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How to Read a Balance Sheet

Understanding a company's balance sheet can help you separate good stocks from bad. Learn how to read a balance sheet and become a better investor.

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While a company's income statement presents the current results of a company's operation, other financial statements can present how a company is performing using other factors. The [balance sheet](#), for example, depicts the financial strength (or weakness) of a company.

So what's in a balance sheet?

A company's balance sheet has three main sections:

- Assets: Items of economic value that are owned by a company.
- Liabilities: A company's financial obligations.
- [Equity](#): Sometimes referred to as shareholders' equity, this represents the net accounting value of the company.

And the basic formula of a balance sheet is:

$$\text{Assets} = \text{Liabilities} + \text{Equity}$$

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Now, instead of launching into a full-blown lesson on an accountant's perspective of the balance sheet, let's look at them from an investor's perspective. There are three degrees of a company's financial health you can gauge from a balance sheet. By looking at various companies with strong balance sheets, weak balance sheets and balance sheets that are "under improvement," we can better learn how to analyze both the sheet itself and the performance of a company.

How to Spot a Weak Balance Sheet

When discussing what makes a weak balance sheet, there are several elements you'll need to look for. When businesses are struggling, a glance at the balance sheet will typically reveal some shared issues that are dragging them down. Some of the problems that tend to plague these companies on the balance sheet include:

- Negative or deficit [retained earnings](#)
- Negative equity
- Negative net tangible assets
- Low [current ratio](#)

Negative Retained Earnings

Retained earnings represent the cumulative net income of a company. When a company has a

negative retained earnings balance, it says to the world that it has generated accounting losses over a prolonged period. Looking at the balance sheets over time, you can see how the earnings fall deeper into a deficit year after year. A few examples of companies that have recently struggled with their balance sheets are Six Flags, Sirius XM, and Tesla. These were their retained earnings according to their respective 2017 income statements:

- Six Flags: -\$1,529,608,000
- Sirius XM: -\$3,243,473,000
- Tesla: -\$4,974,299,000

Negative Equity

When the deficit in retained earnings surpasses the amount of capital that the company has, this is a red flag that signals that the company is in distress.

When a company is in distress, it has two options. Option one is to recapitalize its balance sheet by issuing additional capital (selling a common or [preferred stock](#)). If that's not possible, then the other option is to file for bankruptcy.

Two of the companies mentioned earlier – Sirius XM and Six Flags - have negative equity.

Negative Net Tangible Assets

This is caused by an excessive amount of goodwill. Goodwill, or G/W, is the value paid by an acquiring company more than the [book value](#) of the acquired company. G/W sits on the balance sheet like an ugly mole and has to be amortized (expensed) over some time.

However, while G/W has an accounting value, it has no economic value. You cannot sell G/W or exchange it for cash. Thus, G/W has to be made up by successfully operating the acquired company. Net tangible assets are equity minus G/W. Of the companies mentioned so far, in 2017

Sirius XM had -\$762,708,000 in net tangible assets, while Six Flags had -\$125,136,000.

Low Current Ratio

The current ratio is derived by dividing a balance sheet's "current assets" amount by its "current liabilities" amount. This ratio represents the ability of the company to meet its short-term obligations, such as accounts payables and the current portion of long-term debt, from readily available sources, such as cash, short-term investments, accounts receivable and inventory.

A high current ratio indicates a liquid company. A low ratio indicates that the company will have problems meeting its short-term obligations, and it could spell more-significant problems. Look for companies with current ratios of at least 1.00 – but to be on the safe side, add some room for comfort and look for a slightly higher ratio.

Sirius XM, Tesla, and Six Flags all have low current ratios (see below), and this is not a good sign. Sirius XM's particular ratio is a major red flag, as it is egregiously low.

To recap, total current assets *divided by* total current liabilities *equals* current ratio:

- Six Flags: $\$221,072,000 / \$297,840,000 = 0.74$
- Tesla: $\$6,570,520,000 / \$7,674,670 = 0.86$
- Sirius XM: $\$470,901,000 / \$2,821,538,000 = 0.17$

Be careful, though, with the current ratio. While it can be helpful if you're doing a quick scan, you still need to dig further into a company's balance sheet. Also, the current ratio will vary among different industries.

