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Analyzing your balance sheet

By Dennis L. Monroe

Last month we looked at P&Ls as the window to a company's success. Now let's analyze the balance sheet which is more analogous to looking at the financial health of a company. A review of the balance sheet is like getting a physical and learning the various strengths and weaknesses of the business.

The balance sheet has three parts: assets, liabilities and equity.

Assets are arranged into three categories: current assets, fixed assets (property and equipment) and other assets. Assets are further presented on the balance sheet from the most-liquid to the least-liquid assets.

Current assets fall into the following categories:

Cash: Cash is cash, but do not forget the cash in the drawer (in the individual stores) and petty cash.

Receivables: Credit-card receivables are a growing factor and can be significantly higher than cash. Rebates can also be a potential receivable.

Inventory: A restaurant franchise can have a significant amount of inventory if wine and liquor are involved, and auto aftermarket concepts usually have large inventories. The key is inventory control. Franchise businesses historically have not been the best at maximizing inventory turns because, in many cases, the level of inventory is dictated by the franchisor. We are seeing more and more opportunities to reduce inventories with "just in time" deliveries and a focus on increasing turns.

Prepaid expenses: Prepaid expenses can be overstated. These expenses should be reviewed every year, to determine the economic value.

Deposits: Deposits have some liquidity value, but may be held by someone else. Deposits should be analyzed in terms of present value.

We normally divide current assets into two types: quick assets (which are cash and cash equivalents, or assets that can be readily converted into cash, such as credit-card receivables) and the non-quick assets. We even do a ratio of quick assets to current liabilities to see how much liquidity we have versus what we currently owe.

The ratio most commonly used is the ratio of current assets to current liabilities. Most franchise businesses are, by and large, cash businesses, and the current ratio is not necessarily an effective measurement. The ratio is normally less than 1-to-1, and in many cases the ratio is .5-to-1. Many franchise businesses do not accumulate much cash. Except for working capital needs, any accumulated cash is usually distributed out to the owners or used to pay down debt.

Fixed assets: Sometimes fixed assets are called "property and equipment." Fixed assets are presented in order of useful life, normally starting with equipment, leaseholds, building and land. Some balance sheets show depreciation as a separate line item; other balance sheets show assets as a net number after accumulated depreciation. In the future, almost all leases (which are now considered operating leases) will have to be capitalized and be shown as "property and equipment." Depreciation will be applied to the asset value of the leased asset.

Something to keep in mind is that depreciation on financial statements is very seldom equal to the depreciation for tax purposes.

Other assets: This category is a catch-all, comprised of loan acquisition costs, asset acquisition costs, cash value of life insurance, investment in other enterprises, and minority interests that are not consolidated. In general, these are non-operating assets held by the business.

Liabilities: In the franchise world, debt is the life blood of growth. For purposes of financial reporting, liabilities (debt) is divided into current liabilities and long-term liabilities.

Current liabilities: Current liabilities have a maturity of less than one year. These liabilities are listed in order of maturity. The first item usually is the line of credit or any type of demand note normally used for working capital. Next would be any short term notes currently payable and the current maturity (due within the current year) of any long-term debt. This is followed by the largest classification areas for most franchises: accounts payable and accrued payables (such as payroll, rent and property tax). I often see franchise companies separate their accrued payables between trade accrued payables and accrued payroll and benefit payables.

Long-term liabilities: Long-term liabilities have a maturity of over one year. The most prominent of these liabilities is long-term debt. The first classification of long-term liabilities is deferred liabilities, which is a major part of the franchise industry. Some of these deferred liabilities are the difference between the cash rent paid and rent, gift card liabilities, any liabilities associated with frequent customer purchasing programs and contingent liabilities that may be due in the future (such as obligations to repurchase stock from employees or deferred compensation

arrangements). Many times banks want a detailed explanation of a business' deferred liabilities because it looks like a much larger number than probably economically justified.

Pure senior debt is usually the major part of long-term debt and is the company's leverage. This senior debt is the starting number in calculating the fixed charge coverage ratio; that is, the amount of cash flow you have to annual debt service.

Many times long term liabilities contain shareholder loans or subordinate debt (which is provided either by outside investors or by shareholders). In the future, when all leases are basically capitalized, your long-term liabilities will go up, particularly if you have typical leases that are common in the franchise world.

Equity: The equity account (stockholders, member or partner equity) is composed of the actual amounts contributed to the company's capital and the company's historic earnings.

Paid in capital: This can be in the form of common stock, preferred stock, membership interest, partner contributions or other classifications. It is money that stays in the company, and the contributor is the last to get paid. There are many forms of equity (from common to preferred to convertible).

Retained earnings and current earnings: Retained earnings are the historic amount of money the company has made less any distributions to the owners. This may be a negative number if there are historic losses or a positive balance showing historic earnings. Additionally, there is normally a separate line item that is year to date net income.

Total equity: Total equity is the sum of paid in capital plus all earnings.

Adding the liabilities and equity accounts give you an amount that happens to balance with the total assets.

Below are some thoughts when evaluating a company's balance sheet:

Assets:

- Is there liquidity to carry the company through for least one year?
- What life stage are the fixed assets at? Do the assets need repairs, maintenance or other types of improvements?
- Is there impairment in the assets? Or, do the assets on the balance sheet really reflect a true, ongoing value? Impairment is becoming more of an issue, particularly if you are a multi-unit operator.
- Are there non-operating assets that should be spun off to clean up the balance sheet?

Liabilities:

- In checking the aging of the accounts payable, is the aging in line with available liquidity?
- Are the lines of credit cleaned up each year and only used for seasonality?
- In checking the current maturity of the debt, are there balloon payments that will need to be dealt with?
- Long-term debt is a leverage issue. Companies in today's economic environment should maintain a debt to equity ratio of less than 3.5-to-1.

It may be a wise idea to convert shareholder loans equity. Doing this will certainly look better from the bank's standpoint and is probably more appropriate than trying to accrue interest on those obligations which may not be repaid.

The balance sheet is always a work in progress and key qualitative decisions must be constantly made. FT

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