Bird's Eye View of the Balance Sheet

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Dave

0:00

All right, folks, welcome to Investing for Beginners Podcast. Today we're going to do a bird's eye view of the balance sheet. This is going to be a continuation of our three part series of working through the three main financial statements. Two weeks ago, we did the income statement. Last week, we did the cash flow statement, and we're going to finish up with the balance sheet. So with that, we'll go ahead and talk about the three companies we used in the other example.

So we're kind of keeping the same theme. So we have Netflix, Starbucks, and Apple. So those will be the focus of our bird's eye view today and the balance sheet. So I guess let's start with the absolute basics of the balance sheet. What is it? And why should we care?

Andrew

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What is it, it's probably the most boring of the three financial statements and something that no one really wants to talk about? I kind of look at it like a seatbelt? Why do you wear a seatbelt because in case of crash and burn could save your life, a healthy balance sheets the same way you could drive for a long time without a seatbelt, and nothing will happen to you. A lot of businesses can get away with not wearing a seatbelt not having a great balance sheet.

But every once a while, somebody with a bad balance sheet gets burned. In the same token, if you're not wearing a seatbelt, everyone smile, somebody will also get hurt. So again, that's not the most fun thing to talk about. But you can really reduce the risk of a company going bankrupt, when it has a good balance sheet. And when you don't, it's really scary to invest in companies like that.

Dave

1:27

It really is. And we got a front row seat to how important balance sheets could be with what happened during the pandemic, when everything went south really quickly, in March 20 balance sheets suddenly became very much in focus in the investing world because you were facing the unknown, there were a lot of companies that were We were thinking that they were going to have any revenue and how are they going to pay the bills, because they still have bills to pay.

And living off your balance sheet is kind of like living off your savings account, it was something that a lot of companies, we thought were going to have to do this, and some did, most didn't. But the point is, is that all of a sudden, that became very much in focus. And it showed how important a strong balance sheet really could be. A few months ago, we talked about Texas Instruments, and what a great example of a great balance sheet they are, we did a bird's eye view of them.

And that would be a great episode for you to go back and listen to if you want to find a company that has like probably the best example of what a strong strong balance sheet looks like. So let's talk about I guess the accounting equation of the balance sheet and maybe define a few terms. So people can kind of understand what we're talking about

Andrew

2:40

love it, I feel like within the accounting equation are two things that you can really highlight when you're looking at that company's balance sheet. I'm gonna turn it over to Dave in a second because I feel like you've done some good writing on the formula itself. But I feel like I've said this a million times, you can look at calculating the company's balance sheet just like you would your own personal net worth.

You take what you own, and you subtract what you owe. And that's your net worth. That's also how a company's balance sheet and basic equation that ties the balance sheet together, assets minus liabilities equals equity. Yep,

Dave

3:18

that's exactly right. And the whole idea behind the balance sheet is that has to balance. So there's three main components comprising the balance sheet. So the first part is assets. And those equal what the business owns. So if we think about our own lives, a car or a house, money in the bank, those are all assets, those are all things that we own. Same applies with a business, the inventories that Walmart or the content that Netflix has created, for example, that is an asset for them.

And that's something that they own liabilities, like Andrew said, that's money they owe that's bills that they owe people for payroll for the inventory that they bought any of those kinds of things, that's all considered debt, that's all considered a liability. And then equity is the net worth of the business. It's the amount that we actually owe own. When we buy a share of the business.

We don't technically, well technically we do. But we don't really own the assets of Netflix, for example, we own the equity. And so that's what really what we're buying. And when you think about how the balance sheet works, the assets equal the liabilities plus the shareholders equity. And that's kind of how it all has to balance.

