FINANCIAL STATEMENT ANALYSIS: A LOOK AT THE BALANCE SHEET

By John Bajkowski

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This fundamentals article is the first in a series on financial statements—how to read them and use them for security analysis. The goal is certainly not to turn you into accountants, but to broaden your knowledge so you can make more informed investment decisions.

Every other issue of the *AAII Journal* this year will carry an article exploring the use and interpretation of financial statements. And on our Web site (www.aaii.com) within the stocks area, we will present these articles together, along with member questions and answers on the topic. If you have any questions or comments on the articles, please address them by E-mail to financials@aaii.com.

THE FUNDAMENTAL TOOLS

Successful investing has no secret formula. A good strategy and a basic understanding of the rules of the game are required to do well in the long run. Since financial statements are basic tools of fundamental analysis, it is important to be able to read and analyze them.

Financial statements provide the means to measure the performance of the company and its management. These statements allow investors to compare one company's performance to other companies and industry norms. Items reported in the financial statements, such as sales, earnings, and cash flow, help value and growth investors gauge the worth of the stock price.

The amount of emphasis you place on various parts of financial statement analysis depends upon your viewpoint. A credit analyst extending a short-term, unsecured loan to a company might emphasize the firm's cash flow and liquidity. An investor with a growth strategy looking at stock may look closely at items that impact upon a firm's ability to produce future earnings. A value investor examining a distressed company may also concern himself with the financial structure of a firm to identify whether it has the resources to work its way through a difficult period. When working with financial statements, you must keep in mind that they are historical records and public information. Spending a great deal of time scrutinizing financial statements with the hope of finding hidden assets is generally not a productive use of spare time.

There are three primary financial statements—the balance sheet, the income statement, and the cash flow statement. The balance sheet indicates the current financial position of the firm. The income statement summarizes the sales and profit performance over a period of time, while the cash flow statement details the use and generation of cash over a period of time.

Annual and quarterly reports remain the best, most readily available sources of financial statements. Companies produce formal reports for two main groups—shareholders and the Securities and Exchange Commission (SEC). Although the reports sent to shareholders are similar to those filed with the SEC—the annual report is similar to the Form 10-K filed with the SEC, and the quarterly shareholder report is similar to Form 10-Q—there are some differences.

Under the Securities Exchange Act of 1934, public companies are required

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to file with the SEC a number of very informative reports, including 10-Qs and 10-Ks. The SEC specifies the contents of each report and the frequency with which each report must be filed. In contrast to the slick reports produced for shareholders, the SEC reports may seem very drab. However, the financial statements presented for both the shareholder reports and SEC reports will be the same. For example, the annual report must include audited financial statements (balance sheets for the two most recent fiscal years, and income and cash flow statements for the three most recent years), selected quarterly data for the two most recent years, and a summary of selected financial data for the five most recent years. Most professionals choose to read the SEC-filed reports, because they are typically more detailed in describing the company's line of business and competitive environment, and they present data in an order mandated by the SEC.

You can request copies of a firm's 10-K and 10-Q filings directly from the company, but now that companies are required to file the forms electronically, they can also be retrieved from the SEC Web site at www.sec.gov. Companies must file their quarterly 10-Q reports within 45 days of completing a quarter and within 90 days after their fiscal year end. A firm's fiscal year may or may not correspond to the calendar year. Companies also typically release their quarterly performance figures to the public prior to filing their statements with the SEC. Normally these announcements come about a month after completing a quarter, and publications such as the Wall Street Journal provide an Earnings Digest section to summarize these announcements.

This fundamentals article sets the stage for our series on financial statement analysis with a look at the structure and composition of the balance sheet. Future articles will examine the income and cash flow statements, issues regarding the quality of a firm's earnings, and ratios and techniques to measure items such as a company's financial strength, liquidity, operational efficiency, and profitability.

THE BALANCE SHEET

The balance sheet of a firm represents the financial history of a firm at one point in time—normally the end of a company's fiscal quarter or year. The income and cash flow that occurs during the period into and out of the accounts represented on the balance sheet are not reported, but the end-of-period account balances reflect a summary of all transactions. It is best to think of the balance sheet as a single snapshot at the end of the quarter or year, while looking at the income and cash flow statements as photo albums that capture events over a period of time.

