The Balance Sheet

Most people go to a doctor once a year to get a checkup—a snapshot of their physical well-being at a particular time. **Similarly**, companies prepare balance sheets as a way of summarizing their financial positions at a given point in time, usually at the end of the month, the quarter, or the fiscal year. **In effect**, the balance sheet describes the assets controlled by the business and how those assets are financed—with the funds of creditors (liabilities), with the capital of the owners, or with both. A balance sheet reflects the following basic accounting equation:

Assets = Liabilities + Owners' Equity

Assets in this equation are the things in which a company invests so that **it** can conduct business. **Examples** include cash and financial instruments, inventories of raw materials and finished goods, land, buildings, and equipment. Assets **also** include moneys owed to the company by customers and others—an asset category referred to as *accounts receivable*.

Now look at the other side of the equation, starting with liabilities. To acquire its necessary assets, a company often borrows money or promises to pay suppliers for various goods and services. Moneys owed to creditors are called *liabilities*. **For example**, a computer company may acquire $1 million worth of motherboards from an electronic parts supplier, with payment due in thirty days. In **doing so**, the computer company increases its inventory assets by $1 million and its liabilities—in the form of *accounts payable*—by an equal amount. The equation stays in balance. **Likewise**, if the same company were to borrow $100,000 from a bank, the cash infusion would increase its assets by $100,000 and its liabilities by the same amount.

Owners' equity, also known as shareholders' or stockholders' equity, is what is left over after total liabilities are deducted from total assets. **Thus**, a company that has $3 million in total assets and $2 million in liabilities would have owners' equity of $1 million.

Assets – Liabilities = Owners' Equity

$3,000,000 – $2,000,000 = $1,000,000

If $500,000 of this same company's uninsured assets burned up in fire, its liabilities would remain the same, but its owners' equity—what's left after all claims against assets are satisfied—would be reduced to $500,000:

Assets – Liabilities = Owners' Equity

$2,500,000 – $2,000,000 = $500,000

Thus, the balance sheet "balances" a company's assets and liabilities.

The balance sheet also describes how much the company has invested in assets, and where the money is invested. **Further**, the balance sheet indicates how much of those monetary investments in assets comes from creditors (liabilities) and how much comes from owners (equity). Analysis of the balance sheet can give you an idea of how efficiently a company is utilizing its assets and how well **it** is managing its liabilities.

Assets

The balance sheet **begins** by listing the assets most easily converted to cash: cash on hand, accounts receivable, inventory, and prepaid expenses. These are called *current assets*. Generally, current assets are those that can be converted into cash within one year.

Accounts Receivable is the money that is currently owed to a company by its customers. The reason why the customers owe money is that the product has been delivered but has not been paid for yet. Companies routinely buy goods and services from other companies using credit.

Inventory may be your largest current asset. On a balance sheet, the value of inventory is the cost to replace it. **If** your inventory were destroyed (lost or damaged)**,** how much would it cost you to replace or reproduce it? Inventory includes goods ready for sale, as well as raw material and partially completed products that will be for sale when they are completed.

But not all companies have inventories, particularly if they are involved in advertising, consulting, services or information industries.

Prepaid expenses are listed as a current asset because they represent an item or service that has been paid for but has not been used or consumed. An example of a prepaid expense is the last month of rent of a lease that you may have prepaid as a security deposit. **It** will be carried as an asset until it is used. Prepaid insurance premiums are another example of a prepaid expense.

Next, the balance sheet registers other assets that are tougher to convert to cash—for example, buildings and equipment. These are called plant assets, long-term assets, or, more commonly, *fixed assets* (because **it** is hard to change them into cash). Fixed assets are the assets that produce revenues. They are distinguished from current assets by their longevity. They are not for resale. Many small businesses may not own a large amount of fixed assets. **This** is because most small businesses are started with a minimum of capital. Of course, fixed assets will vary considerably and depend on the business type (such as service or manufacturing), size and market. Fixed assets include furniture and fixtures, motor vehicles, buildings, land, building improvements (or leasehold improvements, if you rent), production machinery, equipment and any other items with an expected business life that can be measured in years.

Since most fixed assets, except land, depreciate—or become less valuable—over time, the company must reduce the stated value of these fixed assets by something called accumulated depreciation. **In fact**, all fixed assets (except land) are shown on the balance sheet at original (or historic) cost less any depreciation. Depreciation subtracts a specified amount from the original purchase price for the wear and tear on the asset and is a conservative accounting practice to reduce the possibility of overvaluation. **It** is important to remember that the original cost of an asset may be more than **that** in the balance sheet because **it** can include shipping, installation, and any associated expenses necessary for adjusting the asset for service.

Some companies list *goodwill* among their assets. **If** a company has purchased another company for a price above the fair market value of its assets, that so-called goodwill is recorded as an asset. **This** is, however, strictly an accounting fiction. Goodwill may also represent intangible things such as brand names or the acquired company's excellent reputation. **These** may have real value. **So too** can other intangible assets, such as patents.

Finally, we come to the last line of the balance sheet, total assets. Total assets represents the sum of both current and fixed assets.

Liabilities and Owners' Equity

Now let's consider the claims against those assets, beginning with a category called current liabilities. *Current liabilities* represent the claims of creditors and others that typically must be paid within a year; they include short-term debts, notes payable to banks (or others), accrued expenses (such as wages and salaries), taxes payable, the current due within one year portion of long-term debt, and accounts payable.

Long-term liabilities are any debts that must be repaid by your business more than one year from the date of the balance sheet. **These** are normally loans from banks or other financial institutions that are secured by various assets on the balance sheet, such as inventories. They are typically bonds and mortgages—debts that the company is contractually obliged to repay, with respect to both interest and principal.

According to the aforementioned accounting equation, total assets must equal total liabilities plus owners' equity. **Thus**, subtracting total liabilities from total assets, the balance sheet arrives at a figure for the owners' equity. Owners' equity comprises *retained earnings* (net profits that accumulate on a company's balance sheet after any dividends are paid) and contributed capital (capital received in exchange for shares).