And if any of those are not in line, it doesn't balance, and therefore that's what they called a balance sheet. So that's really kind of the strength of looking at this in some businesses, the balance sheet is going to be air quote, more important than others to focus on but it's always a great place to really start to look at the financial well being and strength of the business. Because if that part doesn't manage well then all the other components aren't going to fit together very well either. So I Guess after covering some of those more basic stuff? Why don't we start to maybe kind of look at these companies and kind of work through kind of the different sections of the balance sheet. Let's start with the assets. That's always the fun one to start with.

Andrew

5:13

Okay, so we're gonna do the same thing we've done with the bird's eye view of that we did for the other two financial statements, we're going to look at Apple, Starbucks and Netflix. Now with the assets side, you can think of it, how they arise is two different things. You have current assets and non current assets. So what does that mean? So looking at Apple, some of their current assets current is just another way to say short term. And then non current is long term, Apple defines it as total current assets. And total non current looks like Starbucks doesn't say non current, but they do have current. And then Netflix has current and then total assets.

So I'm pretty sure with every balance sheet, you'll see the current assets has its own section, and then a lot of the other stuff, you just kind of assumed that's more long term in nature. So the short term current assets would be something like accounts receivable or inventories. Those are accounts receivable, as we talked about previously, is, you know, if I'm apple and I have sold a lot of iPhones to AT and T, for example, an 18 T is going to pay me in 30 days, 90 days, 120 days, that's going to be an accounts receivable bill that they owe to Apple. And so those kinds of things tend to be resolved within 12 months. And that's why something like accounts receivable will be under current assets.

Dave

6:38

Yeah, exactly the basic idea when you look at a balance sheet, especially the easiest way for me to think about it, when I look at the assets, the current assets and the assets, is they're generally listed in the order of liquidity. So in other words, how quickly a company can turn a particular item into actual cash. So for example, if you look at the apple, the top of the apple balance sheet, you see cash and equivalents, which is obviously money, cash, they can turn it around marketable securities, those are typically short term investments that a company can turn around and sell quickly to convert into cash, accounts receivable, and inventories are also quickly can be quickly turned into cash and so on as you work down through the balance sheet. That's kind of how you think about the liquidity of those items.

And it can tell you, especially at a company that has a lot of cash on their balance sheet, that means that they have a lot of dry powder to do things like investments and different things to try to drive the business. One thing I forgot to mention that I wanted to kind of touch on real quick, when you think about the assets, the liabilities and the shareholders equity sections of the business, the assets are what drive the revenue growth of the business, the liabilities and the shareholder equity are the two ways two ways that the company can buy those assets, to drive the revenues of the business. And so when you kind of think of how the balance sheet is construction, constructed, the assets contain the things that the business can do to drive revenues, like Content Inventory, for example, for Netflix, obviously, the more shows the better shows, you know, the more money they spend on Stranger Things, you know, we're all going to line up and watch that that's more money for Netflix, and that's an asset for them. But they have to spend money to do that.

And so then they will use equity or debt or other liabilities to invest in that content to drive future sales for the business. And so that's kind of how the balance sheet kind of links into the income statement. So when you're kind of thinking about how do these, I don't understand how these all interconnect, and that's, that's really the driver for all that. So when you look at the balance sheet, it's order of liquidity, and cash is king, you know, the more liquid of businesses, the better because it gives them more flexibility. Ideally, not always. But

that's kind of the the general rule behind that. So when you're looking at these, just remember that it kind of goes in order of liquidity. So how quickly can I turn that particular asset into cash? And like Andrew said, the current assets are generally a one year or less timeframe, and everything else is going to be a much longer timeframe. It could be 13 months, or it could be 17 years. It just depends, though. That's kind of that's Yeah, it's really kind of how I look at it. So did you want to touch on some of the other maybe long term assets and talk through those kind of briefly?

Andrew

9:37

I do I want to go down that path just one step further because I don't know if it's helpful for somebody trying to learn this stuff. But it is a fact when it comes to these balance sheets and you kind of touched on a couple of times when you said this stuff needs to balance. That sounds really simple, but it's actually profound because the balance sheet connects to the income statement and it connects to the cash flow statement. Like we talked about last episode as a cash item moves from the cash flow statement, a company outlays that cash and then that becomes an item on their balance sheet under assets.

