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Introduction to the Balance Sheet

Current and Non-Current Categories Can Reveal a Business's Health

The balance sheet lists assets, equal to liabilities and shareholders' equity, or A = L + SE. Within the balance sheet, assets and liabilities are categorized into current and non-current amounts. Current assets are those expected to be converted into cash within one year and current liabilities are those expected to be settled (paid in cash) within one year. Non-current assets and non-current liabilities are not expected to be converted into cash or settled with cash within one year. The current and non-current categories are important to investors because they indicate how a business is structured to generate cash. Healthy businesses generate lots of cash that is either reinvested to grow the business, or used to pay interest and dividends to investors. Figure 1 illustrates a balance sheet with current categories.

ABC Corp Statement of Financial Position (Balance Sheet) As of December 31, 2016			
Assets		Liabilities	
Current Assets		Current Liabilities	
Cash	$10	Accounts Payable	$4
Accounts Receivable	6	Accrued Liabilities	5
Inventory	18	Total Current Liabilities	9
Total Current Assets	34		
		Note Payable to Bank	22
Plant and Equipment	25	Bonds Payable	28
Patents	12	Total Liabilities	59
		Shareholders' Equity	
		Various shareholders' equity accounts	12
Total Assets	$71	Total Liabilities and Shareholders' Equity	$71

For many entities, current assets include cash, along with accounts receivable, inventory and other current assets, such as marketable securities (investments in shares of stock and bonds of other entities) that are expected to be sold for cash within a year. Accounts receivable are amounts owed to the entity by its customers. They are typically settled in a relatively short period of time (30-90 days). Accounts receivable exist because many businesses choose not to require customers to pay immediately for every item purchased. Instead businesses keep track of all sales orders from customers for a period of time (a month perhaps) then send one invoice to each customer for that month's orders. This process works well for businesses that sell to

customers repeatedly because it saves transaction costs and work. Inventory is another current asset because businesses expect to sell their inventory within one year.

Current liabilities typically include accounts payable, accrued liabilities and other current liabilities such as income tax payable, salaries payable or deferred revenue (advance payments from customers to buy products and services). Accounts payable are amounts owed by an entity to its suppliers. Accrued liabilities are amounts owed by an entity for various services, such as electricity, water, security, repairs and maintenance. Salaries payable include salaries and wages owed to employees that will be paid in the near future. Occasionally, customers pay for products and services before receiving them. Advance payments by customers, termed deferred revenues, are a liability to the entity because the entity owes the customer the product or service paid for.

Non-current assets include buildings, manufacturing facilities (plants), land, patents expected to be useful for more than one year, investments in other entities that are expected to be held for more than one year, etc. Non-current liabilities include loans, bonds payable and notes payable that will be settled more than a year in the future. Non-current liabilities also include amounts to pay for lawsuit settlements, environmental cleanups, etc.

Reporter's Takeaway

- For current assets such as inventory and accounts receivable, compare balances to prior accounting periods, asking whether balances are growing or shrinking at a healthy rate. If a retailer builds up excessive inventory, it may signal problems with sales and cash generation. Likewise, if a retailer's products are always on back-order, inventory levels may be too low, hurting the business.
- A similar comparison of accounts payable and accrued liabilities balances to prior accounting periods may highlight changes in business performance.
- A long-standing rule of thumb is that current assets two times the size of current liabilities indicates a healthy relationship.
- Another rule of thumb is that non-current assets should be funded primarily with non-current liabilities. A simple comparison of non-current asset and liability balances could highlight potential insights into financing strategies and risks.