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HOW THEY
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How to Analyze a Balance Sheet

A guide to understanding a company's financial health



App Economy Insights

Jan 13

73

14

Hello there!

Greetings from San Francisco!

Welcome to the new members who have joined us this week!

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Several community members have requested an explainer on basic financial terms.

So we launched a recurring series called **How To Analyze**.

You can return to these articles when you are unsure about specific financial concepts or want a refresher. Over time, I'll cover more complex topics and explain them in plain English.

Welcome to the second article of our three-part mini-series on the three primary financial statements that every business owner or investor should know:

- **Income statement (Profit & Loss):** shows a company's revenue and expenses over a specific period, resulting in a net profit or loss.
- **Balance sheet:** shows a company's assets, liabilities, and equity at a specific point in time. It's a snapshot at the end of a period.

• **Cash flow statement:** shows how a company's activities have affected its cash position over a specific period.



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In this series, we'll break down each financial statement and explain what they're all about. We'll use examples and illustrations to ensure you don't fall asleep at the wheel.

You can find other articles in this series on our website:

- [How to Analyze an Income Statement.](#)
- [How to Analyze a Cash flow Statement.](#)

Introduction to the balance sheet

A balance sheet is a snapshot of a company's financial health *at a specific point in time*. The income and cash flow statements show what happened over the entire period analyzed (for example, from January 1st to December 31st). Meanwhile, the balance sheet shows where things are at the very end of the period (for a calendar year, it would show the numbers as of December 31st).

The balance sheet provides valuable information about a company's assets, liabilities, and equity. By analyzing a balance sheet, you can gain a better understanding of a company's ability to pay its debts, grow its business, and return profits to its shareholders.

Whether you're a small business owner, an investor, or someone who wants to learn more about personal finance, understanding how to read and analyze a balance sheet is essential.

We'll go over all the important stuff you need to know:

1. **What's included in a balance sheet:** assets, liabilities, shareholder's equity.
2. **Key ratios:** Current ratio, acid-test, debt-to-equity, assets turnover.
3. **Types of analysis:** Traits to look for, trends, and comparisons.

So grab a cup of coffee (or whatever your drink of choice is), and let's get started!

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1) What's included in a balance sheet

A balance sheet is a financial statement showing a company's assets, liabilities, and shareholders' equity at a specific point in time. It's called a "balance sheet" because the assets must equal the liabilities plus the shareholders' equity; in other words, it must balance.

The basic equation for a balance sheet is:

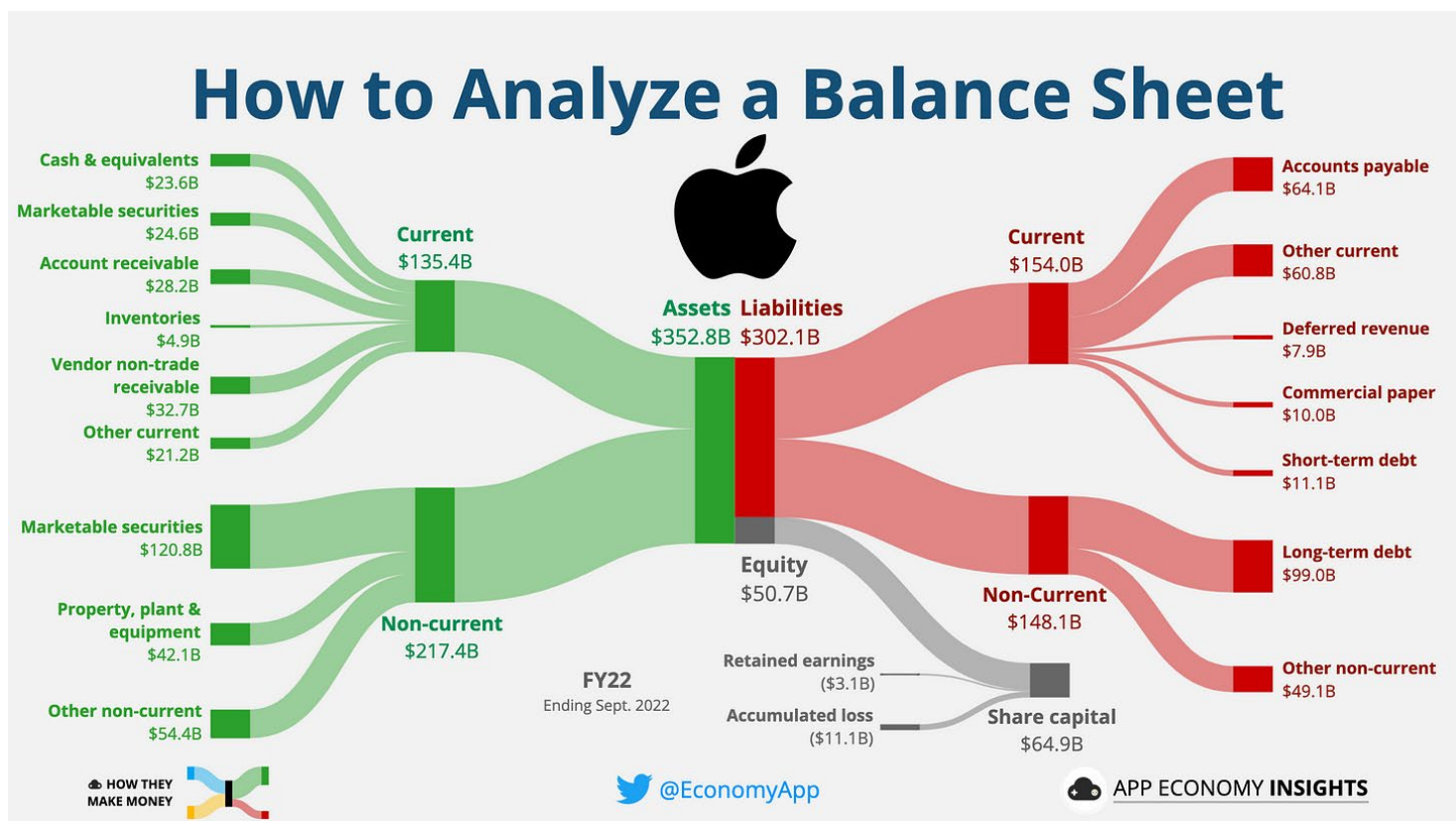
$$\text{Assets} = \text{Liabilities} + \text{Shareholders' Equity}$$

