The Balance Sheet

by Michael Goldman

What is the first thing you would look at to determine if your company's inventory levels were sufficient to support the sales plan, if it owes more than it can pay back, or whether the company has too much in accounts receivable (usually indicating either credit or quality problems)?

The typical young accountant will often jump right into sub-ledgers (very detailed accounting listings), which provide a wealth of useful information but make it very easy to lose sight of the forest for the trees. Then they move on to the Income Statement, considered the most important because they've been taught that it is the report that "measures the success of enterprise operations for a given period of time".

On the other hand, most experienced professionals who work in finance, restructuring, investment, or business management consider the Balance Sheet to be the most important accounting report. The Balance Sheet is considered to have the information needed to evaluate liquidity and financial flexibility. Great care must be taken though in interpreting this information.

If the Balance Sheet is merely a statement of what the company owns and owes at a particular point in time, why is it so important? One of the main reasons is because it balances. The rule that Assets = Liabilities plus Equity is simple, yet profound.

Without identifying specific legal claims, the balance sheet shows exactly what the company owns (assets) and what claims exist against those assets. The claims on the assets are either from outsiders (liabilities) or owners (equity). The Balance Sheet doesn't let you get away with just the good, showing how many wonderful assets you have. It requires you to present a fair and balanced picture of your financial condition.

Every transaction a company enters into leaves its mark on the balance sheet. For example;

- When an owner invests in the company there is an increase in both an asset (usually cash) and Owners Equity.
- When productive assets are purchased there is an increase in Fixed Assets and either a corresponding decrease in cash or increase in a liability.
- When goods are bought on credit, both inventory (asset) and accounts payable (liability) are increased.
- When goods are sold accounts receivable or cash (assets) increase, inventory (asset) decreases, and the profit or loss ends up in Retained Earnings (owners' equity). In fact any transaction that has a profit or loss impact also gets reflected in Retained Earnings.

Every transaction has both a debit and a credit. Every transaction shows up in two places, and at least one of those places will make its way to the balance sheet. Thus, the Balance Sheet is all-encompassing.

The other great thing about the balance sheet is that almost everything on it is conceptually simple. Cash is cash. Accounts receivable, inventory, buildings, machinery, equipment, etc. are all easy to understand. Intangible assets are a little tougher, but in today's business environment that is so based on intellectual property, concepts like goodwill, patents, trademarks, etc. are also easy to understand (don't worry if you don't, they will be covered in a future chapter).

The other side of the Balance Sheet is also easy - most liabilities are amounts clearly defined and owed to others. Some liabilities, such as accrued expenses, are estimates but are usually logical and straight-forward to calculate. Owners Equity is the sum of all contributions to the company by the owners plus the cumulative income or loss, less any distributions back to the owners.

What is so great about this? The Balance Sheet is straight-forward enough that it is easy to get it right. The Income Statement, on the other hand, is chock full of estimates, assumptions, and judgment calls. That old joke about asking the accountant what Net Income is and the accountant answers "what would you like it to be?" is much closer to reality than to being a joke when preparing an income statement - there is that much leeway in arriving at the Net Income figure.

The Balance Sheet is less prone to manipulation or management decision making because it's numbers are much easier to verify. Ask the accountant what the cash balance is or how much is in accounts payable, and there is only one correct answer he can give you. This is not to say there hasn't been Balance Sheet fraud, there definitely has been, but if the auditors are awake Balance Sheet fraud is very much easier to identify than Income Statement fraud.

So, if you have a good Balance Sheet you can tell exactly what Net Income was by reconciling this Balance Sheet to your previous Balance Sheet. You don't have to know what sales were, what gross profit was, what anything else on your Income Statement was - take two Balance Sheets and by analyzing the changes in owners' equity you can calculate what Net Income was during the period between them.

In some respects a Balance Sheet is like a large water bed, the old-fashioned kind before they figured out how to put stabilizers in them. The mattress was basically a huge water balloon big enough for one or two people to sleep on. You plopped down on the mattress and you sank, while mattress parts that you weren't on rose up around you. Every time you moved, water displaced to another part of the mattress (these beds were horrible when you were really drunk).

Since every transaction in a company manifests itself somewhere on the Balance Sheet, the Balance Sheet has the same sensitivity as those early water beds did. It is the place where fraud is often detected and where legitimate corporate imbalances often accumulate. A company that is doing too much of an activity will eventually accumulate too much of something (inventory, accounts payable, etc.) on its Balance Sheet. A company that is not doing enough productive activity (such as collecting its account receivables or turning its inventory fast enough) will also start creating both excesses and deficiencies on its Balance Sheet. Find the excess accumulations or the areas that are deficient on the balance sheet and you have a wonderful start to zeroing in on the company's problems.

"Excess" and "deficient" are relative terms. "Excessive" in terms of what? Balance Sheet items get compared to other items on the current financial statements, prior financial statements, budgets and forecasts, competitors' financial statements, and perhaps most importantly, your personal knowledge of what is going on in the company and industry.

The types of questions you will ask include: Do each of the items on the balance sheet make sense in relation to each of the other items on it? What trends are occurring over time from one Balance Sheet to the next? How does this company's Balance Sheet compare to the Balance Sheets of other companies in the same industry? For everything it shows, the Balance Sheet is still only a snapshot of the company at one particular point in time. The best way to use it is to continually ask questions about it.

Before accepting the Balance Sheet as the holy grail of accounting, you must also be aware of its limitations, because they are significant. The Balance Sheet does not reflect current market values - everything is stated at historical cost. Even worse, assets that a company internally generated over time rather than buying in an arm's length transaction are not on the Balance Sheet at all. The value of a law firm, for example, lies almost totally in its reputation. The Balance Sheet of that law firm has its cash balances, its accounts receivable, its furniture and equipment, etc., but reputation will never appear on that law firm's Balance Sheet.

Always remember that any number by itself is just a number - one piece of a large puzzle. When taken in its full context, with all of your other information surrounding it, that individual number now helps to form a picture. Most puzzle solvers start with the corner and edge pieces. In financial work, most players start with the Balance Sheet.

Attorneys shouldn't shy away from financial statements just because they consist of numbers instead of words, sentences, and paragraphs. Analyzing financial statements is no different than building a case by sifting through the evidence and arranging the various pieces into a coherent whole. Balance Sheets are usually the best place to start this process, but a single Balance Sheet by itself without any surrounding context is often close to useless. The next few installments of this series will delve deeper into specific balance sheet categories to help you better understand what it is you are looking at.