amount of net income the company decides to keep. Every period, a company may pay out dividends from its net income. Any amount remaining (or exceeding) is added to (deducted from) retained earnings.

Importance of the Balance Sheet

The balance sheet is a very important financial statement for many reasons. It can be looked at on its own and in conjunction with other statements like the income statement and cash flow statement to get a full picture of a company's health.

Four important financial performance metrics include:

1. **Liquidity** – Comparing a company's current assets to its current liabilities provides a picture of liquidity. Current assets should be greater than current liabilities, so the

company can cover its short-term obligations. The Current Ratio and Quick Ratio are examples of liquidity financial metrics.

2. **Leverage** – Looking at how a company is financed indicates how much leverage it has, which in turn indicates how much financial risk the company is taking. Comparing debt to equity and debt to total capital are common ways of assessing leverage on the balance sheet.
3. **Efficiency** – By using the income statement in connection with the balance sheet, it's possible to assess how efficiently a company uses its assets. For example, dividing revenue by the average total assets produces the Asset Turnover Ratio to indicate how efficiently the company turns assets into revenue. Additionally, the working capital cycle shows how well a company manages its cash in the short term.
4. **Rates of Return** – The balance sheet can be used to evaluate how well a company generates returns. For example, dividing net income by shareholders' equity produces Return on Equity (ROE), and dividing net income by total assets produces Return on Assets (ROA), and dividing net income by debt plus equity results in Return on Invested Capital (ROIC).

❖ <u>Text Based Activities</u>

Exercise 01: **Short Answer Questions**

1. What are the three main components of a balance sheet?.
2. How are assets listed on the balance sheet, and why?.
3. What is the difference between **current** and **non-current** liabilities?
4. Give an example of an **intangible asset** and explain why it is intangible?
5. Why is the balance sheet important for assessing a company's financial health?

Exercise 02: Mark the following statements as **True (T)** or **False (F)** based on the text.

- Intangible assets include items like patents and goodwill.
- The balance sheet shows a company's financial performance over a period of time.
- Long-term liabilities are listed on the balance sheet before current liabilities.

- Retained earnings represent the total net income the company has distributed as dividends.
- The Quick Ratio and Current Ratio are examples of liquidity financial metrics.

Exercise 03: Fill in the blanks with the correct words from the box:

(assets, liabilities, liquidity, shareholders, inventory, cash, retained earnings)

1. The balance sheet reports a company’s ___________, ___________, and shareholders’ equity.
2. ___________ is the most liquid asset and appears first on the balance sheet..
3. ___________ includes raw materials, work-in-progress goods, and finished goods.
4. The ability of a company to meet its short-term obligations is called ___________.
5. ___________ represent the profits that the company has chosen not to distribute as dividends.