While the balance sheet is also called the statement of financial position or statement of financial condition, the term balance sheet indicates an important characteristic—the balance sheet must balance. Asset values must equal the sum of liabilities and owner's interest (or equity).

Assets = Liabilities + Equity

The assets consist of the items owned by the firm and used to conduct business. The liabilities and equity represent the claims against the value of the assets. Liabilities are what the company owes to others, while the owner's interest or equity essentially is what is left over. Equity is the value of all your assets less all your debts, similar to your personal net worth.

A typical, if simplified, balance sheet is presented in Figure 1. The complexity and detail of the balance sheet presentation varies from company to company and industry to industry. Companies also publish notes to accompany the financial statement, which help to explain the construction of the various accounts listed in the balance sheet as well as some of the assumptions made by management when presenting the figures. While we will not cover these notes in this article, they are an important element that should be examined during the analysis process.

The balance sheet format is relatively standardized, although due to the unique nature of some industries, such as banks, the format does differ. Standardization makes it easier to become familiar with the statements, allowing investors to identify key elements and compare company performance.

Within the balance sheet, various accounts are placed in standard classes and presented in order of liquidity. More liquid short-term assets and current liabilities are placed first. A brief examination of each account should help bring the balance sheet into focus.

CURRENT ASSETS

Cash is the most liquid of the assets and is watched carefully by equity and credit analysts. Keep in mind that when we are referring to cash, we are also including marketable securities and other cash-equivalent interest-bearing accounts. Too little cash may make it difficult for a firm to meet its cash obligations, such as the interest payment on a bond. However, too much cash reduces the potential earnings of the firm. Attractive companies should be able to earn more in their normal business lines than the prevailing short-term interest rate.

Accounts receivable is the credit extended to customers to purchase goods. The accounts receivable balance is the total money owed to the company by customers at the end of the reporting period. A low accounts receivable balance may indicate that the firm is efficient in its collections or that credit standards are too restrictive and depressing sales. A large balance may

FIGURE 1. THE BALANCE SHEET: AN EXAMPLE

Assets		
Current Assets		
Cash		$ 320
Accounts receivable	1,070	
Less: allowance for doubtful accounts	90	
Net accounts receivable		980
Inventory		1,400
Prepaid expenses		100
Total Current Assets		2,800
Investments		350
Property, Plant and Equipment		
Land, buildings, machines, equipment, and furniture	930	
Less: accumulated depreciation	230	
Net property, plant & equipment		700
Other Assets		
Goodwill		300
Total Assets		4,150

Liabilities and Stockholders' Equity	
Current Liabilities	
Accounts payable	$ 540
Accrued expenses	230
Income tax payable	60
Notes payable	170
Current portion of long-term debt	100
Total Current Liabilities	1,100
Long-Term Liabilities	
Deferred income tax	150
Long-term debt	1,000
Total Liabilities	**2,250**
Stockholder's equity	
Common stock	800
Paid in capital	800
Retained earnings	300
Total Stockholder's Equity	1,900
Total Liabilities and Stockholder's Equity	4,150

indicate that the company is having difficulty collecting the money it is owed and its credit standards are too lax. Once a company recognizes that an accounts receivable will not be collected, it must reduce the value of the account and write the uncollectable accounts off. The recognition of this charge will ultimately impact the company. Companies maintain a reserve against potentially uncollectable accounts receivables, titled an *allowance for doubtful accounts*. It represents management's estimate of how much customers will default on their bills. The allowance reduces (is charged against) the accounts receivable account. The higher the allowance for doubtful accounts, the more conservative the company is in its estimates. Acceptable levels vary by industry, so it is important to compare a company against similar firms.

Inventory levels are also crucial. A low level of inventory that is may make it difficult for the firm to meet demand, thereby losing sales opportunities; an inventory level that is too high reduces the return on assets and may also imply that the inventory may not be easily converted to sales. Acceptable inventory levels vary by industry and are tied to the useful life, cost and replacement pattern of the goods. For example, personal computer manufacturers must balance the risk of not being able to finish goods because of the shortage of a critical component such as a processor, against the possibility of being stuck with out-of-date or devalued inventory due to product enhancements or price declines. Inventory is generally a wasting asset that must be written off once it becomes obsolete. Inventory levels should be checked against sales. The two items should grow at roughly the same rate. Deviations merit further examination.

