

Reading a Balance Sheet

Financial Skills

Team FME

www.free-management-ebooks.com

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Preface

This eBook will give you a thorough understanding of the balance sheet, a powerful decision-making tool that every manager should be familiar with.

You will learn:

- Exactly how assets, liabilities, and equity are defined and documented
- How to use a balance sheet to determine an organization's liquidity and solvency
- How the balance sheet and other key financial documents fit together
- How to perform vertical and horizontal common-size analyses to detect changes in an organization's financial status
- How to assess the ability of an organization's management by using key financial ratios

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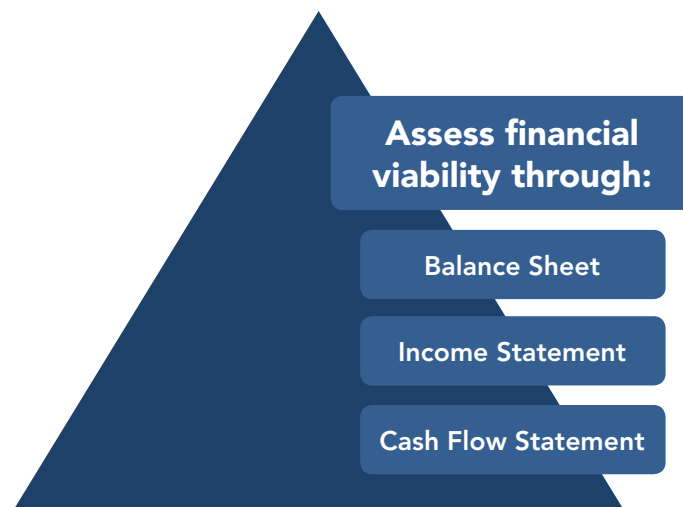
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Introduction

You will increasingly need to be able to communicate in the language of finance as you progress upwards through the levels of management. This eBook will give you the knowledge to interpret any organization's balance sheet and draw conclusions about its performance and profitability.



A balance sheet, also known as a 'statement of financial position,' shows a company's assets and liabilities, and the owners' equity. Together with the income statement and cash flow statement, it makes up the cornerstone of any company's financial reports. If you wish to become more familiar with income and cash flow statements visit our website www.free-management-ebooks.com and download our free eBooks 'Understanding Income Statements' and 'Controlling Cash Flow.'

As a manager, it is important that you understand how a balance sheet is structured and how to analyze it so that you can take an active role in strategic and business development decision making. These decisions determine which assets are required and how they will be used within the organization to attain its mission or goal.



The main concept of a balance sheet is that total assets *must equal* the liabilities plus the equity of the company at a specified time. When you describe assets in this way it shows you how they were financed. This is either by borrowing money (liability) or by using the owner's money (equity).

A Balance Sheet

Shows what tools are available to an organization to remain profitable

Is the only financial statement that relates to specific point in time & not a period of time

Can be presented either in Report or Account format

Most organizations need both staff and resources in order to deliver their goods or services. Even a self-employed designer working from a home office will need a computer and some office furniture. A large manufacturing corporation may have millions of dollars worth of buildings, as well as office and manufacturing equipment. These are referred to as assets and they are an important part of any business.

Whether you are looking at your own organization, a competitor, or a prospective partner organization you need to understand how financially sound they are. The balance sheet will tell you if they are profitable, and furthermore what tools are available to make those profits again in the future. A balance sheet is a three-part financial statement that summarizes an organization's

1. Assets (presented in order of liquidity),
2. Liabilities and
3. Equity

at a specific point in time.

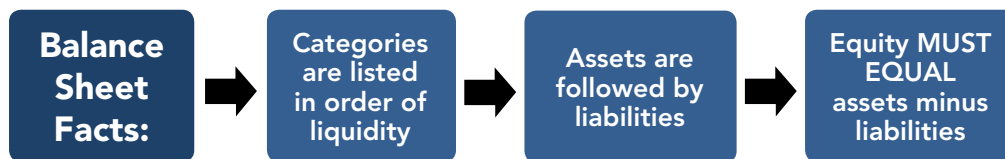
Unlike the other basic financial statements (income statement and cash flow statement), the balance sheet applies to a single point in time rather than a period of time. This is usually the date that corresponds to the end of an organization's financial year, and consequently the balance sheet is often described as representing a 'snapshot' of a company's financial condition.

An organization's balance sheet can take one of two forms:

- **Report form**—uses a vertical format to show assets followed by liabilities and then equity.
- **Account form**—lists assets on the left-hand side and equity plus liabilities on the right-hand side.

For large corporations the balance sheet is an essential element of their annual report and the figures are usually shown alongside those for the previous year.

As stated earlier, the assets are usually listed first (in order of liquidity) followed by the liabilities. The difference between the assets and the liabilities is known as equity and this equity *must* equal assets minus liabilities.



Balance sheets are usually presented with assets in one section and liabilities and equity in the other section with the two sections 'balancing.'

Each of these terms has a very specific meaning when being used in financial statements and it is essential that you have a clear appreciation of each one. If you want to refresh or clarify your understanding of these terms then download our eBook 'Accounting Principles' by visiting www.free-management-eBooks.com.

KEY POINTS

- ✓ The ability to understand a balance sheet is a key management skill that you will use more and more as your career progresses and you need to make decisions based on financial information.
- ✓ The balance sheet, together with the income statement and cash flow statement, make up the cornerstone of any organization's financial statements.
- ✓ The main concept of a balance sheet is that total assets must equal the liabilities plus the equity of the company at a specified time.

