



A Balancing Act

The Balance Sheet Must be Analyzed in Concert With the Income Statement

By Dexter Braff

MANY HOME CARE COMPANY OWNERS and managers have a good understanding of the meaning and value of their businesses' income statements. However, the information contained in a balance sheet is frequently overlooked and misunderstood. To obtain a more complete picture of a company's financial performance, this statement must be carefully analyzed by itself and in conjunction with the income statement.

The balance sheet provides a "snapshot" of the firm's financial position at any given moment in time. In particular, it looks at the company's assets and how those assets were financed. Typically, a home care company's assets consist of cash, inventory, accounts

receivable, rental equipment and vehicles. These assets are basically the resources that the firm uses to generate revenue and profits.

Companies often finance their assets by borrowing money from creditors, which are typically vendors, employees and banks. Money is usually borrowed in the form of trade payables, wages payable and notes payable, respectively. Combined, these borrowings represent the company's liabilities.

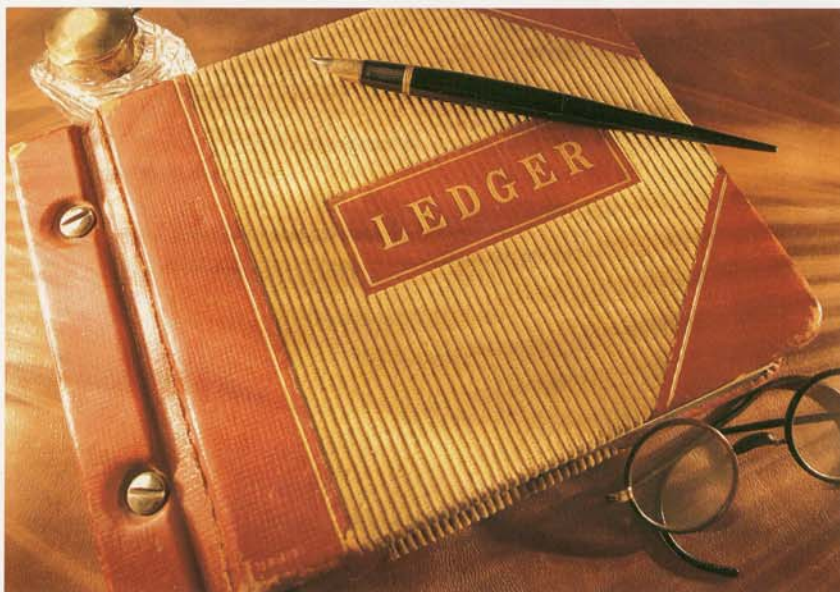
Companies can also finance assets through capital invested by the principals or earnings retained by the firm. Combined, the contributed capital and retained earnings are considered shareholders' equity, or the owners' claim on the company's assets.

Understanding that the investment in assets must equal the financing available, the fundamental balance sheet equation emerges:

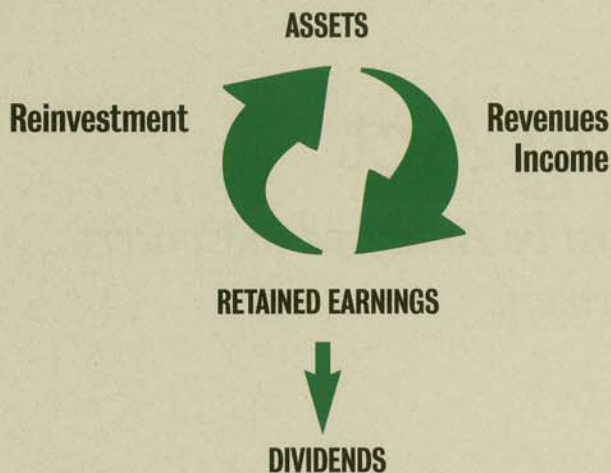
$$\begin{aligned} \text{Assets} &= \text{Liabilities} + \\ &\text{Shareholders' Equity} \\ \text{Investment} &= \text{Financing} \end{aligned}$$

The balance sheet equation can reveal critical information about a company's performance. For example, if assets are financed primarily by liabilities, the firm could be at risk for having to make principal and interest payments in the event of a sudden downturn in business. On the other hand, if assets are financed primarily by shareholders' equity, the firm like

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Balance Sheet and Income Statement Link Through Retained Earnings



ly has untapped debt that could be used to finance substantial investment and growth. Note that the

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relationship between liabilities and shareholders’ equity is captured in the debt-to-equity ratio, which is a fundamental descriptive measure of a firm’s capitalization.

The critical elements of the balance sheet, as described above, are typically classified into basic sub-categories, yielding further insight into the company’s financial position. Generally, assets and liabilities are broken down into current and noncurrent categories. Current assets are those that are expected to turn into cash or be used within one year. Examples include cash, accounts receivable and inventory. Noncurrent assets tend to have a longer “lifetime,” such as rental equipment, vehicles, buildings and leasehold improvements. Similarly, current liabilities, such as trade and wages payable or bank lines of credit, are expected

to be paid off in one year. Noncurrent liabilities are those that are expected to be paid off over a longer period of time.

Some of the most powerful measures of liquidity, or ability to generate cash and pay off debts, are based on the relationship between current assets and current liabilities. Perhaps the most popular of these measures is the “current” ratio, which is calculated by dividing current assets by current liabilities. The resulting ratio expresses the company’s ability to meet its short-term obligations. In an industry such as home care, where reimbursement and receivable collections are highly volatile, this is a critical indicator of a company’s short-term health.

The equity portion of the balance sheet is primarily composed of contributed capital and retained earnings. Contributed capital represents the start-up capital and any subsequent investments made by shareholders to fund the company’s operations. Retained earnings represent income since the company’s inception that has been retained or reinvested to finance replacement assets and facilitate

growth. As the name implies, retained earnings represent the income remaining after dividends or distributions are paid to shareholders. Since they accumulate over the life of the company, retained earnings are not the same as annual income.

Retained earnings do, however, provide the critical—and frequently overlooked—link between the income statement and the balance sheet. Consider that, over the life of the firm, the company acquires and employs assets to generate income (revenue less expense). This income can be used either to finance additional assets to stimulate growth and increased profit or to pay dividends to shareholders. Accordingly, any operating activity that affects the income statement affects the balance sheet. Remember that to remain in balance, assets must be equal to liabilities and equity.

Consider what happens from an accounting perspective when a firm writes off unreserved accounts receivable. The receivable asset is reduced by recording a bad debt to the income statement, which in turn reduces retained earnings and equity, keeping the balance sheet in balance. This link is the key to understanding that the balance sheet and income statement are not separate and distinct. Rather, they are a function of one another.

Bearing these basic concepts in mind, managers can use the balance sheet to gain insights into the firm’s operations that would be missed in an analysis of the income statement alone. **HC**