Let's break down each component of a balance sheet:

- **Assets:** Anything that a company owns.
- **Liabilities:** Anything that a company owes.
- **Shareholders' Equity:** A company's value after all liabilities are paid off (whatever is left after you subtract liabilities from assets).

Simple, right?

I love using visuals to help us digest financial statements. So as an example, let's use the largest company in the world, [Apple \(AAPL\)](#), using their balance sheet at the end of September 2022, which was the end of their fiscal year 2022 or "FY22."



Apple September FY22 balance sheet - Chart by App Economy Insights

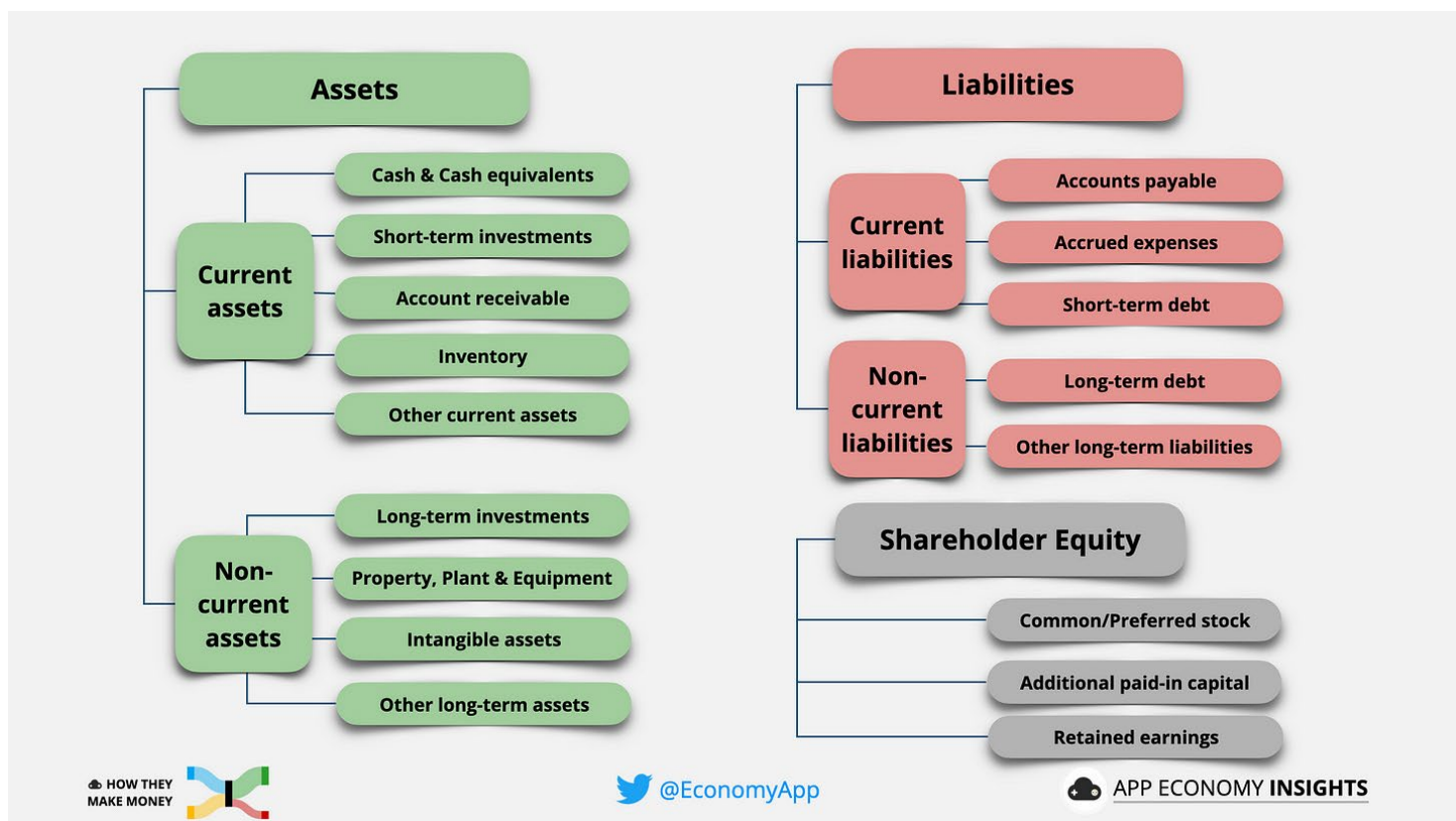
- **Assets:** In green, I'm showing assets. They can be divided into two categories:
 - **Current assets** (assets that can be converted to cash within one year). Examples of current assets include cash, accounts receivable, and inventory.
 - **Non-current assets** (assets that will take over one year to convert to cash). Examples include fixed assets like property, plant, and equipment.

