

Balance Sheet Analysis Walkthrough

[% oldschoolvalue.com/blog/valuation-methods/analyzing-financial-statements-circuit-city-balance-sheet/](http://oldschoolvalue.com/blog/valuation-methods/analyzing-financial-statements-circuit-city-balance-sheet/)

To help get new investors started, here are some great resources on the Balance Sheet:

- [Fundamental Analysis: The Balance Sheet](#)
- [Understanding the Balance Sheet](#)

Circuit City Balance Sheet (click to enlarge)

Cash

Any company with lots of cash is a reassurance to investors that the company should be able to survive during downturns as well as expand during booms.

Divide the cash by the number of shares outstanding to see how much of the stock price is made of cash. On Feb 29, 2008, Circuit City had \$1.76 in cash per share but by August 31, 2008, that number dropped to \$0.54 and has probably dropped further since then.

If the cash per share is greater than the share price, it could be a potential [net net](#).

Accounts Receivables

As I covered in the Statement of Cash Flows, accounts receivables is an indication of whether the company is able to collect its payments. If accounts receivables decrease from the previous years (you have to compare by going back a few years), the company has been able to collect its money.

If this is continually increasing, the company is either willing to sell to anyone or the company may have become lenient in its payment policies to customers which could lead to an inflation of earnings causing nasty surprises later on.

Compare the increase in accounts receivable with increase in sales. e.g. If accounts receivables has increased 120% while sales only increased 90%, the company is not collecting bills.

I've only displayed a quarterly statement for Circuit City but if we look back at the previous statements, Circuit City has been unsuccessful in reducing this line. Although the sum of \$330mil is a good reduction from \$447mil in Nov 2007, the overall story shows that Circuit City has an unimpressive payment collection system.

Inventory

One of the most important aspects of the balance sheet. Ben Graham has written that inventory should be marked down to 50% of its valuation when calculating a [liquidating value](#). This is true especially when it comes to electronics. With a product life cycle lasting only a few months, old inventory will continually have to be discounted.

Inventory should also be compared with cost of goods. This inventory indicator is a reliable sign of whether a manufacturer or retail company will stumble if the difference is substantial. In terms of inventory growth, Circuit City hasn't done too bad of a job but their inventory level is far too high for a business of their size.

It's also a good idea to compare the inventory turnover with competitors. While Best Buy has been able to turn over its inventory 6.9x times a year for the past 5 years, Circuit City has only managed an average of 5.5x in the past 5 years.

A further discussion of inventory will be required in another post as we look at how companies calculate and state the value of inventory.

One Time Items

Deferred income taxes and income tax receivables should not be considered as part of business assets. They add no value to the operations of the business. Hopefully these numbers are kept low and not included too often. Circuit City needs all the cash it can get. It shouldn't be overpaying taxes and waiting to receive it without interest from the government.

PP&E and Goodwill

PP&E is an illiquid asset and is mostly taken into consideration when the company is liquidating.

If the company owns land, additional research would be to find today's market value of the land.

As most readers know, goodwill is best ignored. No tangible value exists and impairment charges usually always appear from a goodwill that is too high.

Although Circuit City "may" have a brand, I believe there is no tangible value because there is nothing stopping a consumer from crossing the road to Best Buy if they have better prices.

Liabilities

Liabilities is much like the assets section. There are payments that have to be made and if this number increases, the company has not been paying their bills.

Circuit City's problem is that they are overladen with debt and no cash. They need to pay suppliers in excess of \$750 mil, expenses in the amount of \$270 mil and \$343 mil for accrued expenses and other

| Circuit City Stores, Inc. Consolidated Balance Sheets (Amounts in thousands except share data) | | August 31, 2008 (Unaudited) | February 29, 2008 |
|--|----|--------------------------------|-------------------|
| ASSETS | | | |
| Current assets: | | | |
| Cash and cash equivalents | \$ | 91,235 | \$ 296,055 |
| Short-term investments | | 1,268 | 1,366 |
| Accounts receivable, net of allowance for doubtful accounts | | 329,516 | 330,599 |
| Merchandise inventory | | 1,508,944 | 1,573,560 |
| Deferred income taxes, net of valuation allowance | | 32,466 | 38,672 |
| Income tax receivable | | 161,389 | 158,116 |
| Prepaid expenses and other current assets | | 43,868 | 41,352 |
| Total current assets | | 2,168,686 | 2,439,720 |
| Property and equipment, net of accumulated depreciation of \$1,574,546 and \$1,448,250 | | 966,707 | 1,037,321 |
| Goodwill | | 113,928 | 118,031 |
| Other intangible assets, net of accumulated amortization of \$7,974 and \$7,224 | | 15,802 | 18,400 |
| Other assets | | 134,057 | 132,458 |