- ✓ A balance sheet shows what tools are available to an organization to remain profitable.
 - ✓ It is the only financial statement that relates to specific point in time and not a period of time.
 - ✓ It can be presented either in Report or Account format.
-

Assets, Liabilities, and Equity

By presenting the balance sheet data in three sections, prospective and current investors, plus third parties wishing to work with an organization, can gain an appreciation of what the company owns and owes, as well as the amount invested by the shareholders.

Each of the three segments of the balance sheet will have many accounts within it that document the value of each. For example,

Assets section will usually have accounts for things like stock/inventory, buildings, equipment, and money owed to the company.

Liabilities section will have accounts for money owed by the company to suppliers and its own workers in the form of wages that have not yet been paid.

Equity section will show the net assets, often referred to as shareholder equity, and consists of issued capital and reserves, both controlling interests, as in a parent or holding organization, and non-controlling interest in equity. (The latter, also known as 'minority interest,' is the portion of an organization's stock or shares not owned by the parent. Usually this figure should be below 50% in order for an organization to remain a subsidiary.)

Balance sheets for a large corporation are often quite complex, but once you have learnt how to decipher and interpret each section you will find it an invaluable skill. Once you attain this knowledge you will recognize the importance it plays in aiding your understanding of what really is going on inside an organization and where its potential lies.

To illustrate this, we have chosen to work through two examples. First, a simple balance sheet a self-employed individual would use and then a typical balance sheet used by a large manufacturing organization.

Simple Balance Sheet Example

Larry's Lawn Cutting is a one-man business that offers a grass cutting service. Larry has just come to the end of his second year in business. He started by cutting neighbors' lawns with his own small grass-cutter. After a year he realized that the best way to make money cutting grass was to work for local schools and parks departments who have large areas of grass.

Larry's Lawn Cutting Income Statement Year to December 31		
	Last Year \$	Previous Year \$
Sales	100,000	75,000
Cost of Sales (Labor)	(45,000)	(45,000)
GROSS PROFIT	55,000	30,000
OPERATING EXPENSES		
Secretarial Services	1,000	1,000
Bookkeeping	1,000	1,000
Depreciation	10,000	0
Total Operating Expenses	(12,000)	(2,000)
OPERATING INCOME	43,000	28,000
Interest Expense	(15,000)	0
NET INCOME	28,000	28,000

First we need to consider Larry's income statement. The one above shows his two consecutive years side by side for easy comparison between the past year and the previous year.

It is important for Larry to examine his income statement because this is where he can look at his earnings for each year and see how effectively he has managed his expenses. The key findings of this income statement are:

- Sales have increased 33%, from \$75,000 to \$100,000.
- Gross profit rose by 83%, from \$30,000 to \$55,000.
- Operating income increased 53% from \$28,000 to \$43,000.
- Despite both of these substantial increases, his net income remained static at \$28,000. The reasons for this are:

- A six-fold increase in his total operating expenses from \$2,000 in his first year to \$12,000 in the last year. This increase is solely due to depreciation rising from \$0 to \$10,000.
- Interest expense in the previous year was zero but in the last year it was \$15,000. So non-operating expenses made a significant impact on net income.

Does this income statement show that Larry's business is in better shape in the last year? Do you have sufficient information in this comparative income statement to draw a conclusion?

It is impossible to tell exactly why these operating and non-operating expenses have arisen from the income statement alone. You can speculate why you think this may have occurred. For example, you might guess that there has been a large expenditure on equipment but it is not possible from the income statement alone to see exactly what assets (in the form of machinery) Larry's company owns.

This can only be determined by looking at a sample of Larry's balance sheet (shown below), as this is where the details of any productive equipment the organization owns is recorded along with how much is left to pay on it.

Larry's Lawn Cutting Balance Sheet December 31, 2013	
Assets	\$
CURRENT ASSETS	
Cash & Equivalents	7,000
Accounts Receivable	15,000
Bad Debt Provision	500
Total Current Assets	22,500
Equipment	50,000
Less Accumulated Depreciation	(10,000)
Total Equipment	40,000
TOTAL ASSETS	62,500
Liabilities	
CURRENT LIABILITIES	
Accounts Payable	500
Income Taxes Payable	3,000
Current Portion of Long Term Debt	15,000
Total Current Liabilities	18,500
LONG TERM LIABILITIES	
Lease contracts	50,000
Less Current Portion of Long Term Debt	(15,000)
Total Long Term Liabilities	35,000
TOTAL LIABILITIES	53,500
EQUITY	9,000
TOTAL LIABILITIES PLUS EQUITY	62,500

From the balance sheet you can see that Larry has invested \$50,000 in equipment.

To buy it, he needed to borrow this amount from the bank and has agreed to pay this back at a rate of \$15,000 per year plus interest (over 4 years). This investment was made because Larry realized that even working for 50 hours a week he could only make \$28,000 cutting garden lawns as there simply weren't any more hours in the day for him to work. Consequently, he decided to invest \$50,000 in a professional grass-cutting machine. This allowed him to work faster and more efficiently. It also enabled him to take on larger contracts for grass cutting in public parks.

As part of this decision-making process Larry would also have looked at his expected revenue for the coming year to ensure the additional revenue would cover the repayment costs. For example, Larry expects to make sales worth around \$180,000 as a result of his increased efficiency. This should translate into an income of around \$100,000 even allowing for \$4,000 to maintain the new machine.

The depreciation for the equipment is listed in the assets section and shows a figure of \$10,000 for the year, as he expects it to last for 5 years before it needs to be replaced.

Note that there is no figure for the interest that Larry needs to pay on the \$50,000. This is because the interest will only become a liability as it falls due.

Organizations often add 'notes' to their financial statements to provide a narrative explanation of certain items and Larry himself could include an explanation of his reasons for the investment. This would be worth doing if Larry decided to apply for a bank loan or overdraft, as the bank could then see the rationale for his purchase of the machine.