- **Liabilities:** In red, I'm showing liabilities. They can be divided into two categories:
 - **Current liabilities** (liabilities that must be paid within one year). Examples include accounts payable, wages payable, and taxes payable.
 - **Non-current liabilities** (liabilities that will take over one year to pay off). Examples of long-term liabilities include loans and mortgages.

- **Equity:** In grey, I'm showing equity. It can be further divided into categories: common stock, preferred stock, and retained earnings. Equity is also known as net assets or shareholders' equity.

As you can see from the visual of Apple's balance sheet, the total assets equal \$352.8 billion, and the total liabilities and equity equal \$352.8 billion (\$302.1 billion and \$50.7 billion). The balance sheet is balanced!

Here is the structure of a standard balance sheet:



Balance sheet structure by App Economy Insights

Note that management can adjust the exact terms and classification, so every balance sheet is somewhat unique. When in doubt, it's best to look at the company's filings on its investor relations website for definitions.

Now that we've covered the basics of a balance sheet, we will dive deeper into what is included in assets, liabilities, and equity in the following sections.

Assets

Assets are economic resources that are expected to provide future economic benefits.

They are the resources controlled by a company as a result of past transactions or events and from which future economic benefits are expected to flow.

They are either tangible (physical) or intangible (not physical) and are classified as current or non-current:

- **Current assets:**
 - **Cash and cash equivalents:** Cash on hand, cash in the bank, and other short-term investments that can be easily converted to cash.
 - **Accounts receivable:** Money owed to the company by its customers for goods or services that have been sold but not yet paid for.
 - **Inventory:** Raw materials, work-in-progress, and finished goods that the company holds for sale.
 - **Prepaid expenses:** Expenses paid in advance, such as rent or insurance.
- **Non-current assets:**
 - **Fixed assets:** Assets used in the company's operations over a long period, such as property, plant, and equipment. They are depreciated over time (see Depreciation in our income statement review).

- **Long-term investments:** Investments in other companies or assets the company plans to hold for a significant period, such as stocks and bonds.
- **Intangible assets:** Assets that have no physical form, such as patents, trademarks, and goodwill (value attributed to reputation, brand, and customer base, and premium paid for acquisitions). They are amortized over time (see Amortization in our income statement review).

Overall, assets give us a sense of a company's economic resources, liquidity, and ability to generate future income.

Liabilities

Liabilities are obligations of an entity that arise from past transactions or events, the settlement of which is expected to result in an outflow.

They are a company's debts and other financial obligations, representing the money that a company owes to others.

They are classified as current or non-current:

- **Current liabilities:**
 - **Accounts payable:** Money owed to suppliers for goods or services received but not yet paid for.
 - **Accrued expenses:** Expenses that have been incurred but not yet paid for, such as wages and taxes.
 - **Short-term debt:** Loans and debts due to be paid within the next year.
- **Non-current liabilities:**
 - **Long-term debt:** Loans and debts due to be paid after one year or more.
 - **Deferred revenue:** Money received before providing goods or services. As a result, the money is owed to the customers until the product is delivered or the services rendered.
 - **Pension liabilities:** Obligations of the company to fund its employees' pensions.
 - **Other long-term liabilities:** Lease obligations, taxes, and other obligations the company expects to pay in the future.

Overall, liabilities represent the debts and other obligations of the company, showing how much money the company owes and to whom. They give us a sense of the company's financial obligations, solvency, and ability to meet its financial obligations over time.