And then when they sell that asset, that becomes revenue and then profit on the income statement. And so that's why you literally have this balancing act. And kind of along that idea when you mentioned Netflix has content assets, what I find interesting about that is, let's say I have an opinion that Stranger Things is the best show on earth. And Dave thinks that show stinks. So I might think Stranger Things is worth $10 million, they might think it's only worth like $2 million. The way that because there's so much subjectivity between assets like that, for any asset, other than cash, or like a security, the way that these assets are treated on the balance sheet is in connection to how much they paid. So when we look at Netflix has 32 point 7 billion in content assets, they've paid that through capital expenditures in the cash flow statement. And it's actually much higher because they depreciate these things over time.

But that's where those numbers on the balance sheet will come from. So to Dave's point earlier about the liabilities and the equity deriving, and basically financing these assets, that's where some of these numbers come into play. And somewhere where it can get kind of confusing, too, because again, if the value of the assets is subjective, then just because Netflix's balance sheet says they have 20 billion and what we call net worth, that might not actually be the case, if all their shows are now garbage.

Or their shows could actually be worth way more, because there are a bunch of really great shows that just happened to knock it out of the park. So that's where it's important, the balance sheets important as a seat belt. And I think beginners, including myself, when I started, I think they get too wrapped up in like, Oh, my

goodness, this company has 20 billion in shareholders equity must be worth way more than that. And that's not always the case. Because that's just the number on the books that has caused everything to balance. It's not necessarily how much the assets worth today.

Dave

12:13

Yeah, that's a fantastic point. So I guess one of the things that confused me at the beginning, was I asked a lot of questions about this too, with different accountants and whatnot. The balance sheet is a snapshot in time of one day of what all those items are in the business. So when they report a balance sheet in a financial statement, that is a snapshot of Tuesday, June 22 2022, it's a specific day, the income statement and the cash flow statement are accumulative.

So those are numbers that have accumulated over a quarter of worth of activity. And one of the things that always confused me a little bit was let's use inventory as an example, because it's easy, and it's something that a lot of people can relate to. And the number you see in the cash flow statement, if they spend this much, you know, they spent 2 billion to buy inventory.

For Apple, you won't necessarily see an increase in 2 billion in inventory on the balance sheet. And some people can get that confused because they think everything has to balance. And it does, but the balance sheet has to balance however, the cashflow statement does not. And it doesn't have to balance with the balance sheet. And so it can be confusing. The other thing that can be a little bit confusing is that these numbers that we see, we don't see all the accounting journals that go back and forth.

Accounting basically has the balance. So whenever you have a journal entry, adding something, you have to have an offsetting journal entry to kind of offset that accounting. And so in basic theory, we don't see the accounting journals that the accountants create for Netflix, for example, we just see their final result and the tallies that everything and so because of the timing of the reporting of the the statements, and the fact that we don't have the accounting journals, the numbers are not always going to balance. And so you're not going to see $4 million for this and see that added or subtracted on the balance sheet.

So, you know, hopefully that helps explain why maybe some of the numbers don't always jibe when you're looking at it. Like I don't understand why the inventory they spent this but it's not going up or didn't goes up as much because they sold some of it and during the time that you know that has occurred over those 90 days, and that's why it won't balance so that's something to keep in mind as well with the balance sheet.

Andrew

14:35

That's a super good point. And yeah, I remember calculating changes and working capital and the cash flow statement just felt like I was banging my head against the wall. I feel like you and I have spent late nights trying to figure out what's going on here and not you know, just missing that one piece, which can be so frustrating. I will recommend this book that really helped me see how the balance sheet and not just the balance sheet but all three financial statements really connect.

