



THE BALANCE SHEET

"He is indebted to his memory for his jests and to his imagination for his facts."

Richard Brinsley Sheridan (1751 – 1816)

These newsletters are attempts to de-mystify financial statements. Last month we focused on the income statement. This month it gets really amped up by moving to the big daddy of the financial statements--the balance sheet. The balance sheet is a little harder to understand than the income statement, but is often a better indicator of the fundamental health of the business.

To keep this newsletter to a reasonable length, we refer you to Wikipedia for a brief, general overview: http://en.wikipedia.org/wiki/Balance_Sheet.

So . . . let's get started.

Oops, a small technical nit, all of the discussions here will be based on "accrual", not cash accounting. We promise to make this nit fairly painless. Also, we will cover the major sections that are fairly typical of most companies. There are plenty of esoteric and exotic sections that can be broken out on balance sheets for specialized companies and financing arrangement. These will not be discussed here.

THE BASICS

The balance sheet has three big buckets. The first is assets. These are all of the things that the company owns that have value. The second is liabilities, or stated more simply, the debts that the company owes. The total of what the company owns, minus the debts the company owes, is the equity of the company.

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

In some sense, the equity is what would be left if the company were to be liquidated, with all the assets sold and all the debts paid.



It is important to note that while investors do consider the balance sheet of a company, they do not typically value the company as simply the equity of the company. There are many reasons for that, and we're not going to go into that here.

First, a bit of slang . . . The "book value" of a company is simply the equity of the company.

ASSETS

SHORT-TERM ASSETS

Cash and its Equivalents

One of the first concepts to discuss is the "quality" of the assets on the balance sheet. When you look at the severe recession of 2009, much of it came from people from all walks of life essentially thinking that assets were worth much more than their "true" value. So, let's look hard at assets and figure out how solid they are.

Cash and short-term investments are certainly the most solid of the assets. By definition, short-term monetary investments are highly liquid, so they are almost as solid as cash.

Customers Receipts

Accounts receivable (AR) are the monies that customers owe the company. Certainly, customers don't pay every bill, but they pay most. In addition, public companies do follow fairly strict guidelines, and reduce AR to account for customers that are not paying bills. You can, however, even get a better feel for how a company is managing receivables by computing "days sales outstanding" for AR. This is very simple to do...

$$DSO = (AR / \text{Annual Revenue}) * 365$$

The longer it takes a company to get paid, the less likely it is for the company to receive payment. Typical values for well-run companies are on the order of 30 days. If these numbers stretch out much beyond 60 days, it becomes a cause for some concern.

Inventories

Next on the hit parade is inventory. Inventory consists of the materials required to ship product to customers. The difficulty with inventory is that as time passes, it becomes harder and harder to sell. Inventory is measured in "turns", or the number of times inventory will be used in a calendar year.

$$\text{Inventory Turns} = \text{Annual Cost of Goods Sold (COGS)} / \text{Inventory}$$

LONG-TERM ASSETS



Plants, property, and equipment (PP&E) or Fixed Assets comprise a fairly easily understood class. Physical things like buildings, tools, and so on are in this category. These assets are held on the balance sheet at a depreciated value. Despite this, these assets should be viewed somewhat with a bit of suspicion, primarily because there are notoriously difficult to sell, possibly making the true value of these assets much smaller than what is reflected on the balance sheet. The flip side of this could be equipment that will not technologically or physically deteriorate much over time. In that case, the depreciated value could be overstated, meaning the equipment has more value than is on the balance sheet.

Depreciation attempts to capture the decrease in value of an asset over time. As an example, if a factory is worth \$10M in Year 1 and \$8M in Year 2, the asset has decreased in value by \$2M. This is shown in the Income Statement by introducing a cost line called depreciation that decreases the profit by \$2M. It should be noted that the effect of depreciation is to spread the cost of a fixed asset over the expected life of the asset. Depreciation does not remove cash from the company (the release of cash occurs when the asset is initially purchased).

Intangibles and/or Goodwill are make-believe assets. Intangibles are, well, intangible – things like the value of a jingle, trademark or brand. Goodwill arises when a company, or some other asset, is purchased for substantially more money than its actual value. If a company has significant make-believe assets, you should take the time to investigate what the company has done to run them up, if they are in fact worth anything at all, and what issues may arise if these assets must be decreased or “written down”. We have discussed industry sectors where this has become a significant problem.

A PET PEEVE: EBITDA, AKA EBIT-DUH...

Some companies will stress Earnings Before Income Taxes less Depreciation and Amortization (EBITDA) as the most appropriate measure for the company. Before we make excessive fun of this approach to life, let's, at least, walk through the logic of focusing upon this metric.

The argument begins by stressing that while depreciation and amortization are negative impacts upon the profitability of the corporation, they are not cash charges. The argument then goes on to say that big things like factories only happen once, so that excluding depreciation provides a better go-forward view of the company.

Let's start by noting that factories, and the equipment used in them, don't last forever and that most businesses with high fixed costs require ongoing capital investment to be competitive. That means that sometime in the future another big capital outlay will be incurred, but since it will be capitalized, the large cash hit won't hurt the profitability of the company much in the quarter that it is purchased. This sort of logic means that you don't have to show the big expenditures when they are made, and you don't have to show the drag of the depreciation either. (Wait! Doesn't that seem just a little too good to actually be true?)