Shareholders Equity

Equity represents the residual interest in an entity's assets after deducting all liabilities. Going back to our balance sheet equation:

$$\text{Shareholders Equity} = \text{Assets} - \text{Liabilities}$$

A great analogy is home equity. Let's say you make a \$20,000 down payment for a house worth \$100,000:

- You own a house worth \$100,000 (fixed asset)
- You owe the bank \$80,000 (mortgage, which is a long-term liability).

So your home equity is $[\$100,000 - \$80,000] = \$20,000$. It makes sense since it's your contribution toward the house so far.

Equity represents the portion of the company's assets that the shareholders own.

It can be broken down into several components:

- **Share capital:** The money that shareholders have invested in the company by purchasing shares of stock.
- **Retained earnings:** The profits that the company has earned but has not distributed to shareholders through buybacks or dividends yet.
- **Treasury stock:** The shares of stock that the company has repurchased from shareholders (negative).
- **Reserve account:** This includes the reserves created by the company for specific purposes (for example, for future legal costs).

Equity represents the company's net worth, and it's what would remain if the company were to pay off all of its liabilities. It gives us a sense of the company's net worth, profitability, and ability to generate future income.

To wrap up this section, here is an example of what a balance sheet looks like when you open an annual (10-K) or quarterly report (10-Q). This is Apple's quarter ending September 2022. It also includes the balance sheet at the end of September 2021.

Apple Inc.

CONSOLIDATED BALANCE SHEETS

(In millions, except number of shares which are reflected in thousands and par value)

	<u>September 24, 2022</u>	<u>September 25, 2021</u>
ASSETS:		
Current assets:		
Cash and cash equivalents	\$ 23,646	\$ 34,940
Marketable securities	24,658	27,699
Accounts receivable, net	28,184	26,278
Inventories	4,946	6,580
Vendor non-trade receivables	32,748	25,228
Other current assets	21,223	14,111
Total current assets	135,405	134,836
Non-current assets:		
Marketable securities	120,805	127,877
Property, plant and equipment, net	42,117	39,440
Other non-current assets	54,428	48,849
Total non-current assets	217,350	216,166
Total assets	\$ 352,755	\$ 351,002
LIABILITIES AND SHAREHOLDERS' EQUITY:		
Current liabilities:		
Accounts payable	\$ 64,115	\$ 54,763
Other current liabilities	60,845	47,493
Deferred revenue	7,912	7,612
Commercial paper	9,982	6,000
Term debt	11,128	9,613
Total current liabilities	153,982	125,481
Non-current liabilities:		
Term debt	98,959	109,106
Other non-current liabilities	49,142	53,325
Total non-current liabilities	148,101	162,431
Total liabilities	302,083	287,912
Commitments and contingencies		
Shareholders' equity:		
Common stock and additional paid-in capital, \$0.00001 par value: 50,400,000 shares authorized; 15,943,425 and 16,426,786 shares issued and outstanding, respectively	64,849	57,365
Retained earnings/(Accumulated deficit)	(3,068)	5,562
Accumulated other comprehensive income/(loss)	(11,109)	163
Total shareholders' equity	50,672	63,090
Total liabilities and shareholders' equity	\$ 352,755	\$ 351,002

Apple Balance Sheet at the end of September 2022 (FY22)

2) Key ratios

Okay, let's move on to the key ratios to review when you analyze a balance sheet.

Several key financial ratios can be used to analyze a company's balance sheet and understand its overall financial health, including:

- **Current Ratio:** This ratio measures a company's liquidity by comparing its current assets to its current liabilities. It is calculated by dividing current assets by current liabilities. Anything around 1 is considered healthy. The higher, the better.

$$\text{Current Ratio} = \text{Current assets} / \text{Current liabilities}$$

- **Acid-Test or Quick Ratio:** This ratio measures a company's liquidity by considering only the most liquid current assets. It is calculated by subtracting inventory from current assets and dividing the result by current liabilities. Anything around 1 is considered healthy. The higher, the better.

$$\text{Quick Ratio} =$$

$$[\text{Cash} + \text{Short-term investments} + \text{Accounts receivable}] / \text{Current liabilities}$$

- **Debt-to-Equity Ratio:** This ratio measures a company's solvency by comparing its total liabilities to its total equity. It is calculated by dividing total liabilities by total equity. A lower ratio indicates that a company is less leveraged and more able to pay off its debts. Anything around 1 is considered healthy. The lower, the better.

$$\text{Debt-to-equity Ratio} = \text{Liability} / \text{Equity}$$

- **Return on Assets (ROA):** This ratio measures a company's profitability by comparing its net income to its total assets. It is calculated by dividing net income by total assets. A higher ratio indicates that a company's assets are used more efficiently to generate profits. Generally, the higher, the better. However, what is considered good or not ultimately depends on the industry and the company. For example, utility companies have a lower ROA than technology companies.