KEY POINTS

- ✓ The assets section will usually have accounts for things like stock/inventory, buildings, equipment, and money owed to the company.
- ✓ The liabilities section will have accounts for money owed by the company to suppliers and its own workers in the form of wages that have not yet been paid.
- ✓ The equity section will show the net assets, often referred to as shareholder equity, and consists of issued capital and reserves, both controlling interests, as in a parent or holding organization, and non-controlling interest in equity.
- ✓ The limitations of the income statement mean that you cannot see what assets a company owns or what its liabilities are.

A More Complex Balance Sheet

Larger organizations have more complex operations than Larry's Lawn Cutting and this translates into a more complex balance sheet. The next example uses Fred's Factory, a medium-sized company that manufactures automotive parts. This company provides a more representative balance sheet with the level of complexity you will find yourself using when you look at competitors or potential partner organizations.

You should work through each section an item at a time until you are confident that you understand how it has been derived and what it means.

The first part of a balance sheet details the assets owned by the organization and includes a total asset value. The second part details its liabilities along with their total value. Normally, both parts of the balance sheet appear together, but for ease of explanation and comprehension we will describe each part separately.

Understanding Assets

The table below shows how Fred's Factory's assets would be shown on the balance sheet.

Fred's Factory Balance Sheet December 31, 2013	
Assets	\$
CURRENT ASSETS	
Cash & Equivalents	12,000
Accounts Receivable	88,000
Bad Debt Provision	9,000
INVENTORY/STOCK	
Raw Materials	17,000
Work in Process	3,000
Finished goods	24,000
PREPAID EXPENSES	1,000
Total Current Assets	154,000
PROPERTY AND EQUIPMENT	
Property	200,000
Factory Equipment	18,000
Office Equipment	7,000
<i>Less Accumulated Depreciation</i>	(12,000)
Total Fixed Assets	213,000
OTHER ASSETS	
Deposits	1,000
Long Term Investment	2,000
Total Other Assets	3,000
TOTAL ASSETS	370,000

Within this section you will find the total figures under the following headings. The first three headings comprise Fred's total current assets:

- Current Assets
- Inventory/Stock
- Prepaid Expenses
- Property and Equipment (Fixed Assets)
- Other Assets

Current Assets

Under this heading is a list of all assets that can either be converted to cash or used to pay current liabilities within 12 months. Typical current assets include:

- Cash and cash equivalents
- Short-term investments
- Accounts receivable
- Bad debt provision

These are the assets that produce most of the liquidity in an organization and are the main source of working capital.

Cash and Cash Equivalents

Cash is the most liquid asset of all and is the first item included on the balance sheet. It refers to currency or currency equivalents that Fred's Factory can access immediately or within a few days.

It also includes their petty cash fund and all of the money available in their current accounts plus any cash reserves. The latter may be kept in the form of savings accounts, bank certificates, money market accounts, or other short-term investments.

Accounts Receivable

This consists of the short-term obligations owed to Fred's Factory by its clients or through its trade accounts—for example when they sell their products or services on credit. These obligations are held in the current assets account until the customers pay them off.

Bad Debt Provision

This is simply an estimated amount that Fred's Factory allocates for the possibility that some sales will not be paid for and will have to be written off. From past experience Fred's will know what percentage of its sales fall into this category and use this figure to guide the amount allocated as bad debt provision. Any organization that sells on a credit basis will sooner or later experience bad debt and this reserve is used to absorb the cost of bad debts as they occur.

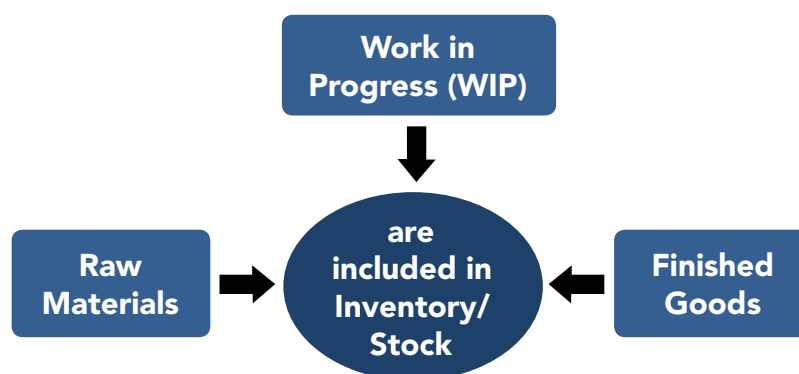
Inventory/Stock

This section covers production materials or products purchased or manufactured and then held by Fred's Factory for sale. As a manufacturer they will divide this section into:

- **Raw materials**—these are the materials and components required by Fred's to make its products.
- **Work in process (WIP)**—includes those raw materials and components that are being used in the production of Fred's finished goods as well as those products as yet unfinished.

The balance sheet will include raw materials costs as well as the labor and related costs applied to those materials during the manufacturing process.

- **Finished goods**—are all those products ready to be sold and the figure on the balance sheet includes all labor costs and related overheads such as factory rent supervision and product inspection.



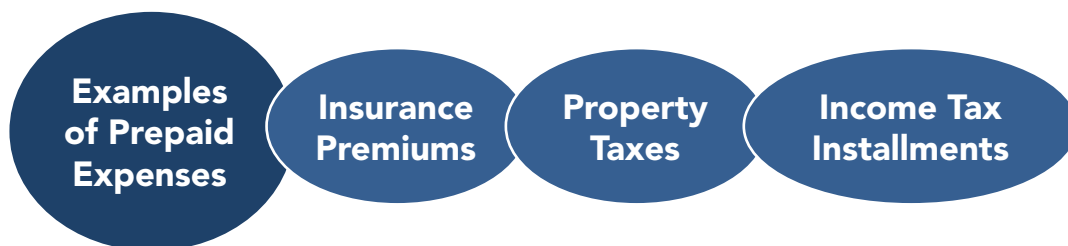
In the case of retailers, distributors, and trading companies who purchase fully manufactured products that they simply resell, the balance sheet will usually show only a single line for this item.

