Balance sheet analysis example pdf

Click to download the eBook In the previous video we provided a balance overview. In this video, we're going to explain some easy ways to analyze balance. We will focus on three key areas: liquidity, financial strength, and how well the business is managed. LIQUIDITY The first area we will look at is liquidity. Essentially, this is how easily a company can pay from existing assets for its running costs, including wages, inventory and investments in capital equipment. CURRENT RATIO As with the earnings and earnings report, the easiest way to parse your balance sheet is to look at the ratio. The first ratio we will look at is called the current ratio and sometimes referred to as the working capital ratio. It's very easy to calculate. These are simply current assets divided by current liabilities. In this example, this means that $6,670,000 of current assets divided by $1,839,000 of current liabilities gives you a number of 3.63. Accounting textbooks will tell you that the current ratio of 2.0 or higher is an indicator of a company with sufficient liquidity. This is one of the key liquidity measures. FAST RATIO The next ratio we'll be looking at is a quick ratio. This excludes some current assets that cannot be easily converted to cash, such as inventory. So it's more like extremely liquid current assets, and then that amount is divided into current liabilities. Thus, in this example, assets that will qualify as liquid current assets include cash, market securities and receivables, and then we divide that by current liabilities, and we get a ratio of 1.91. Accounting textbooks mostly say a ratio of 1.0 or higher shows adequate liquidity for most companies. DEBT-TO-EQUITY RATIO After assessing liquidity, the next thing to look at is financial strength. The most common ratios to watch here are several different debt-to-equity ratios. The first is long-term debt divided by equity and the other by total debt divided into equity. When we talk about debt here, we're talking about interest bearing debt - that means loans and the bank's revolving lending line. We are not talking about non-conducive liabilities, which are also debts such as payables. And equity, as you may recall, is the amount of money that shareholders have invested in the company plus net income that has been earned and saved over the years. When assessing a company's strength using a debt-to-equity ratio, the lower the ratio, the better because the company is financially stronger, the less debt it has compared to capital. However, in many sectors, it is normal for debt to be several times larger than its own although, as this ratio gets higher and higher, it starts to be known as junk debt rather than in investment grade. So you can see in the first example $2,332,000 long-term debt is shared by equity shareholders at $4,203,000 and we get a ratio of .55, which is excellent. When we with total debt, we received short-term debt (the current part of long-term debt) at $1,021,000 and we add that to $2.3 million of long-term debt and split that by the same total equity, and this time the ratio is higher - it's 0.8 - but it's still well below 1.0, so that's the financial strength of this company looks solid. PERCENTAGE COVERAGE Another indicator of financial strength is percentage coverage, which is also sometimes referred to as earned interest time. In essence, it is an operating profit divided by interest expense. None of these items are on balance, they are actually from income. But when you're talking about the debt-to-equity ratio and company debt, it's also important to gauge financial health to look at the company's current operating profit versus the amount of interest it has to pay to its debt holders. Obviously we want a ratio above 1 to indicate that operating profit is greater than interest costs, and usually something at 5 to 7 is considered very healthy. For this company, they have very little interest expense and quite a bit of operating profit, so their interest coverage ratio is extremely healthy. RETURN ON EQUITY Next we are going to measure how efficiently management manages the company. The first ratio we will look at is return on equity. This is a measure of the company's earnings on equity invested by shareholders. We just take net income and divide it into equity. In this example, $397,000 of net income divided by $4,203,000 of equity gives us a return on equity of 9.45%. In today's market with low inflation and high risk, people are very happy that 9% are coming back. As with other ratios, it would be good to compare this return on equity with other companies in the same line of business to get a better idea of how well this management team generates profits compared to peers. We discuss how to get information about other companies in the same industry in the Financial Reporting Analysis series. RETURN ON ASSETS The next efficiency ratio is very similar, but it is the profitability of common assets instead of just equity. This is a measure of the return on all capital invested in the business used to acquire assets. To calculate this, we simply take net income and divide it into common assets. In this example, net income of $397,000 is divided into total assets at $8,374,000 and we receive asset income of 4.74%. The debt-to-equity ratio of a particular company affects the return on equity. The asset profitability ratio eliminates the impact of the funding source, whether it's debt or equity, on measuring management performance, and that's why it's good to look at both ratios when comparing companies. Inventory There are three other efficiency ratios that we can look at to get an idea of how well management is actually managing several specific very important assets of the company. The first is inventory turnover. He Is He how well they manage their inventory. One way to calculate this is simply to take the cost of the goods sold and split that by ending the inventory. In this example, we share the costs of goods sold for $9,905,000, ending with an inventory of $2,936,000 and a result of 3.73 means the company sells its inventory 3.73 times a year. Some people prefer to look at it as the number of days that something is in inventory, so to see that we share 365 days on 3.73 times inventory turns, and the result is 108 days. That means it takes an average of 108 days to sell all the stock. There are several other ways to change this calculation, which is discussed in a series of financial statements analysis. The best way to understand if the resulting number is good or bad is to compare with other companies in the industry. ACCOUNTS RECEIVABLE DAYS OUTSTANDING Another efficiency ratio is Receivables Days Outstanding also known as Days of Debt Sales, often referred to as DSO. This measures how well management turns sales into cash and represents how long it takes to collect on sales. The longer it takes, the more work funds are needed to finance the company, and this can lead to debt collection problems. It can also be an indicator that management does not focus on keeping receivables in line, or that they have to give longer terms or sell riskier, slower pay to customers to get sales. To calculate this, we just take the remainder of the receivables at the end of the period and divide it by sales for the past year, and then multiply that by 365 days. So in this example we have $1,667,000 in receivables on balance sheet and split that by a total sales of 11,892,000 and multiply that number by 365. This gives us a result of 51.5 days. This company needs an average of 51 1/2 days to collect on its sales. ACCOUNTS PAYABLE DAYS OUTSTANDING The final efficiency ratio will look at this payable days of debt. This indicates how quickly the company pays its bills. For companies thinking about doing business with this company, this is a very important ratio as you want to know how quickly you are paid. To calculate it, we simply take the creditor balances and divide it into the value of the goods sold, and then multiply that by 365 days. The reason we use the value of goods sold instead of sales in this calculation is because the surcharge is due to costs, not revenues. For companies where the costs of goods sold account for a small portion of total operating expenses, it may be better to use the costs of goods sold plus operating expenses as the denominator in the equation. To calculate the standard ratio for this company, they had $625,000 towards payables, and we share that by goods sold $9,905,000 and then multiply that by 365, and it shows that their payable days were only 23 days. That means they're a very fast payer. Companies that think providing credit to this business should feel very comfortable with this number. Next video Next video in this series - Introduction to the statement of cash flow. Remember that you can download a financial statement analysis book that includes more than 50 definitions and calculation ratios. It also contains an Excel spreadsheet that calculates key ratios as you enter financial data. If you need help collecting debt, we are big business claims specialists and we can refer you to other agencies if your needs don't meet our expertise. Just fill out the Quote Request form or call us. Call.