How To Analyze A Company's Financial Position

To understand and value a company, investor have to look at its financial position. Fortunately, this is not as difficult as it sounds.

If you borrow money from a bank, you have to list the value of all your significant assets, as well as all your significant liabilities. Your bank uses this information to assess the strength of your financial position; it looks at the quality of the assets, such as your car and your house, and places a conservative valuation upon them. The bank also ensures that all liabilities, such as mortgage and credit card debt, are properly disclosed and fully valued. The total value of all assets less the total value of all liabilities gives your net worth, or equity.

Evaluating the financial position of a listed company is quite similar, except investors need to take another step and consider financial position in relation to market value. Let's take a look.

Start With the Balance Sheet:

Like your own financial position, a company's financial position is defined by its assets and liabilities. A company's financial position also includesshareholder equity. All this information is presented to shareholders in the balance sheet.

Let's suppose that we are examining the financial statements of fictitious publicly listed retailer, The Outlet, to evaluate its financial position. To do this, we examine the company's annual report, which can often be downloaded from a company's website. The standard format for the balance sheet is assets, followed by liabilities, then shareholder equity. (For more on the balance sheet, see the

Current Assets and Liabilities:

Assets and liabilities are broken into current and non-current items. Current assets orliabilities are those with an expected life of less than 12 months. For example, suppose that the inventories that The Outlet reported as of January 31, 2010, are expected to be sold within the following year, whereupon the level of inventory will fall and the amount of cash will rise.

Like most other retailers, The Outlet's inventory represents a big proportion of its current assets, and so should be carefully examined. Since inventory requires a real investment of precious capital, companies will try to minimize the value of inventory for a given level of sales, or maximize the level of sales for a given level of inventory. So, if The Outlet sees a 20% fall in inventory value together with a 23% jump in sales over the prior year, this is a sign they are managing their inventory relatively well. This reduction makes a positive contribution to the company's operating cash flows.

Current liabilities are the obligations the company has to pay within the coming year, and include existing (or accrued) obligations to suppliers, employees, the tax office and providers of short-term finance. Companies try to manage cash flow to ensure that funds are available to meet these short-term liabilities as they come due.

The Current Ratio:

The current ratio - which is total current assets divided by total current liabilities - is commonly used by analysts to assess the ability of a company to meet its short-term obligations. An acceptable current ratio varies across industries, but should not be so low that it suggests impending insolvency, or so high that it indicates an unnecessary build-up in cash, receivables or inventory. Like any form of ratio analysis, the evaluation of a company's current ratio should take place in relation to the past. (To learn more, read*Dynamic Current Ratio: What It Is And How To Use It*.)

Non-Current Assets and Liabilities:

Non-current assets or liabilities are those with lives expected to extend beyond the next year. For a company like The Outlet, its biggest non-current asset is likely to be the property, plant and equipment the company needs to run its business.

Long-term liabilities might be related to obligations under property, plant and equipment leasing contracts, along with other borrowings. (Learn more about analyzing long-term liabilities in *Financial Statements: Long-Term Liabilities*.)

Financial Position: Book Value:

If we subtract total liabilities from assets, we are left with shareholder equity. Essentially, this is the book value, or accounting value, of the shareholders' stake in the company. It is principally made up of the capital contributed by shareholders over time and profits earned and retained by the company, including that portion of the any profit not paid to shareholders as a dividend.

(Learn more about book value and what it means to investors in *Book Value: How Reliable Is It To Investors?*)

Market-to-Book Multiple:

By comparing the company's market value to its book value, investors can in part determine whether a stock is under- or over-priced. The market-to-book multiple, while it does have shortcomings, remains a key tool for value investors. (You can read more about the market-to-book multiple in the article *Value by the Book*.) Extensive academic evidence shows that companies with low market-to-book stocks perform better than those with high multiples. This makes sense since a low market-to-book multiple shows that the company has a strong financial position in relation to its price tag.

Determining what can be defined as a high or low market-to-book ratio also depends on comparisons. To get a sense of whether The Outlet's book-to-market multiple is high or low, you need to compare it to the multiples of other publicly listed retailers.

The Bottom Line:

A company's financial position tells investors about its general well-being. A study of it (and the footnotes in the annual report) is essential for any serious investor wanting to understand and value a company properly.