Balance Sheet

The balance sheet is divided into three broad groups: assets, liabilities, and stockholders’ equity. It provides us with information about the resources available to management and the claims against those resources by creditors and investors. The balance sheet is reported as of a point in time. Assets and liabilities are usually reported at their original purchase or issue price, not their current market value. As a result, although assets that have permanently declined in value are written down, there can be unrealized gains associated with assets, especially those of intangible assets.

Assets — Reflecting Investing Activities

Companies acquire assets to yield a return for their shareholders. These investments are expected to produce revenues, either directly when the asset is sold (e.g., inventories) or indirectly, such as with a manufacturing plant that produces inventories for sale or a corporate office building that houses employees supporting the revenue generating activities of the company. To create shareholder value, assets must yield income that is in excess of the borrowed and invested funds that were utilized to acquire the asset.

The asset section of the Walt Disney balance sheet is reproduced in Exhibit 1. Its dollar amounts are expressed in millions, which is common. Specifically, Disney reports $49,988 million of total assets as of September 30, its year-end. The amounts reported on the balance are at a point in time—that is, midnight on the last day of the period.

Walt Disney’s business is not particularly seasonal. Other companies, such as retailers of children’s toys, look quite different at different times of the year. For example, Toys ‘R’ Us holds 50% more inventories during the fourth quarter than it does during the summer period. Seasonality factors can result in large changes in the balance sheet at various points during the year and our analysis must consider these.

It is important to realize that managers only record on a balance sheet what they can reliably measure. This means that there is a fair amount of information that is not reflected on a balance sheet. For example, consider the well-recognized image of Mickey Mouse. This image is referred to as an intangible asset. Like the Coke bottle silhouette, the ‘Kleenex’ name, an excellent management team, or a well-designed supply chain, intangible assets are only measured and recorded on the balance sheet when they are purchased. As a result, and many of these are of enormous value, internally-created intangible assets, like the Mickey Mouse image, are not recorded on a balance sheet.
More generally, and in addition to being reliably measurable, an asset must possess two further characteristics to be reported on the balance sheet:

1. It must be owned (or controlled) by the company.
2. It must possess expected future benefits.

For the first requirement, owning or controlling an asset implies that a company has title to it (like the title to our car) or has the unrestricted right to use the asset, such as under the terms of a lease. The second expected future benefits part, implies that a company expects to realize a benefit from the asset. Benefits can be cash inflows such as when an asset is sold or when sales occur from products produced by the asset. Benefits also can refer to the receipt of other assets such as with an account receivable from credit sales. Or, benefits can mean the reduction of a liability such as when assets are used to settle debts.

Asset value can also be impaired, which refers to a reduction in value from that presently recorded. When impairment in asset value occurs, the company removes the impaired amount from the asset value reported on the balance sheet and transfers that cost to the income statement. This process reduces current period income.

The assets section of a balance sheet is laid out in order of liquidity, which refers to the ease of converting noncash assets into cash. Cash is listed first as it is the most liquid asset. Next are marketable securities. These are short-term investments, such as stock holdings, that can be quickly sold to raise cash. Many investments are a place to put excess cash (which generates no return) in a desire to yield a safe, low return. Accounts receivable are listed next. These represent amounts due to the company from other companies and are usually collected within 60 to 90 days. Inventories are listed after receivables since their conversion into cash usually takes longer than the collection of receivables. Also, inventories are usually sold on credit and are not converted to cash until the resulting receivable is collected. Other assets such as prepaid expenses and taxes receivable are usually listed last. These assets make up what is often called liquid assets.

Disney’s liquid assets amount to $8,314, see Exhibit 1, which are more formally called current assets. Current assets are assets expected to be converted into cash or used in operations within the next year (in very special cases, this can exceed one year).

The amount of current assets is an important measure of liquidity. Companies require a degree liquidity to effectively operate on a daily basis. However, current assets are expensive to hold—they must be insured, monitored, financed, and so forth—and they typically generate returns that are less than those from noncurrent assets. As a result, companies seek to only maintain current assets sufficient to cover liquidity needs, but not so much so as to unnecessarily reduce income.
While the first section of a balance sheet reports current (short-term) assets, the second section reports noncurrent (long-term) assets. Noncurrent assets consist of plant assets (property, plant and equipment), intangible assets (trademarks, franchises, etc.), other long-term investments, as well as costs incurred in purchasing other companies (in whole or in part) such as goodwill. Noncurrent assets are not expected to be converted into cash for some time and are, therefore, listed after current assets.