$$\text{Return on Assets} = \text{Net Income} / \text{Assets}$$

- **Return on Equity (ROE):** This ratio measures a company's ability to generate profit in relation to its shareholders' equity. It is calculated by dividing net income by shareholders' equity and is used to evaluate a company's profitability and management efficiency using invested capital. A high ROE indicates that a company is generating a high return on the equity invested by shareholders. At the same time, a low ROE suggests the company is not generating an acceptable return. It's essential to compare the ROE ratio to the industry average and the company's historical data to understand its performance better. Note that a high ROE can also indicate too much leverage.

$$\text{Return on Equity} = \text{Net income} / \text{Shareholder's Equity}$$

- **Asset Turnover Ratio:** This ratio measures a company's efficiency by dividing sales by total assets (the average of a specific period's beginning and ending assets). A higher ratio indicates that a company effectively uses its assets to generate sales. The higher, the better. However, what is considered good or not ultimately depends on the industry. For example, retail companies have a higher asset turnover ratio than utility companies.

$$\text{Asset Turnover Ratio} = \text{Sales} / \text{Assets}$$

- **Interest Coverage Ratio:** This ratio is calculated by dividing earnings before interest and taxes (EBIT) by interest expenses. A higher ratio indicates that a company earns more than enough to cover its interest expenses. While this ratio is based on amounts available in the income statement, it gives us a view of a company's financial health and solvency. The higher, the better, as it indicates that a company is generating enough income to cover its interest expenses and that it is less likely to default on its debt.

$$\text{Interest Coverage Ratio} = \text{EBIT} / \text{Interest expenses}$$

- **Goodwill to Assets Ratio:** This ratio helps to evaluate the proportion of a company's assets that are represented by goodwill. Goodwill is an intangible asset that arises when a company acquires another company and pays more than the fair market value of its net assets. It is an indicator of the premium paid for a company's reputation, brand, and customer relationships. A high ratio indicates that a significant portion of a company's assets are represented by goodwill, suggesting that the company paid a high premium for the acquired assets or is growing primarily through acquisition. However, a high ratio is not necessarily bad, as it may reflect that a company has paid a premium for valuable intangible assets that will generate future income.

$$\text{Goodwill to Assets Ratio} = \text{Goodwill} / \text{Assets}$$

3) Types of analysis

Now that we've covered the basics of a balance sheet and the various tools and techniques used to analyze a company's assets, liabilities, and equity, let's put it all together and learn how to interpret a balance sheet.

The traits to look for

When interpreting a balance sheet, it's essential to consider the following:

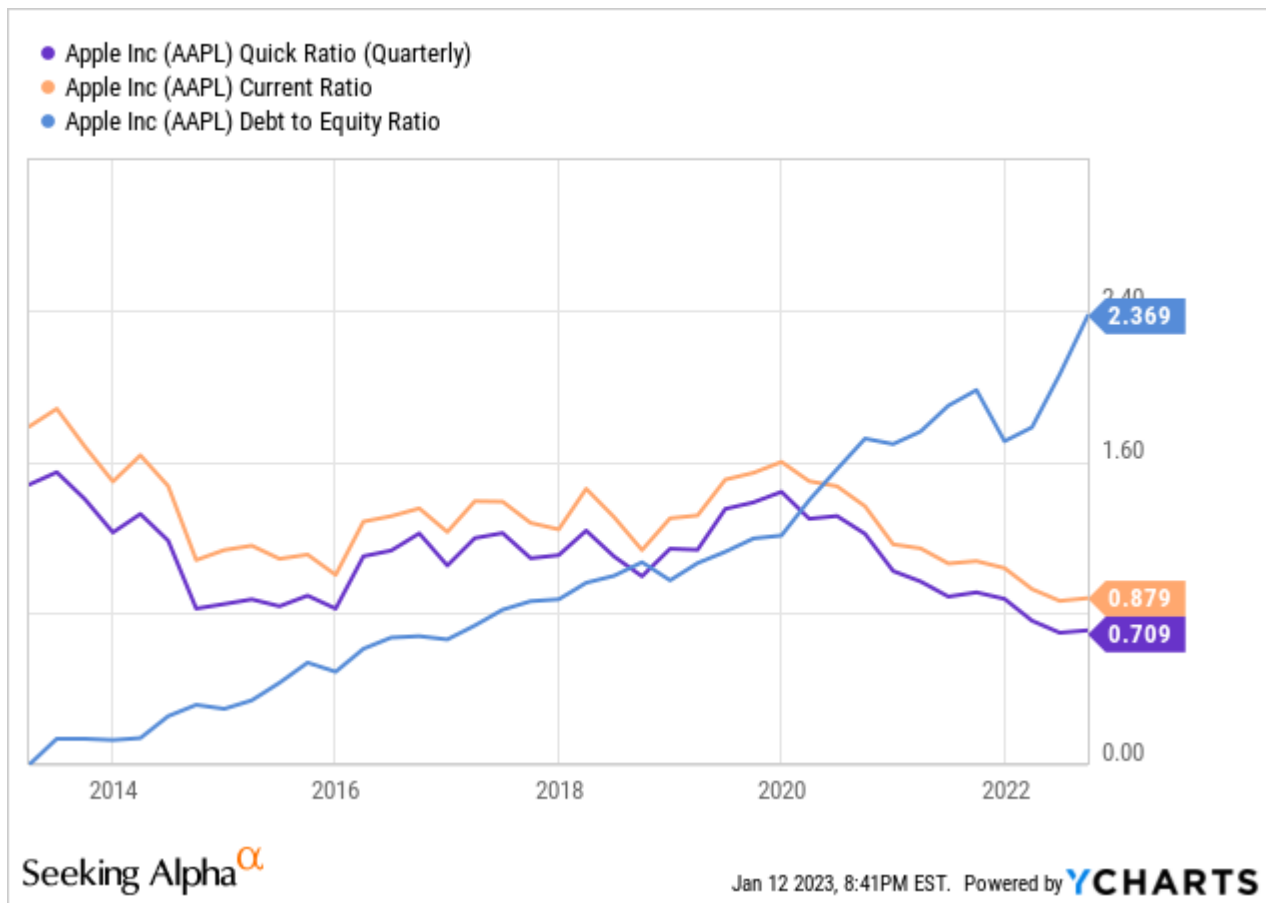
- **Liquidity:** A company with high liquidity will have a strong ability to pay off its short-term debts and a healthy current ratio and acid-test ratio.
- **Solvency:** A company with high solvency will have a solid ability to pay off its long-term debts and a healthy debt-to-equity ratio.
- **Profitability:** A company with high profitability will have a positive return on assets, return on equity, and a reasonable interest coverage ratio.
- **Efficiency:** A high-efficiency company will have a high asset turnover ratio.
- **Positive retained earnings:** A company with a healthy balance sheet should have positive retained earnings that can be used for reinvestment in the company's operations, to pay off debt, or for other purposes.
- **Overall financial health:** To wrap it up, a company with a strong balance sheet will have a healthy mix of assets and liabilities, with a good balance of liquidity and solvency. It will also have positive retained earnings and return on assets.