Prepaid Expenses

These are expenses that have been paid in advance and therefore will not have to be paid again. For example,

When the accounting periods are monthly, an eleven-twelfths portion of an annually paid insurance cost is added to prepaid expenses, which are decreased by one twelfth of the cost in each subsequent period when the same fraction is recognized as an expense, rather than all in the month in which such cost is billed.

The not-yet-recognized portion of such costs remains as prepayments (assets) to prevent such cost from turning into a fictitious loss in the monthly period it is billed, and into a fictitious profit in any other monthly period.

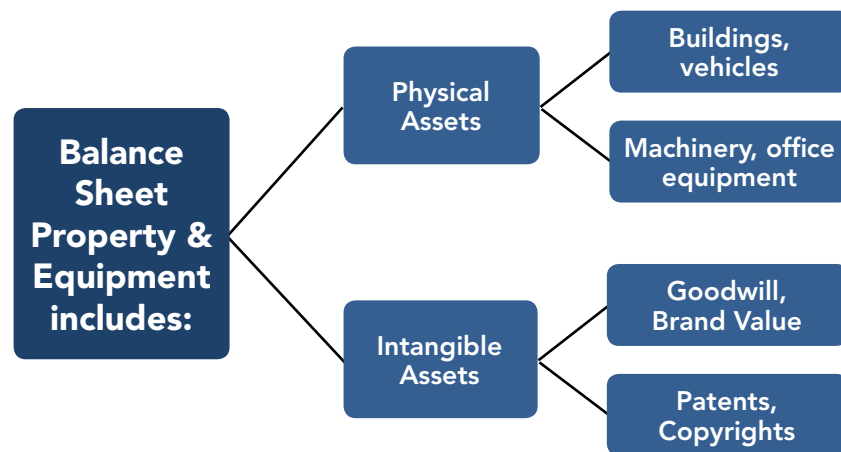


Other examples of prepaid expenses Fred's might have are property taxes or income tax installments. The reasoning behind this is that if an annual insurance policy were canceled halfway through its year, half of the premium already paid would be refunded. This would represent an account receivable from the insurance company and therefore represent an asset.

There are instances where some invoices contain a small prepayment aspect that is so small that separating the prepaid and current aspects are not worthwhile or are too complex. For example, some phone or utility bills have a standing charge that covers a future period. Such items will usually appear in the accounts payable figure on the balance sheet.

Property and Equipment

These are also known as non-current assets, fixed assets, or as property, plant, and equipment (PP&E). Every organization requires physical assets that it uses to conduct its business. For Fred's this includes such items as its buildings, manufacturing equipment, vehicles, and office equipment.



'Property and Equipment' also includes intangible assets, such as goodwill, patents, or copyright, which is why many organizations refer to this section as non-current assets. These assets may not be physical in nature, but they are 'life-blood' (e.g. a brand name) and without them the organization would fail. The value of your organization's non-current assets should not be underestimated.

Your organization will calculate and deduct depreciation from most of these assets, which represents the economic cost of the asset over its useful life. These assets are used for extended periods of time (usually years) and are thus not current assets as they are not held for resale to customers. As such, they cannot be considered sources of liquidity or cash flow.

Accumulated Depreciation

The value of a fixed asset will usually decline over time and for accounting purposes an organization needs to depreciate its assets in a controlled and uniform manner. This figure is then subtracted from the total value of all its non-current assets.

Many items have a standard way in which depreciation is applied to them and you need to understand the rules that your organization adheres to. For example,

An item of manufacturing equipment cost \$50,000 and has an expected life span of 10 years. To recognize and allocate this cost over its life span an organization will write-down its cost at rate of \$5,000 per year.

The total amount written off in this way since the fixed asset was purchased is shown under accumulated depreciation on the balance sheet. The total of this accumulated depreciation for all an organization's fixed assets is shown immediately after the original cost so that the net value of fixed assets can be shown.

It is important to appreciate that both 'Property and Equipment' and 'Depreciation' are always stated in cost figures regardless of their current market value. There are several reasons for this even if in some cases the market value is less than the purchase cost when the accumulated depreciation is subtracted:

- It would take too much time and money to obtain an appraisal for every asset the business owns.
- The frequency required makes the task completely impractical, as well as virtually impossible to verify.
- The cost minus accumulated depreciation figure has the virtue of being difficult to manipulate as well as providing a uniform standard.
- Meaningful comparisons can be made between companies.

Other Assets

These are items in Fred's Factory that are neither current nor fixed. They could include:

- An investment held for an extended period of time.
- A deposit paid to the landlord from whom the company leases its offices.

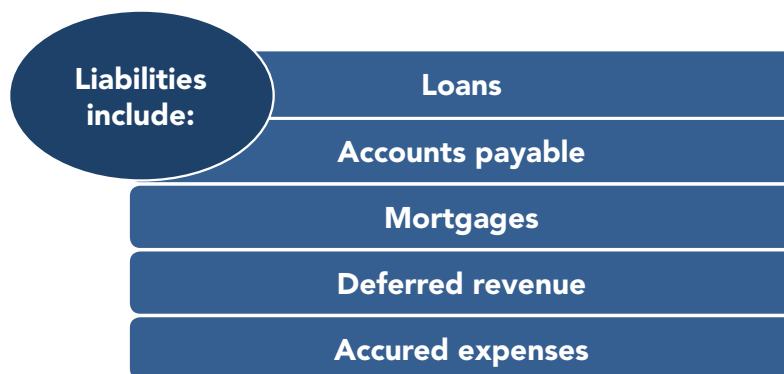
The reason why a deposit paid to a landlord is not classified as an expense is that it could be applied against the final rent invoice or returned to the tenant when the property is vacated. It must therefore be classified as an asset.