They basically take a Income statement balance sheet cash flow statement, they show you how when you add one number and you subtract from another, and they show you how that counter balances itself. So the book is called financial statements, a step by step guide to understanding and creating financial reports. And it's by a guy named Thomas ittelson. I was like, that's a game changer book games.

Dave

15:21

It was for me to visualize, because it helps you visualize everything so well, it's a fantastic book, I can't recommend it enough, it really, really helps you kind of put connect the dots, I guess, is the best way of putting it. And yeah, it was fantastic. It you know, my mind was born after reading that I'm not gonna lie.

Andrew

15:37

So I feel like, you know, we could totally go down every line item. But I don't know how interesting that is necessarily. Let's circle back to the theme of what would be the two things you would focus on most, as an investor trying to learn about balance sheets, and trying to basically make it simple enough to get a good picture of what's going on, at any given point of time without getting bogged down by the details?

Dave

16:00

Yeah, that's a great point. That's a great question. I think one of the things that I guess the two things that I'm going to look at probably, initially, are going to be the drivers of the assets for the revenue. So I would probably look at the debt. And I would look at the equity of the businesses, those would be two things that would probably first draw me to the balance sheet.

And I would probably do those in comparison to what kind of current assets or cash they have on the balance sheet, you kind of get a sense of one of the things that you can do is you can look at kind of a net debt number. And basically what that means is you can look at how much debt does a company have, and how much cash Does the company have.

And you can look and see what that ratio is. And if a company has more cash than debt, then even if they take on more debt, that just means that the business, the idea being that if the business stopped doing what they're doing tomorrow, they would still be able to function and operate and pay their bills, because they have enough cash on the balance sheet to satisfy any debt obligations, they have more than and then continue operations. And so that's an easy way to find out how liquid a company is, in case something bad happens, because we never know when something bad will happen. And that's part of the idea of a margin of safety for me is finding companies that have, you know, a decent ratio to that.

And it's gonna vary company, company, industry, by industry and whatnot. And as you get more experienced, you'll be able to, you know, play with those numbers, depending on how how you understand the business and whatnot. I guess those are the first two things that I would look at. I'm going to turn it back on you, sir. Because you're the balance sheet King. So what are your thoughts on

Andrew

17:42

that? Call myself that for sure. I would say it's the same thing. I mean, you can look at a company's debt, or you can, one thing I did when I first started out was just looking at the company's total liabilities, and comparing that with the equity. And so remember, we go back to the beginning of the conversation, it was assets minus liabilities equals equity. Or if you put liabilities on the other side, equity plus liabilities equals assets. So if you scroll down to the bottom of any balance sheet, they're going to have the equity at the bottom, as well as total liabilities and shareholders equity, which is the same as total assets.

So what I like to do is I take the total assets, I subtract the total shareholders equity, and that gives me the total liabilities. And I figure, at some point over the life of this investment, they're gonna probably have to pay a decent chunk of those total liabilities. So you can compare as one of the first shortcuts of considering a company's financial health, what is their total liabilities, and how's that compared to their equity, you divide the liabilities by the equity. And the higher the number, the worse. But it's not as of course, it's not that simple.

But in general, that's the case. And that's really very similar to a debt to equity formula. And that's the way I calculate that equity just to make it super simple. And so you get to be in general rules, anything below one is really good.

Anything above one, the further away from one you get, the more problematic, but then you also have financials and real estate investment trusts that generally run out those much, much higher. And then you also have a company like what blew my mind was Apple, Microsoft, Google, to your point they have about having net debt. If you look at these huge companies, they actually you take into account the securities they have which they can quickly sell Apple, Microsoft, Google are all net debt free.

So in that case, that's equity ratio would not necessarily be a good indicator because, in fact, they have all these investments, they could just sell and pay off their debt tomorrow. So it's a good rule of thumb. It's a good Good place to get yourself started to get away, they kind of start to grasp how a company's balance sheet is. But it's far from the all encompassing number that tells you the company back company. Yeah, exactly.