It's critical to compare a company's balance sheet to its industry peers and its own historical balance sheets to better understand its financial health over time.

More importantly, we cannot analyze a balance sheet in a vacuum.

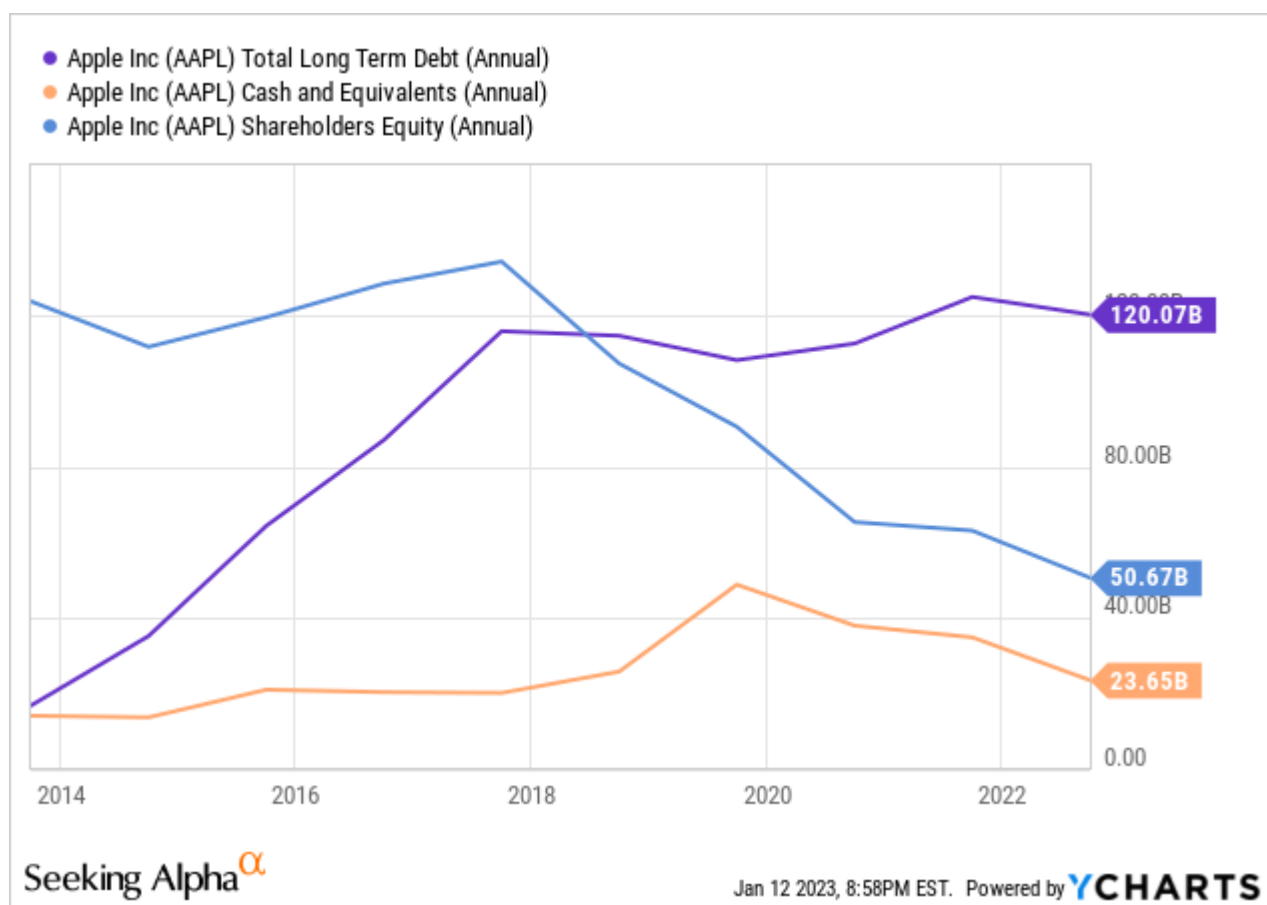
For example, let's look at Apple's balance sheet at the end of FY22:

- Quick ratio of 0.7 (weak).
- Current ratio of 0.9 (healthy).
- Debt-to-equity ratio of 2.4 (weak and worsening).



Data by [YCharts](#)

Let's zoom in on what impacts these ratios by looking at long-term debt, cash and equivalent, and shareholder's equity in the past decade.



Data by Ycharts

Apple’s debt-to-equity ratio has been worsening in the past decade:

- The company took on more debt from 2014 to 2018 when interest rates were favorable to finance share buybacks, increase dividends, and re-invest in its growth. However, the long-term debt has been relatively stable in the past five years.
- Apple’s debt-to-equity ratio has worsened mainly because of a significant drop in shareholder’s equity.

So what is happening here?

Legendary investors Warren Buffett and Charlie Munger often talk about why they like to pay attention to the “cannibals.” They refer to companies that actively buy back their shares over the years.

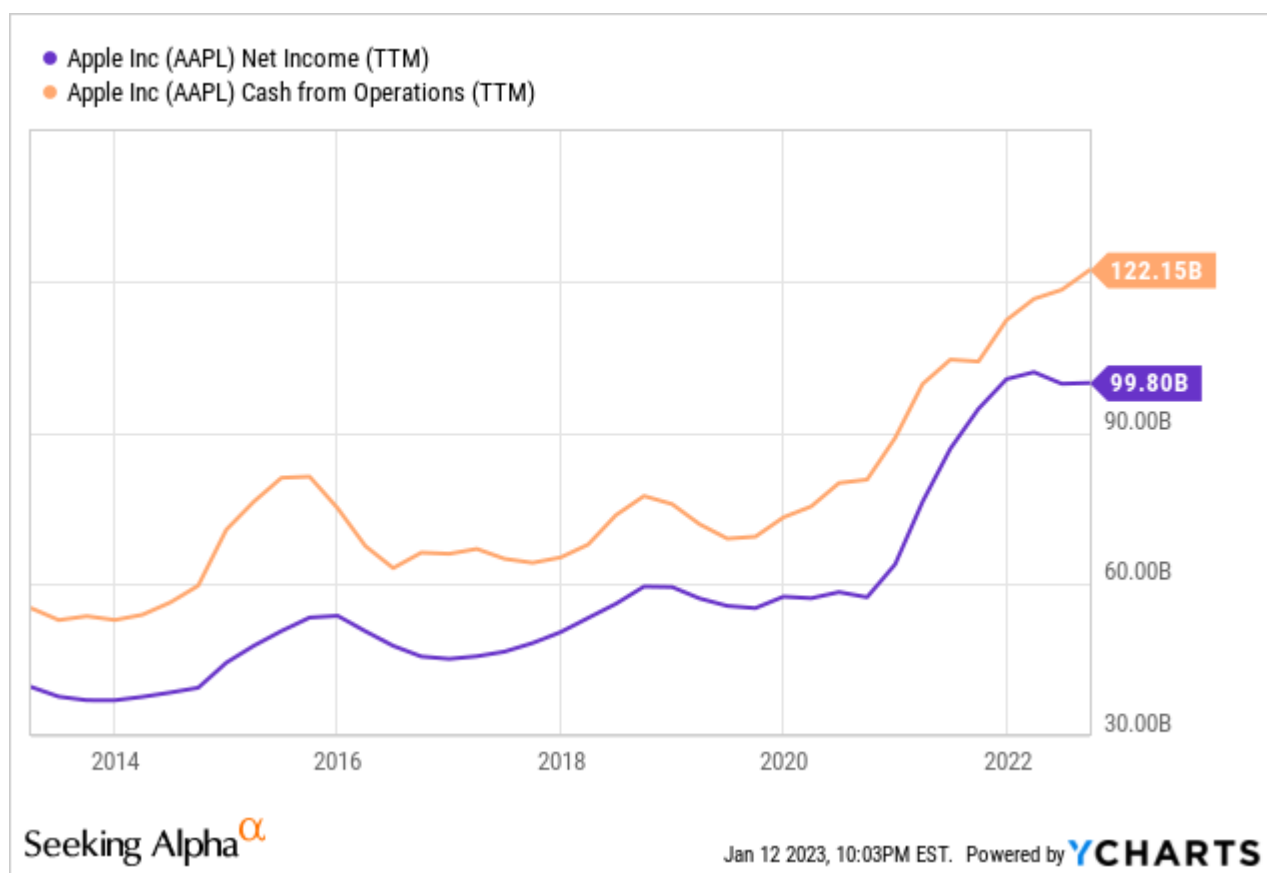
So the reason why the debt-to-equity ratio has dramatically worsened is that the company is returning cash to shareholders by buying AAPL shares on the open market.