KEY POINTS

- ✓ Current assets include cash and cash equivalents, short-term investments, accounts receivable, and bad debt provision.
- ✓ Inventory includes raw materials, work in process, and finished goods.
- ✓ Prepaid expenses are those things that have been paid in advance like insurance premiums, property taxes, and income tax installments.
- ✓ Property and equipment includes such items as buildings, manufacturing equipment, vehicles, and office equipment.
- ✓ Accumulated depreciation allows an organization to depreciate its assets in a controlled and uniform way.

Understanding Liabilities

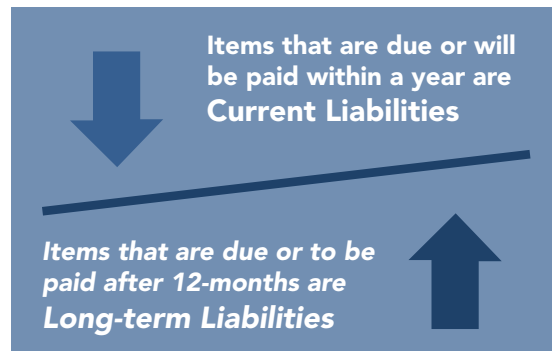
On the other side of the balance sheet are the liabilities. These are a company's legal debts or obligations that arise during the course of business operations. Liabilities include loans, accounts payable, mortgages, deferred revenues, and accrued expenses.



Within this section of the balance sheet you will find the total figures under the following headings.

- Current liabilities
- Long-term liabilities
- Equity

Like assets, they can be both current and long term. Long-term liabilities are debts and other non-debt financial obligations, which are due after a period of at least one year from the date of the balance sheet.



The table below shows how the liabilities section of Fred's Factory's balance sheet would look.

Fred's Factory Balance Sheet December 31, 2013	
Liabilities	\$
CURRENT LIABILITIES	
Accounts Payable	28,000
Accrued Payroll	12,000
Other Accrued Liabilities	2,000
Income Taxes Payable	4,000
Notes Payable to Banks	1,000
Current Portion of Long Term Debt	4,000
Total Current Liabilities	51,000
LONG TERM LIABILITIES	
Lease contracts	22,000
Long Term Debt	180,000
Loans from Shareholders	60,000
Less Current Portion of Long Term Debt	(4,000)
Total Long Term Liabilities	258,000
TOTAL LIABILITIES	309,000
EQUITY	
Capital Stock	10,000
Contributed Capital	5,000
Retained Earnings	46,000
Total Shareholder Equity	61,000
TOTAL LIABILITIES & EQUITY	370,000

Current Liabilities

Current liabilities are those that will become due, or must be paid, within one year. They usually include payables such as wages, accounts, taxes, and accounts payable, un-earned revenue when adjusting entries, portions of long-term bonds to be paid this year, and short-term obligations (e.g. from purchase of equipment).

In this example these items are listed under the following headings:

- Accounts Payable
- Accrued Payroll
- Income Taxes Payable
- Other Accrued Liabilities
- Notes Payable and Other Bank Debt
- Current Portion of Long-term Debt

Accounts Payable

This includes all of Fred's bills as yet unpaid from suppliers and service providers. It is usually the first item listed under current liabilities. The amounts in this category should be listed in accordance with the trade terms on the supplier invoices, for example 30 days, 60 days, etc.

Accrued Payroll

This represents the amount earned by Fred's employees, but which has not yet been paid to them. This is because employees are paid in arrears for time they have already worked. Every organization has some amount of money owed to its employees but not yet paid.

Other Accrued Liabilities

These include expenses that Fred's Factory has incurred for which they have not yet received an invoice. Their finance officer needs to estimate the liability rather than wait for an invoice with an exact figure.

Notes Payable and Other Bank Debt

Within this section, Fred's Factory includes such items as bank loans that represent borrowed money. These loans and its associated repayments typically have special terms and need to be recognized in their own right.

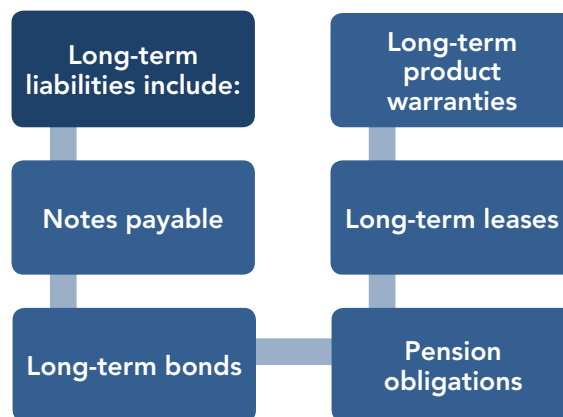
These are not simply trade accounts Fred's Factory has with its suppliers as these items are always shown separately.

Current Portion of Long-term Debt

This is the portion of the debt Fred's has that must be repaid within the next 12 months. This is likely to be something such as the latest interest payment on a 10-year loan.

Long-term Liabilities

Under this section heading of the balance sheet Fred's Factory list any long-term liabilities they have. These would be any debts and other non-debt financial obligations, which are due after a period of at least one year from the date of the balance sheet.



