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Identifying red flags on the balance sheet

Similar to the income statement, the first step in analyzing the balance sheet is to create a common-size balance sheet. This is done by expressing at least five years or twelve quarters of each line item as a percentage of total assets. Look for items that are experiencing significant changes over time.

When analyzing individual line items within the balance sheet , the objective is to detect weak liquidity, or excess leverage and to identify assets that are overstated or liabilities that are understated, Here are some specific area to look for -

- Weak Liquidity - Values for the current ratio below .95 mean the firms current resources are not sufficiently large to pay its current liability. If the firm's operating activities are consuming cash or its operating efficiency is deteriorating, this warns of a potential liquidity problem.

- Excess Leverage - A debt to equity ratio much higher than sector peers is a sign of a company that may be unable to cover its debt obligations. Average values vary by sector, but generally a debt to equity ratio above 4.0 indicates high leverage and risk of a commercial or industrial firm. This rule of thumb does not apply to financial services firms, which are more highly leveraged.

- Times Interest Earned (earnings before interest and taxes / interest expense) – Values below 2.0 warn that the firm may not generate sufficient profit to cover its interest costs.

- Assets likely to generate less value
  A) If goodwill is more than 10 percent of firm's assets it raises a red flag. Goodwill is a write off waiting to happen. Many firms do not realize enough value from acquisitions to justify the purchase premium and later must impair or write off goodwill.
  B) Accounts receivable – Look for evidence that firms is collecting from customers more slowly – decreasing accounts receivable turnover ratio or increasing days to collect. This warns of a future write off of receivable, because the longer receivable remains unpaid, the more likely they are to become uncollectible.
  C) Inventory – Look for evidence that inventory is selling more slowly – decreasing inventory turnover ratio or increasing days to sell inventory. This may be a sign that inventory is accumulating in the warehouse, which warns of a future write off or write down of inventory.

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- Off balance sheet items – If these were brought on the balance sheet, they would increase company’s leverage.
  A) Operating leases - Operating leases unable a firm to lease assets and hide the liability. Although operating leases are contractual obligations with certain cash payments, they do not create a liability (or asset) on the balance sheet. Use information in the notes to the financial statements to estimate the value of liability by calculating the present value of future cash payments associated with operating leases.
  B) Equity Method Investments - Firms can use these investments to hide debt , because accounting rules require a one-line consolidation. The only impact of these investments on the owner’s balance sheet is creation of an asset.
  C) Special purpose entities – Firms use this world to hide debt. It is important to read the fine print and learn as much as possible about these entities.

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