Handwritten notes:
 - "big drop" with a red box around the Cash and cash equivalents values.
 - "mostly made up of invent" with a red arrow pointing to the Merchandise inventory value.
 - "~ same" with a red arrow pointing to the Accounts receivable values.

| | | | |
|--|----|---------------------|---------------------|
| Other assets | | 134,931 | 134,438 |
| TOTAL ASSETS | | \$ 3,400,080 | \$ 3,745,930 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | | |
| Current liabilities: | | | |
| Merchandise payable | \$ | 754,521 | \$ 912,094 |
| Expenses payable | | 268,107 | 232,386 |
| Accrued expenses and other current liabilities | | 343,525 | 346,818 |
| Accrued compensation | | 74,729 | 85,127 |
| Accrued income taxes | | 17,165 | 17,680 |
| Short-term debt | | 215,000 | - |
| Current installments of long-term debt | | 14,203 | 11,582 |
| Total current liabilities | | 1,687,250 | 1,605,687 |
| Long-term debt, excluding current installments | | 52,566 | 57,050 |
| Accrued straight-line rent | | 152,369 | 145,960 |
| Deferred rent credits | | 168,578 | 163,662 |
| Accrued lease termination costs | | 78,564 | 82,900 |
| Deferred income taxes, net of valuation allowance | | 31,281 | 35,586 |
| Other liabilities | | 152,720 | 151,910 |
| TOTAL LIABILITIES | | 2,323,328 | 2,242,755 |
| Commitments and contingent liabilities | | | |
| Stockholders' equity: | | | |
| Common stock, \$0.50 par value; 525,000,000 shares authorized; 168,125,359 shares issued and | | 84,063 | 84,430 |
| Additional paid-in capital | | 327,739 | 319,573 |
| Retained earnings | | 570,462 | 981,112 |
| Accumulated other comprehensive income | | 94,488 | 118,060 |
| TOTAL STOCKHOLDERS' EQUITY | | 1,076,752 | 1,503,175 |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY | | \$ 3,400,080 | \$ 3,745,930 |

See accompanying notes to consolidated financial statements.

Balance Sheet Analysis

liabilities as well as a short term debt of \$215 mil due shortly. With only \$91 mil in cash and the rest tied up in inventory, no wonder the suppliers demanded cash up front for delivery of items.

Also, watch out for companies like Circuit City that have accrued so many expenses. These are obligations that must be paid which will hit earnings hard.

Circuit City has also been deferring its rent credits. Companies often abuse deferred charges by pushing expenses into the future so that they can inflate earnings even when things are not going so great.

Circuit City's "other" liabilities add up to over \$150 mil so its always important to check the footnotes as well as the possibility of [off balance sheet liabilities](#).

Quality of assets

Quality of assets is something you should always be asking yourself whenever going through a balance sheet. Circuit City's assets are made up of mostly inventory, property and equipment. However, we know that electronics cant hold their value for more than a few months and Circuit City does not own their stores (land). So all the stated property and equipment is probably associated to shelves, tables and other shop fitting items. Nothing that can fetch full value.

Quality of assets for Circuit City? **BAD**

Summing Up

- Cash helps companies survive and grow.
- Watch the trend in Accounts Receivables. Be careful of companies unable to collect money.
- Take the value of inventory stated on the balance sheet with a grain of salt. Different accounting methods (FIFO, LIFO) produce different ending values even though the products are the same.
- One time items in assets should not appear often such as sale of assets.
- PP&E is illiquid and should be considered mostly in asset plays or liquidation. Ignore goodwill.
- All debt isn't bad. Just when you can't afford it.
- Assets should be high quality (cash is best)

This is how you should do proper [Balance Sheet Analysis](#) .