Assets are usually reported at their original acquisition prices, or historical costs, and not at their current market values. The concept of historical costs is not without controversy. The controversy arises because of the trade-off between the relevance of current market values for many business decisions and the reliability of historical cost measures.

To illustrate, when company valuation is the goal, then current market values of assets are arguably preferred (company value equals the value of its assets less the amounts owed its creditors). What are the sources of market values? For some assets, like marketable securities, values are readily obtained from online quotes or from The Wall Street Journal. For other assets like property, plant and equipment, we can only estimate their values until they are ultimately sold. Allowing companies to report estimates of market values for assets would introduce potential bias into financial reporting. Consequently, companies continue to report historical costs because the loss in reliability from introducing subjectivity with market values is considered greater than the loss in relevance from using historical costs.

Reported assets also suffer in that companies only report what they can reliably measure. If a company cannot assign a monetary amount to an asset with relative certainty, it does not recognize it on the balance sheet. As a result, there are some assets not reported on the balance sheet.

To illustrate, consider brand equity such as with Coca-Cola’s ownership of its coke bottle silhouette and its logo. Notice that both basic requirements for an asset are met: Coke owns these brands and it expects future benefits from them. The problem is reliably measuring expected future benefits. This means these assets are not recorded on Coke’s balance sheet. This is an omission of a sizeable resource.

Some other intangible assets, which are usually nonphysical resources with uncertain benefits, are management quality, internally developed technology, promotions and advertising, and contracts. Generally, such intangible assets confer a competitive advantage, yield above-normal income, and cannot be reliably measured.

Accordingly, it is as important to understand what is measured on the balance sheet and what is not measured on the balance sheet. The excluded assets often relate to knowledge-based assets, like people and technology. This is one reason that knowledge-based industries are so difficult to analyze.

**Liabilities and Equity — Reflecting Financing Activities**

Liabilities and equity represent the sources of capital to the company that are used to finance asset acquisitions. Liabilities are borrowed funds (e.g., accounts payable, accrued liabilities, and obligations to lenders or bond investors). They can be interest-bearing or non-interest-bearing. Equity represents capital that has been invested by the shareholders, either directly via the purchase of stock (net of any repurchases of stock from its shareholders by the company) or indirectly in the form of retained earnings that have been reinvested into the business and not paid out as dividends. We discuss liabilities and equity in this section.

The liabilities and equity sections of the Disney balance sheet are reproduced in Exhibit 2. Dollar amounts are expressed in millions. Disney reports $25,769 million of total liabilities ($8,669 million + $10,643 million + $2,712 million + $3,745 million) and $24,219 million ($23,791 million + $428 million) of equity as of September 30.
Why would Disney obtain capital from both borrowed funds and invested capital? Why not just one or the other? The answer lies in their relative costs and the contractual agreements that Disney has with each. Creditors have the first claim on the assets of the company. They get paid before the stockholders do. As a result, their position is not as risky and, accordingly, their expected return on investment is less than that required by stockholders. So, then, why should a company not use all borrowed funds? The reason is that borrowed funds must be repaid when they mature. Further, if a company cannot pay these debts when they mature, creditors can force it into bankruptcy and potentially out of business. Shareholders, in contrast, cannot require repurchase of their stock, or even the payment of dividends. Thus, companies take on a level of debt that they can comfortably repay and the balance is financed with equity capital at a higher cost.

Liabilities on the balance sheet are listed in order of maturity. Debts coming due first are listed first. For Disney, these are accounts payable (short-term payables due to other companies, usually resulting from purchases of goods and services) and loans payable during the upcoming year. Other short-term liabilities include unearned royalties (royalty payments received before they are actually earned) and accrued liabilities. For Disney, accrued liabilities include items such as wages payable to employees, retirement benefits payable, and income taxes payable.

Accounts payable arise when one company purchases goods or services from another company. Typically, companies offer credit terms when selling to other companies, rather than expecting cash on delivery. The seller records an account receivable and the buyer records an account payable. Disney reports accounts payable of $4,095 million as of the balance sheet date. Liabilities that arise from transactions such as those driving accounts payable are relatively uncomplicated. That is, a transaction occurs (inventory purchase), a bill is sent, and the amount owed is reported on the balance sheet as a liability. Disney also reports as part of current liabilities its long-term debt that matures in the next year ($2,457 million).