How to Spot a Strong Balance Sheet

It would be easy to state that a strong balance sheet has none of the problems of a weak balance sheet, but that is not necessarily the case. There is nothing wrong with having G/W, and G/W appears on some fantastic balance sheets. It is the magnitude of G/W about the company's overall balance sheet that separates the financially strong companies from the financially weak ones. Certainly, a high current ratio would be a welcome sign of a good balance sheet. Again, you need to be careful to only use the current ratio as a starting point.

So what are some of the other standout metrics of a good balance sheet? Here are a few key indicators of strength:

- Cash and short-term investments
- Low or zero long-term debt
- Undervalued assets

Cash & Short-Term Investments

Nothing signals a strong company more than piles of cash and short-term investments (such as CDs or T-bills). This will not only provide coverage for the payment of current liabilities, but it will also give a company the ability to return value to shareholders. How? Companies can return the cash to shareholders through stock repurchases and dividends.

Low or Zero Long-Term Debt

We all live our lives in the hope of not having to pay off our home mortgage. Companies are no different. Long-term debt is money that companies borrowed that needs to be paid back in more than one year and could be due in as much as 30 years.

Companies with balance sheets that are not saddled with debt can be great choices to invest in.

One of the more notable examples of a company like this is PayPal. PayPal's most recent annual

report in 2017 said on its balance sheet that it had nearly \$2.9 billion in cash - and zero long-term debt. They're not the only ones; Facebook has no long-term debt. Same with Chipotle Mexican Grill and Paychex. They can be a bit of a rarity these days, but companies without long-term debt are still out there.

Many companies who in the past had focused on less long-term debt were and still are massively successful companies. Here are some of the data from the 2007 balance sheets of Apple, Google, and Microsoft.

Undervalued Assets

This metric of strength is a little more difficult to spot. Undervalued assets might not be recognized at all unless you do some research into the company itself.

According to accounting rules, assets are held at cost less accumulated depreciation. Thus, there may be some value over and above the "book value" of certain assets. Here is a look at the sources of two typically undervalued assets:

Real Estate

What happens if a company has a piece of prime property, such as Macy's block-long Herald Square store in midtown Manhattan? The balance sheet does not reflect the current value of such an asset. If you dig a little deeper into what a company owns, sometimes you can find a real diamond in the rough. For example, real estate was one of the motivating forces behind Eddie Lampert's acquisition of Kmart debt in the bankruptcy and subsequent acquisition of Sears.

Intangible Assets

"Intangibles" represent certain nonphysical intellectual property and rights that a company might own. These assets usually have no recurring cost other than the initial development and legal fees incurred to create the items. However, the potential for monetizing those intangible assets is enormous.

Examples of intangible assets would be a brand name such as Coke or a logo such as the Ralph Lauren polo horse. When an iconic brand like that can help sell products by itself, that brand recognition becomes its type of asset.

A 'Work-in-Progress' Balance Sheet

I am very focused on companies with strong balance sheets, but I also look for companies that are working hard to improve their financial status.

When investing, you never want to sacrifice the future to benefit short-term appearances. Management's focus on changing the financial condition of a company will pay long-term benefits to shareholders (see "Talking to Management"). Companies that are paying down debt and accumulating cash and equivalents over time have "work-in-progress" balance sheets.

The benefit of holding cash is far less than the cost of issuing debt. Take a look at Salesforce.com's most recent annual report as an example. From [January 2017 to January 2018](#), Salesforce was able to shrink its long-term debt from over \$2 billion to under \$700 million. Simultaneously, the company went from \$1.6 billion in cash and equivalents in 2017 to \$2.5 billion in 2018. In that same period, short-term investments increased from \$602 million to nearly \$2 billion.

Large businesses and companies have tendencies to rack up more and more debt, so finding a company like Salesforce.com (or JPMorgan Chase, which went from \$2.95 billion in 2016 to [\\$2.84 billion in 2017](#)) that is paying that debt off is a very promising sight.

There's a lot to take in when determining the quality of a company's balance sheet. If you're still interested in learning more about analyzing them, you could:

- Review the balance sheets for your stock investments. Determine if you are invested in a company with a strong, weak or work-in-progress balance sheet.
- Look for companies you don't currently own, by scanning for high current ratios, large levels of cash and low levels of debt. Then do some fundamental research on your results. This could identify new investment opportunities.

- Apply balance sheet management to your financial situation.

At the time of publication, Rothbort was long ([AAPL](#)) , ([BA](#)) , ([GOOGL](#)) , ([MA](#)) , ([MCD](#)) , ([RL](#)) .