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Investor Education Centre

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The Balance Sheet

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Just like your annual physical with the doctor, the balance sheet is the best way to do a spot check on the financial health of a company. At its basic level a balance sheet is essentially a credit report showing the level of assets to liabilities that a company has.

There are three headings that you will typically see in a balance sheet – assets, liabilities and equity. Most of us are familiar with assets, which are the resources a company controls and hopefully gets some benefit from. They can range from cash at the bank and the stock on the shelves, to buildings and vehicles.

Liabilities are the claims that others have over the company's assets. These can be things such as bills that haven't been paid or an outstanding balance on a mortgage.

Equity equals Assets minus Liabilities. This is the residual amount that you, the shareholder, would be entitled to if the company sold all of its assets and paid everyone who was due.

So what should we look for when examining a balance sheet? Given the current financial climate, debt and solvency are particularly important issues.

If we delve into the balance sheet we will see what are called "current assets" and "current liabilities". The "current" here simply means they are expected to be used (or paid) in the short term – usually within a year.

One item in the current assets that is very important is "cash or cash equivalents". Good companies generate cash, and the more the merrier. Cash gives a company the power to pay its debts, acquire new competitors, and to grow.

Comparing the level of current assets to current liabilities quickly tells us about the solvency of a company - do they have enough assets available this year to meet their obligations? The difference between the two is called 'working capital' and businesses need it to survive – if there is little or no working capital, then the company will need to raise money quickly or it will go bust.

We can look at debt in a similar vein. If the balance sheet shows us that a company's long term, or 'non-current' assets (such as land) are currently valued at less than its non-current liabilities (such as its mortgage), then warning bells should sound. Banks will often have rules or covenants such as a Loan to Value Ratio (LVR) which will stop a company from owing more than its assets are worth. If the company breaches its covenants, the bank will ask for cash to top it up which can put a lot of pressure on a struggling business.

Balance sheets have been under the spotlight more than usual over the last 12 months as asset values have fallen, forcing companies to raise capital or reduce liabilities to get things back in balance again. The good thing is that as asset values start to improve again, so will the condition of company balance sheets. The medicine has been unpleasant, but we can take some comfort in knowing that most company balance sheets can be restored to full health.

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