Disney’s accrued liabilities total $949 million. Accrued liabilities refer to incomplete transactions. For example, many companies provide a warranty on goods sold. When the sale is recorded, companies must estimate the amount of warranty liability likely to be incurred and record that warranty cost in the same period when the sale is recorded. At the time of sale, companies can only estimate, or accrue, future warranty costs. Generally, companies must report such liabilities when:

1. Occurrence of the obligation is probable, and
2. Amount of the obligation is *reasonably estimable*.
Assuming these conditions are met, the company must record both the estimated liability on its balance sheet and the estimated warranty expense on its income statement. If only one condition is met, such liabilities are only described in the notes.

Disney’s current liabilities subtotal is $8,669 million. **Current liabilities** are those obligations expected to require payment within one year or the operating cycle, whichever is longer. Our analysis of companies compares the level of current liabilities with that of current assets. We prefer more current assets for confidence that companies have sufficient liquidity to pay their short-term debts when they mature.

**Net working capital**, or simply working capital, reflects one relation between current assets and current liabilities and is defined as follows:

\[
\text{Net working capital} = \text{Current assets} - \text{Current liabilities}
\]

The net working capital required to conduct business operations is evident from the **operating cycle**, which is the time between paying cash for goods or employee services and receiving cash from customers—see Exhibit 3.

Manufacturing companies, for example, begin with cash that is used to purchase or manufacture inventories held for resale. Inventories are often purchased on credit (accounts payable) from other companies. This financing is called **trade credit**. When inventories are sold, they are often sold either on credit (accounts receivable) or for cash. When receivables are ultimately collected, a portion of the cash received is used to repay accounts payable and the remainder goes to the cash account for the next operating cycle.

From the time cash is invested by a manufacturer or merchandiser, it remains as inventory for usually 30-90 days, then in accounts receivable for another 30-60 days, and finally back to cash after 60-120 days. Companies strive to reduce operating cycles with various initiatives that aim to:

- Increase trade credit to minimize the cash invested in inventories
- Reduce inventory levels from improved production systems and management
- Decrease accounts receivable from better collection procedures

**Noncurrent liabilities** are obligations not due to be paid within one year or the operating cycle, whichever is longer. Disney reports $17,100 million ($10,643 million + $2,712 million + $3,745 million) of liabilities as noncurrent. Note that long-term debts that are scheduled to mature within the next year are classified as current liabilities called ‘current maturities of long-term debt.’ Disney has $13,100 million of long-term debt, of which
$2,457 million is scheduled to mature within 12 months of its balance sheet date, yielding $10,643 million in noncurrent liabilities.

Disney also reports $6,457 million of ‘other’ long-term liabilities. The notes reveal that $2,712 million of this liability relates to deferred taxes owed to the IRS and other taxing authorities. The remaining $3,745 million relates to deferred revenues ($540 million), long-term lease obligations ($344 million), obligations for program licensing ($466 million), long-term employee benefit liability ($1,183 million), and other long-term obligations ($1,212 million).

The equity section of a balance sheet consists of two basic components: contributed capital and retained earnings. **Contributed capital** is the net funding that a company received from issuing and acquiring its equity shares. That is, the funds received from issuing shares less any funds paid to repurchase such shares. Disney’s equity section reports $24,219 million ($23,791 million + $428 million) in stockholders’ equity. Its contributed capital is $11,055 million, comprised as follows:

<table>
<thead>
<tr>
<th>Account ($ millions)</th>
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</thead>
<tbody>
<tr>
<td>Preferred stock</td>
<td>$ 0</td>
</tr>
<tr>
<td>Common stock</td>
<td>12,154</td>
</tr>
<tr>
<td>Treasury stock (common shares repurchased)</td>
<td>(1,527)</td>
</tr>
<tr>
<td>Minority interests</td>
<td>428</td>
</tr>
<tr>
<td>Total equity</td>
<td>$11,055</td>
</tr>
</tbody>
</table>

While account titles can vary across companies, it is important to understand that Disney received $12,154 million from issuing equity shares, paid out $1,527 million to repurchase its shares, and recognized $428 million as claims of minority shareholders from prior acquisitions. The common shares held in treasury can be resold in the future unless they are formally retired. Until resold, these treasury shares reduce total stockholders’ equity.

