



Navigating Accounting[®]

Balance Sheets and Financial Leverage: How Do I Use the Numbers?

Industry Comparisons 01

Comparing and contrasting balance sheets and financial leverage across industries and time.

Search



This exercise requires you to search for information.

Compute



This exercise requires you to compute information.

Usage



This exercise helps you learn how accounting reports are used by investors, creditors, and other stakeholders.

Judgement



This exercise helps you learn how to use judgement.

Part 1 Question

- Fill in the blank boxes (with red borders) in the data template in the Excel file for this exercise following the guidance below.

Part 1 Guidance

- If you have not already done so, go to NavigatingAccounting.com and then click your way to the materials for this exercise:
 - Click “Analyzing Financial Statements Across Time and Industries”
 - Industry Comparisons Exercises: Series 01
 - Click “Exercise 1: Balance Sheets and Financial Leverage”
- Download the Excel and Word files.
- Search the internet for information needed to fill in the blank boxes:
 - You will find most of this information on the companies’ balance sheets. These are reported in their annual reports or extended versions of these reports they submit to the Securities and Exchange Commission (SEC) called Form 10-Ks. To learn how to locate and download these documents and find the balance sheets therein, watch *Searching and Locating Annual Reports 1*, which is included in the Videos section of the materials for this exercise.
 - You will also need to locate companies’ year-end stock prices. While these are usually reported in annual reports, they are generally easier to find using Big Charts or a similar internet service. To learn how to locate them using Big Charts, watch *Locating Stock Prices Using Big Charts*, which is included in the Videos section of the materials for this exercise.
 - You will need to know some very basic Excel skills to complete the data template. If you are not familiar with Excel, watch *Using Excel 1:Basics*, which is included in the Videos section of the materials for this exercise.

Part 2 Question

- Compare and contrast the riskiness of the owners’ claims for the five companies in the data template at the balance sheet dates, ignoring differences in these dates.

Part 2 Guidance

- **Limit your analyses of the owners’ risks to:**
 - The potential consequences of financial leverage at the balance sheet date for the owners, which affects their risk and depends on two factors: the financial leverage ratio and overall asset risk at that date.
 - The extent to which the company will likely meet its short term obligations, which depends on three factors: the extent to which its current assets exceed its current liabilities, the riskiness of its current assets and thus the likelihood their expected future benefits will be realized, and the ability of the company to raise additional cash by selling long-term assets or issuing more debt or equity.
- Your understanding of the companies’ businesses and the ways they were likely impacted by the financial crisis during this period. Your understanding of the companies’ businesses should be informed by related excerpts from the Management Discussion and Analysis (MD&A) section of the 10-K.

- **Organize your responses with the following titles and guidance:**

(a) **Financial Leverage Comparisons: Analysis and Conclusions.** Compare and contrast the companies' financial leverages at the balance sheet dates, ignoring differences in these dates and assuming:

- All reported balance sheet numbers are measured reasonably reliably, meaning objective experts' estimates of these measures would likely be closely dispersed and the companies' reported measures are based on honest and objective analyses (and thus fall within experts' hypothetical distributions).
- All significant assets and liabilities are recognized on the companies' balance sheets. Thus, no significant assets and liabilities are "off-balance sheet."

To the extent these assumptions are valid, you can put a great deal of confidence in conclusions based on the financial leverage measures in the data template.

(b) **Financial Leverage Comparisons: Caveats.** Discuss concerns you might have about the validity of the two assumptions in part (a) and thus about the confidence you should have in the conclusions based on them:

- Limit your discussion of the reliability of the reported measures to receivables, inventories, and property, plant, and equipment, taking into account how the financial crisis during this period might have affected the reliability of these measures.
- When gauging the reliability of reported measures, classify the dispersion of objective experts' estimates as being most similar to the dispersion of their estimates of the value of (i) cash and cash equivalents, (ii) a used car, or (iii) a patent acquired from another company.
- Limit your discussion of off-balance sheet items to those suggested by the market-to-book ratios reported in the data template and assume there is no significant off-balance sheet debt and the market value of the reported debt does not differ significantly from its book value. These assumptions imply that differences in the market and book values of owners' equity, and thus market to book ratios, are solely attributable to off-balance sheet assets or miss-measured balance sheet assets.

Given these assumptions, you are to assess (in qualitative terms) the extent to which the financial leverage measures based on the data template numbers would change if all assets and liabilities were reported on the balance sheets at their market values. In later chapters, we will consider when it is appropriate to assume there is no significant debt off-balance sheet and the book value of reported debt approximates its market value, which will help you refine your analyses.

(c) **Asset Risk Comparisons: Analysis and Conclusions.** Compare and contrast the companies' asset risks at the balance sheet dates, meaning the risk that the values of these assets will drop in the future (either because the likelihood the assets' expected benefits will be realized decreases or because the likelihood these benefits being delayed increases):

- Limit your discussion to receivables, inventories, and property, plant, and equipment, taking into account how the financial crisis during this period might have affected these assets' risks. For each of these three asset types, did the financial crisis affect risk similarly across the companies? For example, did it affect risk associated with receivables similarly across the

companies? Limit your discussion to your general understanding of the companies' businesses. In later chapters, we will study the risks associated with the "other" assets, which will help you refine your analyses.

- Keep in mind that the consequences of an asset's risk for owners depends on the size of the asset relative to total assets and the probability distribution of the possible declines in value. For example, asset risk increases as the probability of larger declines in value increases.
- Assume all reported balance sheet numbers are measured reasonably reliably, as defined in part (a).
- Assume all significant assets and liabilities are recognized on the companies' balance sheets. Thus, no significant assets and liabilities are "off-balance sheet."

The caveats in part (b) regarding the above assumptions also apply here. You do not need to repeat these or other caveats here.

- (d) **Meeting Short-term Obligations: Analysis and Conclusions.** Compare and contrast the extent to which the companies will likely meet their short term obligations:
- Limit your discussion of the riskiness of current assets to briefly summarizing points you made in part (c) for receivables and inventories.
 - Limit your discussion of the likelihood companies could raise cash by selling assets or issuing debt or equity to your general understanding of the companies' businesses and the ways these businesses were affected by the financial crisis occurring at this time.
- (e) **Overall Financial Strength of Balance Sheets.** Compare and contrast the overall financial strength of the companies' balance sheets, meaning their capacity to continue to weather the financial crisis or further economic downturns and to finance new growth opportunities if the economy picks up after the balance sheet dates:
- Limit your discussion to a summary of conclusions from parts (a)-(d), maintaining the same assumptions and limitations. There is no need to repeat the caveats associated with these conclusions.
 - Discuss the consequences of the companies' financial leverage for owners, which depends on both the financial leverage analyzed in part (a) and the asset risks analyzed in part (c).