Now, let’s put the balance sheet in perspective with the other financial statements (income and cash flow statements).

In FY22, Apple delivered:

- \$100 billion in net income.
- \$122 billion in cash from operations.

So are we concerned the company might be unable to pay interest expenses (less than \$3 billion in FY22)? Certainly not. In fact, Apple could almost pay off its long-term debt (\$120 billion) with just one year of earnings.



Data by [YCharts](#)

In the book *Warren Buffett and The Interpretation of Financial Statements*, we learn that Uncle Warren looks for companies with enough earnings power to pay their long-term debt in less than 3 or 4 years. Apple aces this test.

The point: The balance sheet in itself doesn't tell us much. Indicators can be misleading or entirely useless. So we must learn to connect the dots (across all three financial statements) and put it all in context.

By putting all this information together and interpreting a balance sheet as a whole, alongside the income and cash flow statement, you can understand a company's financial health and ability to generate profits, pay off debts, and grow its business.

More analysis

Here are a few different types of analysis that can be done on a balance sheet beyond the ratios previously discussed:

- **Trend analysis:** Look at how a company's balance sheet has changed over time, typically over the past few years. Look for changes and what may have caused them.
- **Comparative analysis:** Compare a company's balance sheet to its industry peers. It allows you to see how the company stacks up against its competition (for example, if it can outspend the competition).
- **Common-size analysis:** Express the balance sheet items as a percentage of total assets, which allows comparison across different companies. This approach can identify the company's strengths and weaknesses and compare them with industry averages.
- **DuPont analysis:** This type of analysis breaks down the return on equity (ROE) into its three main components: profitability, efficiency, and leverage. It allows us to measure the underlying drivers of ROE and identify where a

company is creating value.

Remember that these are general examples; no absolute rules or unique benchmarks can be applied to every company. However, by familiarizing yourself with industry benchmarks and trends and comparing the company with its peers, you can have a sense of what is healthy for that specific industry.

Final word

Well, that's it! You've made it to the end of our guide. We hope you've enjoyed learning about the balance sheet and how to read one like a pro.

In conclusion, analyzing a balance sheet is crucial for understanding a company's financial health. It provides valuable insights into a company's liquidity, solvency, profitability, and efficiency. You can make more informed financial decisions by understanding the basics of balance sheet analysis, including how to classify assets and liabilities, and how to calculate and interpret key financial ratios.

It's important to remember that analyzing a balance sheet is just one aspect of conducting a comprehensive financial analysis of a company. It should be used in conjunction with other analysis tools, such as the income statement, cash flow statement, and additional ratio analysis.

I hope you can apply this knowledge in your future financial decision-making. Remember, analyzing balance sheets can be fun and rewarding, so don't be afraid to dive in and get your hands dirty! With some practice, you'll be an expert in no time.

Stay tuned for our following guide that will cover the cash flow statement.

Until then, happy financial analysis!



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Disclosure: I am long AAPL in the [App Economy Portfolio](#). I share my ratings (BUY, SELL or HOLD) with App Economy Portfolio members [here](#).

14

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Ali Alharbi

Jan 17 Liked by App Economy Insights

You've just summerized better than Harvarad... There's a course called "financial accounting" on HBS and you've literllay explained a balance sheet better.

Keep it up man love your content!

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1 reply by App Economy Insights



Richard Lindner

Jan 14

I really like this article and the whole series. I had some technical difficulty with the Substack iPad app though. Apparently it cannot render the "pullquote" elements that are used a lot in the key ratios section. Maybe your team can exchange these with pictures or get in touch with Sustack to get this fixed.

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