If high-tech factories really lasted forever, auditors would allow the assets to be depreciated over very long periods of time, effectively making the depreciation cost very low. However, a plant that produces a cutting edge device is typically also cutting edge. Try repeating this phrase for fun: “The high tech fab, now just 8 years old, will be producing revolutionary devices for many years to come.”

Another argument that is sometimes made is that a factory was designed in a boom time, and, therefore, has too much capacity. Because it was made too large, it was too expensive- leading to a depreciation charge that is too large. What is happening here is avoidance, if the factory is too big (and depreciation too large), the value of the factory should be written off to more accurately reflect the value of the factory as an asset. (These types of arguments are really interesting to run by auditors.)

Solid high tech businesses understand that the cash flow that is generated by depreciating assets must generally be re-invested to keep the technological capability of the company competitive. By ignoring depreciation to impress investors or shareholders, executives effectively lower the bar on performance of their companies and run the risk of perpetually having cash slip out of the company.

LIABILITIES

Liabilities, similar to assets, are comprised of short-term (payments are due quickly) and long-term (payments are not due for at least twelve months).

Short-Term Liabilities

Accounts Payable

Accounts Payable result when a company receives a product before it pays. In effect, this is a loan from a supplier, typically at a zero percent interest rate. In the situation where the company has power over its suppliers, payments can often be delayed or “stretched”. In strong, well-run companies Accounts Payable can actually exceed the amount of inventory, implying that vendors are actually stocking the inventory shelves.

Payroll Liabilities

Payroll is comprised of what the company owes to the employees in pay, vacation, and expected bonus payments.

Short-Term Liabilities

Short-Term Loans or Current Portion of Long-Term loans represent the payments the company must make on debts within the coming year.

Warranty



For manufacturing companies, one of the liabilities that is frequently underfunded is the warranty reserve or provision line. This is the expense (not the cash) that a company has set aside for products that are expected to be returned/repared. Ideally, this provision is being historically tracked and the amount listed is representative of what costs are truly expected to be realized. If this number is very large compared to cash balances, caution is in order.

Long-Term Liabilities

Long-term debt, or a debt that will come due more than a year in the future, and long term leases form the two largest classes of this section of the Balance Sheet.

Liquidity Ratios

One of the quickest tests to access financial viability is to compare short-term liabilities to cash holdings and expected receivables. If a company does not have sufficient funds to pay these, or is only able to live “hand to mouth”, the ability of the company to survive inevitable bumps in the road is poor.

There are several metrics that you can use to test the short-term viability of company, including the “Acid Test”, sometimes called the “Quick Ratio”.

$$\text{Acid Test} = (\text{Cash} + \text{Cash Equivalents} + \text{AR}) / \text{Current Liabilities}$$

The Weird Stuff

Some of the hardest things for anyone to understand are off-balance sheet liabilities. These are, as you can imagine, liabilities that are not listed on the balance sheet. In other words, they are liabilities that could become real and become payable *if* certain circumstances occur. From a practical standpoint, the management team has argued to the auditors that the likelihood of circumstance is so small that the liability can be excluded from financial consideration.

An example of one could be the cost of returning a fab site back to an environmentally neutral condition if the site is closed. If the cost of this “clean-up” is too high, it may mean that the company will continue operating this fab indefinitely. If the company attempts to sell the site, the buying company might, or might not, find this clean-up cost in due diligence. Clearly, this off-balance sheet liability would now be considered in the purchase decision, even though it has never been shown on a balance sheet. The most egregious case of off-balance sheet liabilities was the collapse of [Enron](#), which also led to the collapse of the auditing firm Arthur Andersen.

EQUITY

Equity can be thought of to be comprised of two portions: the investments made into the company either by Funding Sources, i.e. Venture Capital, or stock issuances and the cumulative profits (or losses), less dividends paid, of the company since it has been operating (retained earnings).



One of the best ways to get a fast read on a company is to look at the cumulative retained earnings. Particularly for tech companies, since they don't typically pay dividends, this is what the cumulative operational performance of the company has been. If retained earnings are large, the company has a history of creating value. However, if it is a large negative number, the company has a history of destroying shareholder equity. That is the ultimate test of performance.

CONCLUSIONS

We have given a very brief description of some of the most common sections of a balance sheet and given short examples of some things that could be red flags relative to the fundamental operations of companies. This is just the beginning of what can be gleaned from skimming a balance sheet.

Even more can be deciphered when a balance sheet is read in more depth. What is even more important to think about when considering a balance sheet is the relationship of one section to another and the relationship within the subsections to each other. For example, is cash being drained to build inventory? Is there a big difference between the collection time of receivables and the payment cycle for payables? Are intangibles the biggest asset line? Are payables swamping short-term assets? Is the company funding itself by external cash inputs rather than profits and internal cash generation?

Rather than viewing a balance sheet as a static point in time picture of a company, as it is commonly defined, it is much more informative to view the trend of the individual line items and, even more important, the trend of the ratios of the sections. These trajectories tell you whether a company is improving or declining and at what rate these changes are occurring. These are often the best indicators of the capability of the management team as they react to business challenges.

Cheers,

The InSite Team

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