They usually include issued long-term bonds, notes payable, long-term leases, pension obligations, and long-term product warranties. Liabilities of uncertain value or timing are called provisions.

Long-term debt

Fred's Factory has financing needs that extend for many years and has opted to borrow money with very long payment terms. This enables them to put the money to use in order to earn enough to repay the loan.

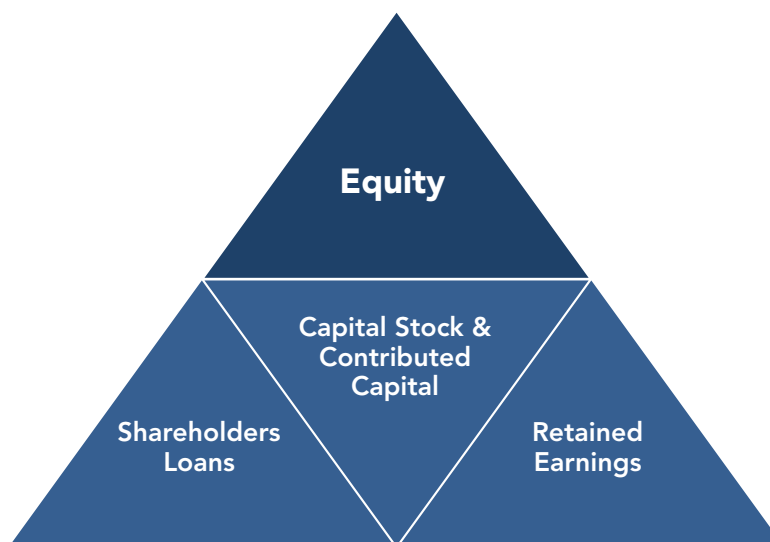
In such cases the entire amount of the loan is reported as long-term debt and the portion of this loan that is due to be paid within the next 12 months is shown in the current liabilities. In this example Fred's have a long-term debt of \$180,000.

KEY POINTS

- ✓ Liabilities are a company's legal debts or obligations that arise during the course of business operations and include loans, accounts payable, mortgages, deferred revenues, and accrued expenses.
- ✓ Current liabilities are those that will become due, or must be paid, within one year.
- ✓ Long-term liabilities are debts and other non-debt financial obligations, which are due after a period of at least one year from the date of the balance sheet.

Understanding Equity

Equity is the difference between total assets and total liabilities. While it is sometimes thought of as indicating the value or worth of the business, this is not really the case because assets are listed at their cost value minus accumulated depreciation rather than their actual market value.

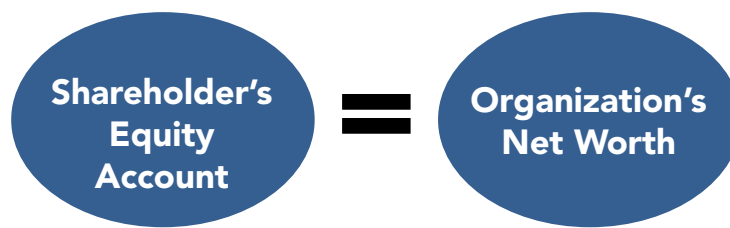


In order for the balance sheet to balance, total assets on one side have to equal total liabilities plus shareholders' equity on the other.

The items that will appear under this section are:

- Loans from Shareholders
- Capital Stock and Contributed Capital
- Retained Earnings

Shareholders' equity is the initial amount of money invested into a business. If, at the end of the fiscal year, a company decides to reinvest its net earnings into the company (after taxes), these retained earnings will be transferred from the income statement onto the balance sheet into the shareholders' equity account. This account represents an organization's total net worth.



Loans from Shareholders

This is often seen on the balance sheets of privately owned organizations such as Fred's Factory that is operated by its owners. This is how an owner can put money into their organization when it is needed and take it back again when it isn't.

Banks and other institutional lenders may require that such balances remain unpaid as long as the organization has outside loans.

Capital Stock and Contributed Capital

Capital stock is the amount paid into the organization by investors to purchase stock at some nominal amount per share. In the case of Fred's Factory they have received \$10,000 capital stock and a further \$5,000 contributed capital from investors.

Retained Earnings

Every commercial organization from its inception develops a history of profits and losses. In times of profit these can be added to retained earnings and when losses are incurred

it reduces these retained earnings. Fred's as an organization has operated with overall profitability and has been able to accumulate \$46,000 as retained income.

Earnings are often retained within an organization as they enable the management to expand and purchase capital equipment or other fixed assets as dictated by their growth strategy. In circumstances where an organization has made a sustained loss this item may be described as a 'Deficit in Retained Earnings.'

KEY POINTS

- ✓ Equity is the difference between total assets and total liabilities.
- ✓ The items that will appear under this section include loans from shareholders, capital stock, contributed capital, and retained earnings.

What a Balance Sheet Tells You

As a manager you can gain a significant amount of knowledge about an organization from understanding the financial information shown in a balance sheet, which can tell you:

- How much it owns—its assets.
- How much it owes—its liabilities
- How much equity owners have—its shareholder equity account

If you were investigating Fred's Factory you would be able to see that their total assets are \$370,000 and their total liabilities are \$309,000, with \$61,000 shareholder equity.