Disney reports $13,164 million of **retained earnings**, which represents earned capital, the cumulative net income and loss, of the company (from its inception) that has not been paid to shareholders as dividends. Its retained earnings consist of the following:

<table>
<thead>
<tr>
<th>Account ($ millions)</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Retained earnings</td>
<td>$13,817</td>
</tr>
<tr>
<td>Accumulated other comprehensive income (loss)</td>
<td>(653)</td>
</tr>
<tr>
<td>Total retained earnings</td>
<td>$ 7,852</td>
</tr>
</tbody>
</table>

There is an important relation for retained earnings that reconciles its beginning and ending balances as follows:

\[
\text{Beginning retained earnings} \pm \text{Net income (loss)} - \text{Dividends} = \text{Ending retained earnings}
\]

This is a useful relation to remember, although there are other items that sometimes impact retained earnings. We revisit this relation after our discussion of the income statement and show how this relation links the balance sheet and income statement.

Reported stockholders’ equity is ‘company value’ as determined by GAAP, which is called **company book value**, or simply book value. This value is different from company **market value**, which is computed by multiplying the number of outstanding equity (common) shares by the per share market price. Book value and market value can differ for several reasons, and the most glaring is the timing and uncertainty of when to recognize some transactions and events in financial statements such as the following:

- GAAP generally reports assets and liabilities at historical costs; whereas the market attempts to estimate fair market values.
• GAAP excludes resources that cannot be reliably measured such as talented management, employee morale, recent innovations and successful marketing; whereas the market attempts to value these with some recognition of uncertainty.

• GAAP does not consider market differences in which companies operate such as competitive conditions and expected changes; whereas the market attempts to factor in these differences in determining value.

• GAAP does not usually report expected future performance; whereas the market does attempt to predict future performance.

Presently for U.S. companies, book value is, on average, about two-thirds of market value. This means that the market has drawn on some different information or processes in valuing equity shares. A major part of this information is in financial statement notes, but not all.

### Business Insight

**Comparing Disney’s Book and Market Values**

Disney’s market value has historically exceeded its book value of equity. This is because much of Disney’s market value results from intangible assets such as brand equity that are not fully reflected on its balance sheet. However, the difference between the two values has declined in recent years following abandonment of Go.com and poor performance in its television and film units:

![Disney Market and Book Value](image)

Note that ‘conservative accounting’ depresses book values of equity as R&D, advertising, wages, etc., are expensed rather than capitalized (versus measurable tangible assets). Intangible assets are capitalized only when purchased, and not when internally developed. Balance sheets of knowledge-based companies are, arguably, less informative as a result.

It is important to understand that, eventually, all factors determining company market value are reflected in financial statements and book value. Assets are eventually sold and liabilities are settled. Moreover, a talented management, employee morale, and recent innovations and successful marketing are all eventually recognized in profitability. The difference between book value and market value is timing. To the extent that market value is accurate, the change in stockholders’ equity represents the change in company market value with a lag.

Disney reports total assets of $49,988 million, total liabilities of $25,769 million, and equity of $24,219 million (including minority interests in equity). There is an important equality that we use throughout in analysis of financial statements. Drawing on the **accounting equation** ($ millions), Disney is reflected as follows:

\[
\text{Assets} = \text{Liabilities} + \text{Equity}
\]

\[
$49,988 = $25,769 + $24,219
\]

We often draw on this relation to assess the effects of transactions and events, different accounting methods, and choices that managers make in preparing financial statements.

To illustrate the process by which financing related transactions and events are reflected in financial statements, consider the effect of a Disney stockholder investing $1,000 cash into the business. Cash would increase and Disney would issue stock to the shareholder, which increases stockholders’ equity (paid-in capital). This transaction is reflected as follows:
Shareholder investment of $1,000 cash

Notice that both assets (cash) and stockholders’ equity (paid-in capital) increase, and the accounting equation still applies (as it always must). Also notice that all major financial statements are reflected in this pedagogical tool. First, the balance sheet is reflected by assets (both cash and noncash), liabilities, and equity (contributed capital and retained earnings). Second, the income statement is reflected by revenues and expenses. Third, the statement of cash flows is reflected by changes in the cash balance. Finally, the statement of equity is reflected by changes in contributed capital and retained earnings. This tool can be expanded to include more detailed accounts if appropriate for your special analysis needs.

As an investing-related illustration, assume that Disney spends $5,000 for upgrading a ride. Cash would decrease and noncash (plant) assets would increase as follows:

Paid $5,000 cash to upgrade a ride

Notice that total assets remained unchanged, except for an exchange of one type of asset for another). Liabilities and equity are unaffected. Again, the accounting equation is maintained.