

## 9.1: Introduction to Balance Sheets

### What you'll learn to do: Explain how a balance sheet is used to evaluate an asset management path

The balance sheet shows a financial picture of what a business is worth at a particular point in time—usually the end of a month. It is not the same thing as an income statement, which provides a snapshot of a company's financial performance over a specified period of time. Instead, the balance sheet shows the culmination of financial performance, including how much the company owns (assets), how much the company owes (liabilities), and the value of the firm (owner's equity or assets – liabilities)

The accounting equation defines the balance sheet:

$$\text{text{assets}} = \text{text{liabilities}} + \text{text{owner's equity}}$$

Think of it this way. There are two sides to a ledger, which must remain balanced or completely equal to one another.

On the left side of the ledger are the company's assets, including cash, accounts receivable (outstanding bills that customers will pay), inventory, facilities, and equipment. These reflect elements of the asset management path, the economic resources owned by a company, such as inventory, buildings, and plant and equipment, in addition to cash and accounts receivables.

On the right side of the ledger are the company's liabilities or things that it owes, encompassing accounts payable (bills it needs to pay for its vendors), wages payable (salaries and benefits that are owed to employees), long-term notes (outstanding loans against which the company is making payments), and more.

These are neither good nor bad; they just are. Because we're looking at the business at a moment in time, we see activity of the firm. Some of that activity means that they have outstanding liabilities or money they owe creditors. For example, if we looked at the balance sheet on payday, wages payable would be \$0.00 because wages had been paid and the next pay period had not yet begun.

But, if this is true, if liabilities and assets can change depending upon the time period, how can we be sure that the left side of the ledger (assets) will always balance with the right side of the ledger (liabilities)? Easy: owners' equity.

Owner's equity simply means the value the owners could extract from the company. Think about it this way. If a firm had \$100 in assets and \$50 in liabilities, what amount could the owners extract from the business if they closed it today? Well, they would use the \$100 in assets to cover the \$50 in liabilities, leaving \$50 in owner's equity. Then, they'd share the \$50 as the proceeds of having managed and run the business.

But, what if part of the liabilities had been \$10 of wages payable and they were paid? How would that change the balance sheet? Well, likely this would mean cash, an asset used to pay wages, decreased by \$10 and wages payable, a liability, decreased by \$10. So, assets would equal \$90, liabilities would equal \$40 and owner's equity would still be \$50.

Owner's equity is positioned on the right side of the ledger because it reflects value that can be drawn out of the company. Think of it this way. An owner (or a shareholder) can happily keep their money invested in the company. But, on some date, they may decide that they have another use for the funds. When this occurs, the firm will need to convert some assets to pay off that owner or shareholder.

So, a firm's value is always expressed by the balance sheet, where assets = liabilities and owner's equity. Here is a sample balance sheet, though it doesn't have a right-side/left-side orientation. However, you will see that assets do equal liabilities + owner's equity:

ZYX Retailer	
Balance Sheet	
December 31, 2019	
ASSETS	
Current Assets	
Cash	\$ 10,900
Accounts Receivable	\$ 40,200

Inventory	\$ 98,000
Prepaid Expenses	\$ 2,000
<b>Total Current Assets</b>	<b>\$ 151,100</b>
<b>Fixed Assets</b>	
Buildings	\$ 180,000
Equipment	\$ 201,000
<b>Total Fixed Assets</b>	<b>\$ 381,000</b>
<b>TOTAL ASSETS (\$151,100 + \$381,100)</b>	<b>\$ 532,100</b>
<b>LIABILITIES</b>	
<b>Current Liabilities</b>	
Accounts Payable	\$ 38,500
Wages Payable	\$ 8,800
Short-term Notes Payable	\$ 1,100
<b>Total Current Liabilities</b>	<b>\$ 48,400</b>
<b>Long-term Liabilities</b>	
Long-term Notes Payable	\$ 25,000
Total Long-term Liabilities	\$ 25,000
<b>TOTAL LIABILITIES (\$48,400 + \$25,000)</b>	<b>\$ 73,400</b>
<b>OWNER'S EQUITY</b>	
Common Stock	
Retained Earnings	\$ 360,000
Total Stockholders' Equity	\$ 98,700
<b>TOTAL EQUITY (\$360,000 + 98,700)</b>	<b>\$ 458,700</b>
<b>TOTAL LIABILITIES &amp; OWNER'S EQUITY</b>	<b>\$ 532,100</b>

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