

Balance Sheet #101

A company's financial statements (Balance Sheet, Income Statement, Cash Flow Statement) are a key source of data for analyzing the investment value of its stock (Publicly Traded Stock) or the Enterprise or Fair Market Value of a Privately Held Company. Investors, both the do-it-yourselfers and those who follow the guidance of an investment professional, don't need to be analytical experts to perform financial statement analysis. Today, there are numerous sources of independent research, online and in print, which can do the "number crunching" for you. However, if you're going to become a serious investor or purchaser, a basic understanding of the fundamentals of financial statement usage is a must. In this brief article, we hope to help you to become more familiar with the overall structure of the balance sheet.

The Structure of a Balance Sheet

A company's balance sheet is comprised of: Assets, Liabilities, and Equity. Assets represent things of value that a company owns and has in its possession or something that will be received (such as Accounts Receivable) and can be measured objectively. Liabilities are what a company owes to others - creditors, suppliers, tax authorities, employees etc. They are obligations that must be paid under certain conditions and time frames. A company's equity represents retained earnings and funds contributed by its shareholders, who accept the uncertainty that comes with ownership risk in exchange for what they hope will be a good return on their investment.

The relationship of these items is expressed in the fundamental balance sheet equation:

Assets = Liabilities + Equity

The meaning of this equation is important. Generally sales growth, whether rapid or slow, dictates a larger asset base - higher levels of inventory, receivables and fixed assets (plant, property and equipment) BUT NOT necessarily so in a "Service" based company who generally has very few assets. For those companies whose assets grow, its liabilities and/or equity also tends to grow in order for its financial position to stay in balance.

How assets are supported, or financed, by a corresponding growth in "Payables", debt liabilities and equity reveals a lot about a company's financial health. (A complete "Ratio Analysis" may be researched on the Web and several models as well.) For now, it is sufficient to say that depending on a company's line of business and industry characteristics, possessing a reasonable mix of liabilities and equity is generally a sign of a financially healthy company. While it may be an overly simplistic view of the fundamental accounting equation, investors and potential purchasers should view a much bigger equity value compared to liabilities as a measure of positive investment quality, because possessing high levels of debt can increase the likelihood that a business will face financial troubles.

Balance Sheet Formats

Whether the Balance Sheet format is up-down or side-by-side, all balance sheets conform to a

presentation that positions the various account entries into five sections:

Assets = Liabilities + Equity

Assets:

*Current Assets (short-term): items that are convertible into cash within one year

*Non-current assets (long-term): ie... fixed items of a more permanent nature

Liabilities:

*Current Liabilities (short-term): obligations due within one year

*Non-current liabilities (long-term): obligations due beyond one year

Equity:

*Shareholders Equity (permanent): shareholders' investment and retained earnings

The Importance of Dates

A balance sheet represents a company's financial position for one day at its fiscal year end, for example, the last day of its accounting period, which can differ from our more familiar calendar year. Companies typically select an ending period that corresponds to a time when their business activities have reached the lowest point in their annual cycle, which is referred to as their natural or "fiscal" business year.

However, the income and cash flow statements reflect a company's operations for its whole fiscal year of 365 days. Given this difference in "time", when using data from the balance sheet (a Business snapshot) and the income/cash flow statements... it is more accurate, (unless significant increases or decreases are found from year to year) and is the practice of analysts, to use an average number for the balance sheet amount. This practice is referred to as "averaging", and involves taking the year-end, for example 2008 and 2009 figures and let's say for total assets we add them together, and divide the total by two. This exercise gives us a rough but useful approximation of a balance sheet amount for the whole year 2009. However, it is prudent to know that a company's assets can be significantly increased from year to year and this a legitimate reason to NOT utilize averaging.

Typically, a company's complete financial statements are the basis of analyzing the Enterprise Value of a company for purchase or investment. A Buyer must be aware of the difference between a "Stock" Value for the purchase of traded stocks and Fair Market Value in the purchase of a privately held company.

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