Dave

20:14

I think one of the best ways to, when you're starting to work on looking at balance sheets, is find three to five metrics, if you will, that you can add as part of a checklist. So anytime you look at any company, whoever it may be, start using those metrics as a way to kind of gauge what kinds of balance sheets these companies have. So for example, we're looking at three different companies today.

And we're, you know, we just talked about Microsoft, Apple and Google three of the larger big tech companies who are net debt free. So if you look at a company, that's, for example, let's say that they're in the same type of industry, and you would want to compare, you know, ideally, you'd probably want to compare Amazon to those three, and would they stack up against those three in that particular area, and that could help you eliminate, I'm not saying that Amazon does or doesn't.

But I guess my point is, is that you want to look at across industries, and see if they all how your company stacks up against the competitors. Because those are going to have impacts on what the business does and how they function. And kind of going back to what I said earlier about the liabilities and the equity, driving the revenue, or the income, the growth of the company, all companies really have three ish ways that they can drive revenue for businesses and as reinvesting in different ways. And they have, they can either do it through internal, so cash flow, so the profits that they generate, they can use to reinvest in the assets for the

business, they can also issue debt, which is our bonds, which they sell to investors, and they get cash back for that, and in return, that they can use to invest, or they can sell equity, they can go out in the market and sell shares of their company to generate cash.

So those are the three ways you want to do it. And that's why it's important to look at total liabilities compared to equity that Andrew was talking about. That's why that's so critical. Because when you look at that kind of a ratio, it really tells you how the company can potentially invest in their future. And the more levered they up, though less liquid the business is, the more debt that they carry, the less equity they have, the fewer options they have, that's where these things can become become an issue, it's not always necessarily that they have a huge amount of debt, it's more about the interest payments, that they have to pay on that debt, because when they sell a bond to an investor, like me, for example, I'm giving them my cash in return for my capital back at some point, plus, they're gonna give me payments, dividend payments, those are interest payments.

And the higher those get, the more it could put an impact on the business being able to generate own internal cash to reinvest in the business, or it puts it a, you know, a potential bankruptcy in the future. So all these ideas that we're talking about, they all kind of interconnect. And that's why understanding the financial statements can really be helpful when you're analyzing a business.

And that's why I try to have like three to five different metrics that I use to just kind of judge a balance sheet and kind of go from there. So I guess, when we think about some of these things, well, how does, like if we look at the balance sheets of these three companies, just as a general rule, without throwing numbers at people, because we don't want people to nod off while they're driving? So what do you think, like if you had to just, you know, give grades to the three companies we're talking about here? What would you say grade wise? For those?

Andrew

23:51

Really giving me the hard one? I know, I'd rather you just asked me about the three tech giants Google, Microsoft and Apple X, I'll just say A plus A plus A plus, right? Apple, Starbucks and Netflix. So it kind of goes back to what what I was saying earlier about an asset can be subjective sometimes.

And that's what makes it hard. I think metrics are important. And they're critically important as you're a beginner, because you need context on what the numbers mean, you know, knowing that Apple has $98.9

billion in debt doesn't tell me a thing, because there's nothing to compare it to. So for a company like Apple that's actually kind of small, but it sounds really big.

That's where the metrics come in. If we were to evaluate on metrics, Apple would be number one, Netflix would be number two, and Starbucks would be number three. However, Starbucks does have a lot more value than its balance sheet might show because it is a very coveted consumer brand. Now if that demand goes the other way, and people all of a sudden, don't want to go to Starbucks for their iced coffee, ice cream drinks, that they're all buying there, then the balance sheet really becomes a problem. But it's really on a case by case basis, these are all three really great companies that are growing really fast.

