FINANCE AT A GLANCE

Getting insights into the company's financial health through the balance sheet

Lesson 12

After reading the first 11 lessons, we now know:

1. what the balance sheet means;
2. how its components change as a result of transactions, while maintaining the balance between the assets and the liabilities + equity; and
3. how the balance sheet components are further subdivided, and presented.

With everything that we now know, we are ready to start drawing meaningful insights from the balance sheet.

The ability to draw insights from financial statements is what separates managers from bookkeepers, who only compile and add up figures without understanding the implications of such figures in the operations of a business entity.

When we have a balance sheet on hand, our analysis depends who we are in relation to the company represented by the balance sheet. We can be anyone of the following:

the owner/s or shareholder/s of the company
an employee
a competitor
a potential investor
a customer
a supplier
a banker
a government tax official

Whichever of the above our role may be, we have our own set of interests to look after, and our interests are different from those of the other parties.

For illustrative purposes, we shall assume the role of the owners or shareholders of the company. As such, we are interested to know the overall financial health of our business, as that determines the security of our livelihood. (We will deal with the interests of the other parties in future lessons.)

Let us say that today is January 1, 2009, and you got a copy of your company's balance sheet as of December 31, 2008 showing the following items:

ABC Limited
Balance Sheet
As of December 31, 2008

Cash	250,000	(1)	Accounts payable	200,000	(6)
Accounts receivable	300,000	(2)	Accrued liabilities	100,000	(7)
Inventories	350,000	(3)	Current portion of debt	150,000	(8)
Prepaid expenses	100,000	(4)	Income taxes payable	50,000	(9)
Net fixed assets	5,500,000	(5)	Long-term debt	2,000,000	(10)
			Capital stock	500,000	(11)
			Retained earnings	3,500,000	(12)
TOTAL ASSETS	$6,500,000		TOTAL LIABILITIES & EQUITY	$6,500,000	

First question: Does our company have enough cash to pay for debts that will fall due?
Recall that current liabilities have to be settled within one year. The company has $ 500,000 in current liabilities, which is the total of items 6, 7, 8 and 9. As of today, the company has only $ 250,000 in cash. Will the company be able to settle all of its current liabilities? That depends on whether the company will be able to collect its Account receivable (item 2) in time to pay for the current liabilities. How collectible the receivables are depends on the credit standing of the customers from who these receivables are due. So now, we can see how the analysis extends beyond the balance sheet.

Second question: How capable is the company to pay off its long-term debt? One way to answer this is to compare the amount of long-term debt of $ 2,000,000 (item 10) with the net fixed assets (item 5). A high ratio of net fixed assets to long-term debt is desirable. In our case, this ratio is 2.75 (based on item 5 divided by item 10). In the extreme case that we sell off our fixed assets (because we do not want to carry on with the business) and get $ 5,500,000 in proceeds, we can cover the long-term debt 2.75 times, and that's a comforting piece of information.

The above analyses are very simplistic and are intended to give us some idea of what we can do with the knowledge we already have. As we learn more about business finance, we will have more questions to ask, and more insights to gain as we seek to answer these questions.

Until the next e-lesson,

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