UNMASKING BALANCE SHEETS: UNCOVERING HIDDEN FINANCIAL TRUTHS

When analyzing companies, we use three main financial statements: the **income statement, the balance sheet, and the statement of cash flows.**

The income and cash flow statements show how much the company earned and spent over a period, while the balance sheet captures the values of assets and liabilities at a specific point in time.

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Income and cash flow statements represent **flow statements**, measuring how much the company earned and spent over the period.

Balance sheets capture the values of assets and liabilities at a point in time and thus represent "**stock" statements**.

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Stock statements (balance sheets) are **less reliable** than flow statements (income statement and cash flow statement) because they may not accurately represent what the company did throughout the year.

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Debt on the balance sheet can be manipulated by paying it off just before the end of the year and borrowing again early the next year. Companies can also use lines of credit or seasonal financing to keep debt off the books.

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Clues to detect this practice include looking at quarterly balance sheets to identify big changes in debt and examining interest expenses as a percentage of the year-end debt.

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The cash balance on the balance sheet may not reflect the actual cash the company has today, which is important for accurate valuation.

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Working capital, the difference between current assets and liabilities, can also be altered to make it look smaller just before the balance sheet date.

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Be cautious about relying solely on balance sheet analysis. Instead, consider using other financial statements, such as the income and cash flow statements, to understand earnings and cash flow over time.

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Some companies trade at **negative enterprise values** because market equity is updated, but debt and cash remain frozen at year-end values.

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You can access quarterly balance sheets and the year-end balance sheet if possible. Analyzing quarterly changes in debt and other financial indicators can help identify potential manipulations.

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Pay attention to interest expenses as a percentage of year-end debt. Disproportionately high-interest rates relative to expected payments could indicate potential manipulation.

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When conducting valuations, consider using the actual cash balance today rather than relying solely on the balance sheet's cash balance.

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Recognize that working capital numbers can be altered over short periods. Look for consistency and consider the timing of certain transactions, such as receivable collections and inventory clearance.

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If you are involved in a friendly merger, demand and obtain current information on cash, debt, and working capital from the target company. This can provide a more accurate assessment of their financial situation.