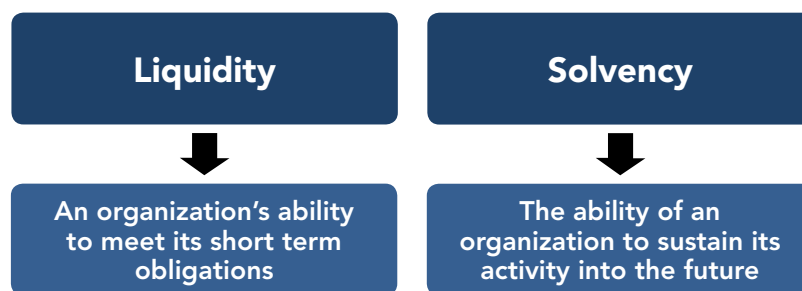
In addition to these figures, you will usually want to gain an appreciation of an organization's liquidity and solvency, as well as how its tangible assets compare to its intangible ones.

From the balance sheet you would also be able to perform a common-size analysis, which expresses the figures as percentages to reveal how efficiently the organization is being managed. There are also a variety of financial ratios you can calculate that enable you to assess how well an organization is managing its inventory and receivables.



This eBook provides you with an overview of each of these key areas. If you want a more detailed explanation then you should download our free eBook 'Assessing Financial Performance' by visiting our website www.free-management-ebooks.com.

Liquidity and Solvency



A key part of your investigation into any organization is to gain understanding of:

- **Liquidity**—the organization's ability to meet its short-term obligations. This includes such items as how much working capital it requires and its debt obligations.
- **Solvency**—the ability of an organization to sustain its activities into the future.

If you wish to assess an organization's liquidity you would use the 'Current Ratio,' which assesses the relationship of its current assets to its current liabilities as defined in the previous sections.

Financial institutions usual require a small organization to have a 2:1 current ratio, but it does depend on the industry sector in question. For instance, a traditional industrial manufacturer will have a lower liquidity ratio than a small retailer.

This 2:1 ratio means that there are twice as many current assets as liabilities. If we look at Fred's Factory his current ratio would be 3:1 and although this represents a good liquidity ratio at first sight you would need to compare to their industry sector before you draw any firm conclusions.

$$\begin{array}{c} \text{Current} \\ \text{Assets} \\ \$154\text{K} \end{array} \div \begin{array}{c} \text{Current} \\ \text{Liabilities} \\ \$51\text{K} \end{array} = \begin{array}{c} \text{Current} \\ \text{Ratio} \\ 3:1 \end{array}$$

There is one aspect of the current ratio some analysts are not happy to include in assessing an organization's liquidity and that is 'inventory.' This is because it is difficult to turn inventory into cash. For this reason analysts prefer to use what is known as the 'quick ratio' to measure liquidity.

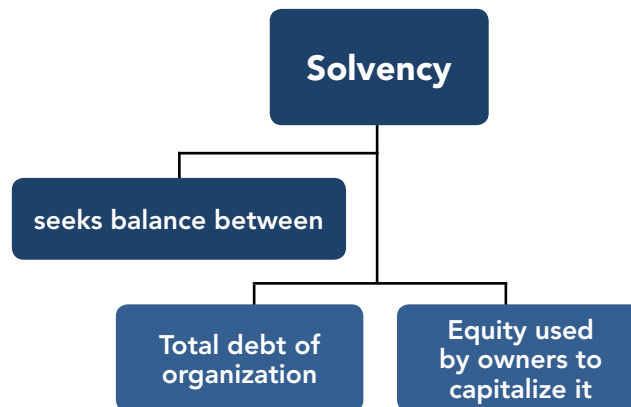
If you choose to use the quick ratio you would calculate the current assets that are judged to be the easiest to turn into cash (for example, cash on hand, marketable securities, and receivables), which you then divide by current liabilities.

As before, being mindful of the industry your organization operates in is essential, as many sectors can more easily than others turn stock into cash. For example, a sector such as retail can collect its receivables more easily than other industries.

$$\begin{array}{c} \text{Current} \\ \text{Assets (less} \\ \text{stock)} \$109\text{K} \end{array} \div \begin{array}{c} \text{Current} \\ \text{Liabilities} \\ \$51\text{K} \end{array} = \begin{array}{c} \text{Quick} \\ \text{Ratio} \\ 2:1 \end{array}$$

The quick ratio for Fred's Factory shows a reduced liquidity ratio because nearly a third of their current assets are accounted for by stock (\$44,000).

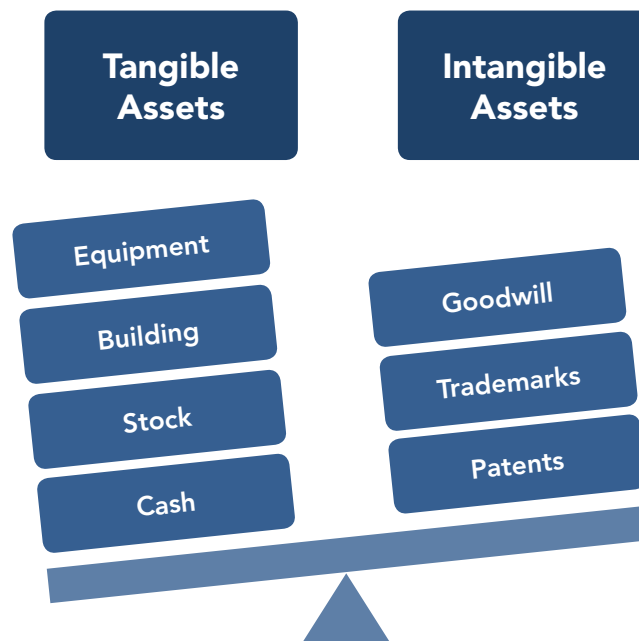
When you want to assess an organization's solvency you want to see an element of balance between its total debt and the equity used to capitalize it. This shows how well the organization is able to sustain its activities for an extended period in the future.



The element of 'balance' will vary between different industries as some (for example banks) use debt to finance their activities, whereas a service company is more likely to finance its growth through equity.