The overall level of *total current assets* also becomes important in comparison to the level of current liabilities. This concept will be developed when we present an article on ratio analysis.

PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment consists of fixed assets used to generate sales over a period of years. Depending upon the business, it may include buildings, computers, office equipment, machinery, etc. With the exception of land, a portion of the original cost of these items is written off as an expense each year over the estimated life of the asset. These expense write-offs are totaled in the accumulated depreciation account. The cost of property, plant and equipment less accumulated depreciation equals *net property, plant and equipment.*

The importance of the property, plant and equipment account will vary from industry to industry. For a manufacturing enterprise, it should be watched carefully. For a company selling services, or even software enterprise, it takes on less importance.

GOODWILL

Other assets can include securities held by the company as long-term investments (important for financial firms) and intangible assets such as *goodwill* and patents. Goodwill is created when one company acquires another and pays a price above the book or accounting value of the firm. It is termed an intangible asset because it cannot be linked directly to the cost or value of a real, tangible item. Companies are required to write off or amortize the goodwill within 40 years. This creates non-cash outlay that lowers reported earnings but not cash flow. Some analysts like to subtract the intangibles account from the owner's equity account to calculate a more conservative tangible net worth value. The need to adjust for intangibles varies from company to company. The potential intangible value of a brand name such as Coke, Disney, or McDonald's is high and can justify a rich premium above the book value. For other firms, a purchase premium may not be justifiable.

CURRENT LIABILITIES

Generally, *current liabilities* are all debts that have a maturity of less than one year. Most of the current liabilities for the average company are tied to trade credit extended by suppliers (*accounts payable*). These liabilities will be paid as the inventories are sold and converted to cash.

Accrued expenses represent costs that have been incurred but not yet paid. This account may include items such as rent, interest, or salaries.

Income taxes payable are simply that, and *notes payable* reflect promissory notes, signed when borrowing short-term funds from financial institutions. The *current portion of long-term debt* reflects the amount of long-term debt that comes due and must be paid within the next year. The company must have the financial resources to make good on this debt or be in a strong enough position to issue new debt.

LONG-TERM LIABILITIES

Long-term liabilities are loans and obligations payable in more than one year out. It can include accounts such as bonds, deferred income taxes, and pension obligations. Long-term bonds are the most common long-term liability and represent debt that has a maturity date and usually requires periodic interest payments.

STOCKHOLDER'S EQUITY

This is the ownership interest in the company and is composed of a common stock account and a retained earnings account. A *common stock* account will appear on the balance sheet when common stock with a stated par value (such as one dollar), meaningless from an investor's viewpoint, is sold. The account will reflect the par value of the shares sold. The *paid-in-capital* account records the amount initially paid by the shareholders above the par value of the common stock.

Retained earnings are the accumulation of earnings, after all expenses and dividend payments. In effect, retained earnings represent the reinvestment of earnings into the firm.

Stockholder's equity is often referred to as the net worth of the firm. This represents the residual value after liabilities are subtracted from assets. Book value is another label attached to stockholder's equity. The usefulness of book value is limited because the balance sheet represents an accounting value that may be dramatically different from the market value. The market value of some of the unfinished goods in inventory may be below the accounting book value, while the market value of some of the property owned by the firm may be well above the stated book value. Service firms may have a substantial level of hidden intangible assets that will never be valued on the balance sheet. It is often said that the assets of a service company walk out the door every evening. While some investors select stocks for their hidden asset values, the majority of investors are concerned with the future earnings and cash flow generation potential of the assets held by the firm.

CONCLUSION

The balance sheet provides an important historical snapshot of a company's assets, liabilities, and ownership interest. We have presented an uncomplicated view of the balance sheet and set the stage for further analysis. If you have any questions regarding the balance sheet, please E-mail them to financials@aaii.com. In February we will post an FAQ (frequently asked questions) article for the balance sheet on our Web site at www.aaii.com. ✦