And customers love them. So I don't necessarily, I don't want to make a judgement without really having dug into the numbers, and really thought really hard about these businesses, I obviously have a reason for why I'm invested in one and not the other two. But I don't feel like I could grade and give this company A, B or C, because I've chosen not to invest in it and not investigate deeper, that could be a great balance sheet or great investment to somebody else who's done the work or see something I don't

Dave

25:54

exactly that we touch on the negative shareholders equity that Starbucks has, for a minute, because that you mentioned a brand, they don't receive any money for the brand strength. You know, Starbucks is arguably one of the stronger brands in the world, but they don't receive any monetary, you know, accolades for that. And, but they do have negative shareholder equity. And so as somebody that doesn't know the company, if I look at that, that would turn me off right away. But that doesn't necessarily mean it is a bad investment. So could you kind of touch on that?

Andrew

26:26

I love that you brought that up. Because remember what I said about what ends up on the balance sheet is what when a company has paid to invest in something to build an asset or buy an asset. But for whatever reason, if Starbucks were the spend $3 billion on advertisements, to promote the Starbucks brand, that actually does not get reflected on the balance sheet at all. It's, I don't know why this is the case, it's just the way the accounting is decided to do it.

So all of these years, and all of these advertising dollars that Starbucks has spent over the years, building the Starbucks brand, and making that a household name, does not show up on their balance sheet. And so that's why their liabilities are higher than their assets. But you could argue the actual earning power of Starbucks is way higher than its brick and mortar stores.

Because everybody, not everybody, a lot of people like Starbucks. And that's what makes it that's what makes it hard. We did have a previous episode though, where we talked about how we did not like their balance sheet, because they took on a lot of debt to buy back shares. And I still stand by that. But you know, that was, what, three, four years ago that they did that. And whether that's improved or not, is up to you to decide if you're looking at a company like that.

That's a really important thing. And I'm glad you brought that up, because it applies to several different companies. I mean, I own a company that also has negative shareholders equity. But I've done the work to understand what's the downside risk in that. So something to definitely keep in mind. And, again, I'm glad you brought that up, because it could be a stumbling block. For somebody who's like, what, this doesn't make any sense at all. I mean, how do you think how do you look at negative shareholders equity?

Dave

28:10

You know, at first, honestly, I looked at it as a negative, no pun intended. But I think as I've learned more, I try to take it more on a case by case basis, and try to try to understand what's driving it and why it is that way. Some businesses may have lower shareholder equity than others, you mentioned off air, the idea of the kind of the franchise model sometimes can lead to, to lower numbers as well, I think you really have to kind of understand what the business is doing and where they are, and what they're trying to do.

And it comes down to really understanding the financials, the operations, the business, what they're trying to do, and the CEO that's running the company, do you trust what they're doing, and you feel like they know what they're doing, and they're driving the bus in the right direction. And so that's how I tried to do it.

Now. It really when I come across something that that if everything else is okay, then it just means that you got to do more work to really understand it. If everything else is bad, too, then it might just be okay. This is probably one of those I need to put in the to hard pile and move on to something else. Like in everything else in the finance world. It depends. And so I try real hard to take it case by case now as opposed to just generalizing and just go bad and move on. From there.

Andrew

29:28

It's a good idea for sure.

Dave

29:31

All right, folks. Well with that we will go ahead and wrap up our series on financial statements as well as today's episode on the balance sheet. We hope that you enjoyed this three part series on the financial statements and that you did not off too much accounting can be fun, if done the right way and it is part of investing and it is something that you need to understand to a certain extent it is the language of investing. So it's it is important and we felt like it needed to be discussed.

If you have any questions About anything that we talked about today we have our website e investing for beginners.com Huge search bar at the top, you can look up items like the balance sheet, you can look up inventory again, you could also look up shareholders equity, any of the topics that we discussed today you will find articles and topics about those. We also have some different episodes that we are different articles that we wrote about different ways that you can analyze the debt of the businesses and stuff.

So all those things are there available for you to give you a little more thorough information past the shallow conversation that we had today on the items. So without any further ado, I will go ahead and sign us off you guys go out there and invest with a margin of safety emphasis on the safety. Have a great week and we'll talk to you all next week.

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