Tangible Versus Intangible Assets

The next aspect of the balance sheet you need to assess is the ability an organization has to liquidate an asset. This is achieved by looking at whether or not assets are tangible or intangible.



The definitions of these different types of assets are:

- **Tangible assets** are items that are physical in nature and include cash, inventory, buildings, equipment, and accounts receivable.
- **Intangible assets** are items like patents and trademarks.

In the case of intangible assets you need to take great care as to how you assign a value to them. When one of an organization's key activities is acquiring other organizations there is likely to be considerable 'goodwill' listed on the balance sheet as an asset. This is classified as an intangible asset because if the organization needs access to funds quickly they cannot cash in this goodwill. During the negotiations, if the expected outcome is not attained the buying organization will have to write down the goodwill.

In the case of Fred's Factory, the majority of their assets are tangible because there is no listing of any patents or trademarks. This means that if Fred's needed to they could easily liquidate assets.

There is another key aspect you must look at within the balance sheet when assessing an organization and that is what is referred to as 'other comprehensive income.' This item is recorded in shareholders' equity and results from any income or losses that occur as part of foreign currency conversions.

Due to the nature of such items they are not included in an organization's income statement. Such income occurs where organizations earn revenue in one currency, such as the yen, but never actually convert it to dollars. In terms of assets, whilst the item may show significant sums of money it cannot be relied upon in the event of liquidation, as it may never be realized.

KEY POINTS

- ✓ An organization's balance sheet allows you to determine its liquidity and solvency as well as the ratios of its tangible and intangible assets.
- ✓ You can also use it to determine key ratios like the current ratio and the quick ratio.
- ✓ Assessing the ability of an organization to liquidate its tangible assets will give you an idea of how well it could deal with a liquidity problem.

Performing a Common-Size Analysis

In the same way that breaking an income statement down into percentages (by dividing each item by revenues) is informative, it is equally revealing for a balance sheet. Performing a common-size analysis on a balance sheet can be done in one of two ways:

- Vertical common-size analysis
- Horizontal common-size analysis

When using a vertical common-size analysis, you express inventory, liabilities, and equity as a percentage of total assets. In the case of Fred's Factory its inventory of \$44,000 is nearly 12% of its total assets of \$370,000.

$$\text{Inventory } \$44\text{K} \div \text{Total Assets } \$370\text{K} = 12\%$$

To fully appreciate the ability of an organization's management, such figures need to be compared to those of the two or three previous years to gain some insight from changes that occur over this period.

For example,

If you know that Fred's inventory this last year was 12% of total assets but that this figure was only 10% in previous years, then you would be able to say that their inventory is growing faster than their total assets.

You could then look into this particular area to discover why this is the case.

You may prefer to perform a horizontal common-size analysis as this compares the change year on year for each item of both the income statement and the balance sheet. This enables you to look at how an item has changed relative to the change in total assets and revenue.

The table below gives you some additional figures so that you can see how Fred's inventory has changed when using this method.

Fred's Factory Horizontal Common-Size Analysis			
	Last Year \$	Previous Year \$	% Change
Revenue	100,000	75,000	33%
Total Assets	370,000	350,000	6%
Inventory/Stock	44,000	36,000	22%

From this, you can see that revenue has grown by 33%, while assets have only grown by 6%, although inventory increased by 22%. You would need to carry out further investigations to be able to discern the reasons why both revenue and inventory have grown so much whilst assets are relatively stable.

You would also want to determine what the long-term impact of this pattern could be if it continued. It may indicate that Fred's need to watch their earnings quality or that they may be in danger of overstating inventory or building it up too much. Whatever the reason, the balance sheet has highlighted this as a potential area of inefficiency that will need to be addressed.

Another key area to watch closely is receivables. If your calculations show that they are increasing faster than revenue, this may indicate that Fred's Factory has a problem with collections. You would want to understand the management's attitude to increasing its allowance for doubtful accounts, because if receivables are increasing faster than revenue Fred's may need to change to a faster pace in this area.

Other Key Ratios

Earnings quality is only one of many ratios you can use to assess the ability of an organization's management. You can also judge how well an organization is managing its inventory and receivables.

A few important ratios you may wish to use as part of your assessment of an organization are:

- Inventory turnover = cost of goods sold ÷ average inventories
- Receivables turnover = sales ÷ average accounts receivable
- Total asset turnover = sales ÷ average total assets

If this is an area you wish to explore in more depth then you should download our eBook 'Assessing Financial Performance' by visiting www.free-management-ebooks.com. This free eBook goes into this area in greater detail using worked examples to ensure clarity.

KEY POINTS

- ✓ Performing a common-size analysis on a balance sheet can be done either horizontally or vertically.
 - ✓ A vertical common-size analysis expresses inventory, liabilities, and equity as a percentage of total assets.
 - ✓ A horizontal common-size analysis compares the change year on year for each item of the balance sheet enabling you to look at how an item has changed relative to total assets.
-

Summary

After studying this eBook you should be better equipped to interpret the figures you see on an organization's balance sheet. You should also have an understanding of how these figures are derived and how to contribute information to your own organization's balance sheet if you are asked to do so.

Analyzing an organization's balance sheet helps you to understand how well it is being managed financially. It also offers you an insight into which aspects of management and strategy are being well managed and which may not be.

Good financial skills will enable you and your organization to be aware of which organizations offer the best investment or partnership opportunities. Remember, the figures on a balance sheet are there to provide you with data that can help you make smarter decisions and forewarn you of potential problem areas.

If you want to develop your financial knowledge and skills further then look at our other free eBooks in the Financial Skills set available from www.free-management-ebooks.com:

- Understanding Income Statements
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