Don't Ignore the Balance Sheet

By Russell T. Glazer

Nearly every valuation of a going concern business analyzes the subject company's income statements. A great deal of time and effort is devoted to examining the recent history of revenues, gross margins and overhead expenses. This is, to be sure, an important part of the valuation analysis that rightly deserves much of the focus. However, the income statement is only part of the valuation story.

The value of any financial asset is derived from the cash flow that the asset can generate for its owners, and the income statement is a great starting point for this, but, more often than not, net income does not equal cash flow. Thus, analysis of the income statement must be supplemented by an analysis of the balance sheet, as well. Income and expense activity, coupled with changes in the makeup of the balance sheet, work in tandem to determine the cash flow available for distribution to the owners annually.

A review of the balance sheet, and an understanding of the company's future plans, will allow the appraiser to make the necessary adjustments to convert net income to net cash flow. Such adjustments may arise because the company is planning to make significant additions to its fixed assets or physical plant. This leads to another related issue - will the fixed assets be paid for with cash, or through financing? If they are to be financed, then on what terms? The effects of these factors on cash flow will not make themselves apparent by analyzing the income statement in isolation.

Or, perhaps the company has only a few years left of paying back term debt, or is in the process of expanding its inventory. As before, the effect on cash flow will not manifest itself in the income statement, and the reduction of available cash flow will be overlooked.

Many other examples can be cited; the lesson to take from this is that, without a thorough examination and understanding of both the balance sheet and the income statement, the valuation conclusion could well be incorrect.

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