How do you read and understand a balance sheet?
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Reading and understanding a Balance Sheet AKA Statement of Financial Position - Practicing level

A Balance Sheet (also known as the Statement of Financial Position) is a financial report that is supplied to the internal and external stakeholders of the business. The Balance Sheet helps stakeholders determine the company's financial strength. The Balance Sheet presents the financial status of a company at a specific point in time.

The Balance Sheet

The Balance Sheet Basics

A typical Balance Sheet will looks like this:

XYZ Company
Balance Sheet
As at 30 June 2010

Current Assets		
Cash at bank	30,000	
Inventory	250,000	
Debtors	75,000	
Total current assets		355,000
Non - Current Assets		
Buildings	550,000	
Plant & equipment	250,000	
Vehicles	120,000	
Total non-current assets		920,000
Total Assets		**1,275,000**
Current Liabilities		
Credit cards	15,000	
Creditors	110,000	
Tax Payable	25,000	
Total current liabilities		150,000
Non-current Liabilities		
Long term loans		700,000
Total Liabilities		**850,000**
Owners Equity		
Capital	100,000	
Retained earnings	250,000	
Current earnings	75,000	
Total Owners Equity		**425,000**

The Balance Sheet is a financial statement or report that (1) itemizes the things of value that the Company owns/controls (Assets) while (2) listing the entities who have legal claims over those assets. These claims are made by two groups (1) the external funding entities (Liabilities) and (2) the internal investors (Owners equity).

It is called a Balance Sheet (Statement of Financial Position) because the total value of the Assets will always equal the total value of the Liabilities and the Owners Equity combined. In the the example above we see that ... Assets 1,275,000 = Liabilities 850,000 + Owners Equity 425,000. This formula is known as the accounting equation. The assets and liabilities listed on the Balance Sheet are further subdivided as current and non-current. This separation helps stakeholders understand the expected time frames of these amounts. Debts that are due within the next 12 months are categorized as current liabilities. Also assets that can be readily converted into cash (usually within the next 12 months) are categorized as current assets. All other assets and liabilities as categorized as non-current.

The total amount of the Owners Equity is also known as the Net Worth of the company. Net Worth is the amount of money that would be left over if all the Assets were sold at Balance Sheet values and the external funders (Liabilities) were paid out in full. Total Owners Equity is the first and obvious read of a Balance Sheet in relation to the company's financial strength. Total Owners Equity quantifies how much the business is worth from an accounting point of view. *Note: an accounting point of view does not take into account any value for future profit potential. The accounting point of view also values assets at the time of purchase not at what they might be worth today.* Owners Equity is typically made up of the shareholders/owners initial and additional investments (Capital), the profits from previous periods that have not yet been distributed to the shareholders/owners (Retained Earnings) and the profits earned from the current trading period (Current Earnings).

Financial ratios

Understanding the financial strength of a business from reading a balance sheet generally requires a certain amount of analysis and comparison. It also requires access to the other financial report, the Income Statement (also known as the Statement of Financial Performance).

This analysis of the Balance Sheet is called the Financial Ratio and Trend analysis. By comparing this period's calculated financial ratios with prior periods, industry benchmarks and generally accepted sound operating levels, allows you to identify healthy/unhealthy trends in the financial strength of the company. Calculating and comparing financial ratios helps stakeholders determine whether :

- the returns from the business are competitive with other investment options
- the company is becoming more or less profitable
- the company is becoming more or less dependent on external funders,
- the company is becoming better or less able to meet its financial obligations when they become due or more or less efficient at managing the assets of the company.

There are many different types of financial ratios but they are generally collated into 4 groups:

1. Leverage Ratios - These ratios calculate the extent to which the company uses external debt in its capital structure rather than use equity funders. An over reliance on external debt makes a company's profitability vulnerable to interest rate raises. Over reliance on external debt also makes the company more vulnerable to liquidation actions by creditors and financial institutions during an economic downturn. The most common leverage ratio is the debt to equity ratio. Using the example above, the debt-to-equity ratio would be ... Total Debt 850,000 / Total Owners Equity 425,000 = 2.0 i.e. for every $1 that the owners have invested in the business, external funders have committed $2. This company would generally be considered highly geared or leveraged.
2. Liquidity/Solvency Ratios - These ratios calculate the company's ability to pay its debts as they become due. Some companies might be profitable but yet unable to pay critical payments like staff, loan repayments or rent because their money is tied up in debtors (money owned to the company by customers) or in inventory. The most common Liquidity/Solvency Ratio is the Quick ratio. Using the example above the Quick Ratio would be ... (Current assets 355,000 - Inventory $250,000) / Current Liabilities 150,000 = 0.70 i.e. for every $1 due for payment in the next month or so, the company has $0.70 in liquid (cash or soon to be cash) assets. Generally a Quick ratio of 1.00 is considered a safe operating ratio.
3. Operational Ratios - These ratios calculate the efficiency of a company's management in its operations and in its use of assets. Typical ratio efficiencies deal with stock turn and debtor days. Stock turn measures the optimum amount of stock required to achieve sales targets. Debtor days measures how many

days it takes for the company to get paid by its customers. Generally you would not want to over-stock and you would want your debtors to pay in the shortest possible time.

4. Profitability Ratios - These ratios calculate the profitable return on sales and capital tied up in the business. These ratios are usually expressed as a % and monitored over time consecutive periods to help identify healthy/unhealthy trends. Typical profitability ratios are Gross Profit as a % of sales, Net Profit as a % of sales, Net Profit as a % of Assets, Net Profit as a % of Owners Equity. Using the example above, Net Profit as a % of Assets would be ... Current earnings $75,000 / Total Assets 1,275,000 = 5.9% and Net Profit as a % of Owners Equity would be ... Current earnings $75,000 / Total Owners Equity 425,000 = 17.6%. i.e. if competing investment opportunities provide a lower return than these %, then the investment in this business remains worthwhile.

Summary - the Balance Sheet:

In summary, by comparing these Balance Sheet report ratios with prior periods, commonly agreed safe operating levels and industry benchmarks helps you understand the changing financial strength/health of the company.