

Assessing Balance Sheets

By BNET Editorial

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A balance sheet gives a “snapshot” view of a company’s financial position at a particular moment in time. It shows the company’s assets (what it owns), liabilities (what it owes), and remaining equity on a given day.

Accounting regulations determine how a balance sheet is set out. Each of the different figures says something about how the company is performing. However, as the situation is constantly changing, it’s important to look at these in a wider context, to spot trends or make comparisons.

What You Need to Know

Why “balance sheet?”

A balance sheet is drawn up according to the basic accounting equation “assets minus liabilities is equal to equity.” By examining the point where the figures balance, analysts and investors can glean information about a company’s financial health.

Does a balance sheet show how much a company is worth?

No. Net worth on the balance sheet is not the same thing as market value. Items on a balance sheet are given a *book value* (an estimated value for accounting purposes) which may turn out to be inaccurate. For example, when depreciating assets like plant and machinery come to the end of their useful life, they may fetch more as scrap than predicted. Or the value of stock listed on the balance sheet may turn out to be an overestimate. Moreover, intangible assets (such as patents, goodwill or a famous brand name), which could be extremely valuable to a potential purchaser, may not be disclosed on the balance sheet at all.

What to Do

The simple balance sheet below shows net assets balanced with stockholder equity:

Fixed assets	\$5,500
Current assets	\$2,500
Less current liabilities	\$1,000

	\$7,000
<i>Less long term debt</i>	\$2,000
Net assets	\$5,000
<i>Profit and loss account</i>	\$2,000
<i>Share capital</i>	\$2,500
Stockholder equity	\$4,500

Understand What Each Item Shows

- **Fixed assets**—assets that are not for sale, but are used to produce revenue. They can include tangible assets like property, machinery, and vehicles; or intangibles like copyright, patents, customer lists or brands.
- **Current assets**—assets that the company expects to convert into cash over the next year—like cash, inventory, and accounts receivable.
- **Current liabilities**—debts that the company expects to pay within the next year. Typically, they include accounts payable, tax and short term loans like overdrafts.
- **Net current assets**—the difference between current assets and current liabilities.
- **Long-term debt**—loans that are due to be paid at least a year after the date of the balance sheet.
- **Net assets**—fixed assets plus net current assets minus long-term debt (essentially, total assets minus total liabilities).
- **Profit and Loss account**—accumulated profits and losses since the company began, that have not been paid out in tax or as dividends to shareholders.
- **Share capital**—the money invested in the company by its shareholders. The formula for calculating share capital is: number of shares issued x nominal share value (the price when issued, not their current market value).
- **Stockholder equity**—profit and loss account plus share capital (in other words, the sum of shareholders' interest in the business).

Interpret the Balance Sheet

What constitutes a typical balance sheet varies considerably between sectors. For example, a business that routinely gives customers credit will have a much larger receivables balance than one that only deals in cash. Likewise, a service company will not have the same level of investment in plant and machinery as a manufacturer. Interpretation therefore depends on what the company actually does to generate its income.

Moreover, although the format of the balance sheet is determined by regulations, there is still plenty of scope for subjectivity. And depending on who is reading the balance sheet, different aspects will be seen as positive or negative—an investor will have a very different agenda from a potential purchaser, for example.

Net assets/stockholder equity

Net assets tends to be the item that people look at first. A positive figure is a good thing; negative assets (liabilities in essence) suggest that the company could be on the brink of trouble, unless support is coming from a source like its parent company, a bank, or an investor.

Net current assets (NCA)

A positive figure that indicates the company can settle its short-term liabilities is most desirable—otherwise, there could be problems with paying off short-term loans. It's also useful to analyze NCA as a ratio (current assets/current liabilities), where a figure of more than one equates to a positive NCA total. The ratio (rather than straight NCA) comes into its own when tracking trends from successive balance sheets, or making comparisons between companies.

Some analysts also choose to look at NCA without stock—in other words, by analyzing the ratio (debtors + cash)/creditors—in order to focus on the most “liquid” assets. Again, a figure of one or more is looked for, and again, it's most useful when used to track trends or make comparisons.

Trade debtors

Figures for trade debtors appear within current assets on the balance sheet. It can be revealing to analyze the number of days' sales that are tied up in debtors (how long the company has to wait to get paid); this is calculated using the formula $(\text{debtors} \times 365) / \text{annual sales}$. An overlong wait suggests it needs to be looked into, although the figure may be unrepresentative because some companies' sales are very uneven. For example, a building firm may be waiting for a very large payment, which can distort the ratio.

Trade creditors

In much the same way as trade debtors can be examined in terms of days' sales, analysts can look at how long a company takes to pay its suppliers using the formula $(\text{trade creditors} \times 365) / \text{annual purchases}$. However, the calculation is less straightforward, because overheads have to be taken into account as well as the goods purchased for resale.

Debt

Debt—long-term plus short-term loans—is a vital figure to most companies. Excessive debt suggests difficulties of some kind; perhaps a downturn, or trouble with interest payments. An “ideal” level of debt is very hard to ascertain because it depends on so many variables, which will be different for every situation. Therefore, companies tend to express debt as a percentage of stockholder equity

(*gearing or leverage*), rather than as an absolute figure. A gearing of 100% would be on the high side in a public company, while something under 30% would be considered a bit low.

What to Avoid

You Think a Balance Sheet is a Valuation of a Company

The figures on a balance sheet do not represent the value of a business. The main purpose of a balance sheet is to present a picture of a company's assets and liabilities, which should be used alongside other financial information (like profit and loss accounts, and cash flow statements) to assess a company's financial strength.

You Forget That the Balance Sheet Is a Snapshot Taken On One Day

Because a balance sheet reflects the company's position on the day it was issued, it does not necessarily show how things are a short while later. In practice, they may very well be similar, but it's important to remember that it's only valid for the date of issue, and is not a permanent representation of the company's financial health. Since then, there could well have been a major event—like a customer defaulting on a large payment—which could change the picture considerably.

You Think That the Balance Sheet Shows Every Asset or Liability

It's important to remember that—as already discussed—certain intangible assets, for which money has never changed hands, can be extremely valuable to a company; but they may never be adequately represented on the balance sheet. Equally, there may be considerable liabilities looming—such as legal costs—that do not yet show.

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