Business Insights

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BALANCE SHEETS 101: WHAT GOES ON A BALANCE SHEET?

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A balance sheet is one of the primary statements used to determine the net worth of a company and get a quick overview of its financial health. The ability to read and understand a balance sheet is a crucial skill for anyone involved in business, but it's one that many people lack.

WHAT IS A BALANCE SHEET?

A **balance sheet** provides a snapshot of a company's financial performance at a given point in time. This financial statement is used both internally and externally to determine the so-called "book value" of the company, or its overall worth.

Balance sheets are typically prepared and distributed monthly or quarterly depending on the governing laws and company policies. Additionally, the balance sheet may be prepared according to GAAP or IFRS standards based on the region in which the company is located.

The balance sheet is just a more detailed version of the fundamental accounting equation—also known as the balance sheet formula—which includes **assets**, **liabilities**, and **shareholders' equity**.

THE BALANCE SHEET EQUATION

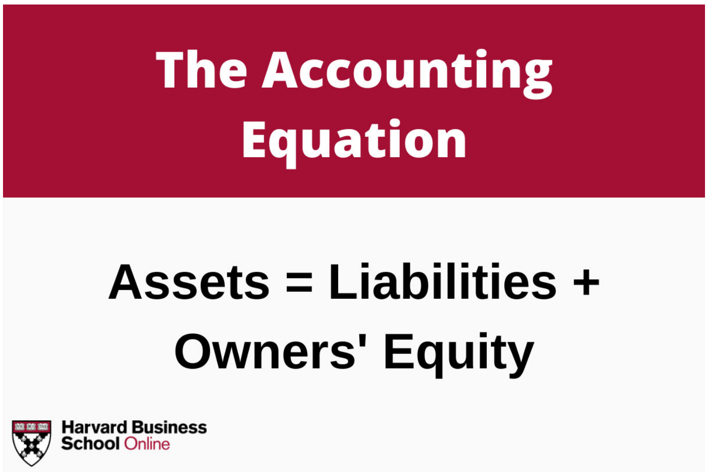
Balance sheets are typically organized according to the following formula:

Assets = Liabilities + Owners' Equity

The formula can also be rearranged like so:

Owners' Equity = Liabilities - Assets or **Liabilities = Assets - Owners' Equity**

A balance sheet must *always* balance; therefore, this equation should always be true.



You've probably heard at least some of these terms before. But what do they actually mean and include? Let's break it down. Below, we'll explore what exactly goes on a balance sheet.

WHAT GOES ON A BALANCE SHEET?

1. Assets

The assets are the operational side of the company. Basically, a list of what the company *owns*. Everything listed is an item that the company has control over and can use to run the business.

The left side of the balance sheet is the business itself, including the buildings, inventory for sale, and cash from selling goods. If you were to take a clipboard and record everything you found in a company, you would end up with a list that looks remarkably like the left side of the balance sheet. The assets are what allow the company to run.

Assets can be further categorized as either current assets or fixed (non-current) assets. Some of the most common **current** assets include:

- Cash and cash equivalents
- Accounts receivable
- Short-term marketable securities
- Inventory

Common **fixed or non-current assets** include:

- Property and equipment
- Long-term marketable securities
- Intangible assets such as patents, licenses, and goodwill

Assets will typically be presented as individual line items, such as the examples above. Then, current and fixed assets are subtotaled and finally totaled together.

2. Liabilities

Liabilities and equity make up the right side of the balance sheet and cover the financial side of the company. This is a list of what the company owes. With liabilities, this is obvious—you owe loans to a bank, or repayment of bonds to holders of debt. The interest rates are fixed and the amounts owed are clear. Liabilities are listed at the top of the balance sheet because, in case of bankruptcy, they are paid back first before any other funds are given out.

Similar to assets, liabilities are categorized as current and non-current liabilities. Common **current liabilities** include:

- Accounts payable
- Salaries and wages payable
- Deferred revenue
- Commercial paper
- Accrued expenses

- Short-term debt

Non-current liabilities include:

- Deferred revenue
- Long-term debt
- Long-term lease obligations

Liabilities are presented as line items, subtotaled, and totaled on the balance sheet.

3. Equity

Below liabilities on the balance sheet is equity, or the amount owed to the owners of the company. Since they own the company, this amount is intuitively based on the accounting equation—whatever assets are left over after the liabilities have been accounted for must be owned by the owners, by equity. These are listed at the bottom of the balance sheet because the owners are paid back after all liabilities have been paid.

Unlike liabilities, equity is not a fixed amount with a fixed interest rate. Any time the value of assets change—perhaps you receive more in cash from a sale than the value of the inventory you sold, or you were forced to write down a truck that was involved in a collision and no longer works—the value of equity changes.

Because the value of liabilities is constant, all changes to assets must be reflected with a change in equity. This is also why all revenue and expense accounts are equity accounts, because they represent changes to the value of assets.

Common line items in the **equity** section of the balance sheet include:

- Common stock
- Preferred stock
- Treasury stock
- Retained earnings

Together, these line items make up total shareholders' equity.

To recap, you'll find the assets (what's owned) on the left of the balance sheet, liabilities (what's owed) and equity (the owners' share) on the right, and the two sides remain balanced by adjusting the value of equity.

THE LANGUAGE OF BUSINESS

It's commonly held that accounting is the language of business. Understanding and analyzing key financial statements like the balance sheet, income statement, and cash flow statement is critical to painting a clear picture of a business's past, present, and future performance. Knowing what goes into preparing these documents can also be insightful.

On a more granular level, the fundamentals of financial accounting can shed light on the performance of individual departments, teams, and projects. Whether you're looking to understand your company's balance sheet or create one yourself, the information you'll glean from doing so can help you make better business decisions in the long run.

Want to learn more about what's behind the numbers on financial statements? Explore our eight-week online course Financial Accounting to learn the key financial concepts you need to understand business performance and potential.

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About the Author

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