Analyzing Balance Sheets Cheat Sheet

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Introduction

Once you have created a balance sheet for your business, there are some easy calculations that you can perform that will give you a better understanding of your company. Using data from your balance sheet, you can calculate liquidity and leverage ratios.
These financial ratios turn the raw financial data from the balance sheet into information that will help you manage your business and make knowledgeable decisions. A ratio shows the relationship between two numbers. It is defined as the relative size of two quantities expressed as the quotient of one divided by the other.
Financial ratio analysis is important because it is one method loan officers use to evaluate the credit worthiness of potential borrowers.
Ratio analysis is a tool to uncover trends in a business as well as allow the comparison between one business and another..

Source: Edward Lowe Foundation. http://www.edwardlowe.org

Current Ratio

The current ratio (or liquidity ratio) is a measure of financial strength. The number of times current assets exceed current liabilities is a valuable expression of a business' solvency. Here is the formula to compute the current ratio:
Current Ratio = Total Current Assets / Total Current Liabilities
The current ratio answers the question, “Does my business have enough current assets to meet the payment schedule of current liabilities with a margin of safety?” A rule-of-thumb puts a strong current ratio at two. Of course, the adequacy of a current ratio will depend on the nature of the small business and the character of the current assets and current liabilities. While there is usually little doubt about debts that are due, there can be considerable doubt about the quality of accounts receivable or the cash value of inventory..

A current ratio can be improved by either increasing current assets or decreasing current liabilities. This can take the form of the following:
- Paying down debt.
- Acquiring a loan (payable in more than one year's time).
- Selling a fixed asset.
- Putting profits back into the business.

Quick Ratio

The quick ratio is also called the “acid test” ratio. It is a measure of a company's liquidity. The quick ratio looks only at a company's most liquid assets and divides them by current liabilities.
Here is the formula for the quick ratio:
Quick Ratio = (Current Assets - Inventory) / (Current Liabilities)
The assets considered to be “quick” assets are cash, stocks and bonds, and accounts receivable (all of the current assets on the balance sheet, except inventory). The quick ratio is an acid test of whether or not a business can meet its obligations if adverse conditions occur. Generally, quick ratios between .50 and 1 are considered satisfactory as long as the collection of receivables is not expected to slow.

Working Capital

Working capital should always be a positive number. It is used by lenders to evaluate a company's ability to weather hard times. Often, loan agreements specify a level of working capital that the borrower must maintain.
Working Capital = Total Current Assets - Total Current Liabilities
The current ratio, quick ratio and working capital are all measures of a company's liquidity. In general, the higher these ratios are, the better for the business and the higher degree of liquidity.

Debt/Worth Ratio

The debt/worth ratio (or leverage ratio) is an indicator of a business' solvency. It is a measure of how dependent a company is on debt financing (or borrowings) as compared to owner's equity. It shows how much of a business is owned and how much is owed.
The debt/worth ratio is computed as follows:
Debt/Worth Ratio = Total Liabilities / Net Worth