The Balance Sheet

How Much Debt Is Too Much? — Lesson Explainer

The Concept

The balance sheet is built on one identity: Assets = Liabilities + Equity. Assets are everything owned; liabilities are everything owed; equity is what's left for shareholders.

Current ratio (current assets / current liabilities) measures short-term liquidity. Debt-to-equity (total debt / shareholder equity) measures leverage. Neither has one 'correct' number - capital-intensive industries naturally carry more debt than asset-light ones. The goal is spotting outliers.

The Balance Sheet Equation, Illustrated

Assets	
Cash & equivalents	$40M
Inventory & receivables	$60M
Property & equipment	$150M
Total Assets	**$250M**

Liabilities + Equity	
Short-term debt & payables	$45M
Long-term debt	$80M
Shareholder equity	$125M
Total Liab. + Equity	**$250M**

Both sides match: $250M of assets is funded by $125M of debt and $125M of equity. Debt-to-equity = $125M / $125M = 1.0 - a reasonably balanced position, though the 'right' number depends heavily on the industry.

5 Things to Know About the Balance Sheet

1. Assets always equal liabilities plus equity - if not, the accounting is wrong.

2. Current ratio below 1 is a liquidity warning - current liabilities exceed current assets.

3. Debt-to-equity has no universal 'good' number - it varies a lot by industry.

4. Rising debt isn't automatically bad - growth-funding debt differs from loss-covering debt.

5. The balance sheet is a snapshot, not a trend - compare several periods, not just one.

4 Things to Check When Reading a Balance Sheet

- Check the current ratio - below 1 is a flag worth investigating further.
- Check debt-to-equity vs peers, not a generic benchmark.
- Track the trend over time - is debt rising faster than equity or assets?
- Ask why debt exists - check the cash flow statement for the answer.

Worth knowing:
the balance sheet is a snapshot at one moment, not the full story. Pair it with the income statement and cash flow statement - a company can look fine here while its underlying trend is deteriorating.

Quiz — Answer the questions, then check the key on the next page

1. What is the fundamental balance sheet equation?

A. Revenue = Expenses + Profit
B. Cash = Assets - Liabilities
C. Assets = Liabilities + Equity
D. Equity = Revenue - Debt

2. What does a current ratio below 1.0 suggest?

A. The company has no debt at all
B. Current liabilities exceed current assets - a potential liquidity warning
C. The company is definitely about to go bankrupt
D. The stock is undervalued

3. Why doesn't debt-to-equity have one universal 'good' number?

A. Because debt is always bad regardless of context
B. Because equity never matters
C. Because the ratio is calculated differently every year
D. Because capital-intensive industries naturally carry more debt

4. Why isn't rising debt automatically a bad sign?

A. Growth-funding debt differs from debt covering ongoing losses
B. Debt is always good no matter the reason
C. Rising debt always means the stock will go up
D. Debt has no effect on a company's risk

5. With $125M debt and $125M equity, what is the debt-to-equity ratio?

A. 0.5
B. 2.0
C. 1.0
D. 125

Answer Key

1. What is the fundamental balance sheet equation?

Correct answer: C. Assets = Liabilities + Equity

Everything a company owns equals what it owes plus what belongs to shareholders.

2. What does a current ratio below 1.0 suggest?

Correct answer: B. Current liabilities exceed current assets - a potential liquidity warning

Worth investigating further, though not an automatic crisis.

3. Why doesn't debt-to-equity have one universal 'good' number?

Correct answer: D. Because capital-intensive industries naturally carry more debt

A utility or airline naturally runs higher debt-to-equity than an asset-light software company.

4. Why isn't rising debt automatically a bad sign?

Correct answer: A. Growth-funding debt differs from debt covering ongoing losses

The reason behind rising debt matters - expansion vs plugging losses are very different signals.

5. With $125M debt and $125M equity, what is the debt-to-equity ratio?

Correct answer: C. 1.0

Debt-to-equity = $125M / $125M = 1.0 - debt and equity fund the business equally.