

# 10 KEY BALANCE SHEET METRICS



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At the core of a company's financial analysis, the **balance sheet** stands as a snapshot of a company's financial capabilities at a given moment. It's a financial mirror reflecting what a company possesses and owes, with **assets** on one side and **liabilities** plus **equity** on the other—always in equilibrium as dictated by the foundational formula:

<b>ASSETS</b> <ul style="list-style-type: none"><li>• Current Assets</li><li>• Non-Current Assets</li></ul>	=	<b>LIABILITIES</b> <ul style="list-style-type: none"><li>• Current Liabilities</li><li>• Non-Current Liabilities</li></ul>	+	<b>EQUITY</b> <ul style="list-style-type: none"><li>• Shareholders Equity</li><li>• Retained Earnings</li></ul>
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Navigating the financial landscape without the proper tools can result in a loss of direction. The balance sheet metrics highlighted in this document serve as essential instruments, illuminating a company's economic health from three crucial perspectives::

- **Short-Term Liquidity:** Evaluating a company's readiness for immediate cash needs to cover operational expenses and debts.
- **Asset Utilization:** Gauging how effectively a company's assets are being employed to produce revenue and bolster profitability.
- **Capital Structure:** Analyzing debt and equity financing, revealing the strategies behind business expansion and operational funding.

## 1. Working Capital

**Working capital** is a key financial metric that represents the difference between a company's current assets and current liabilities. It's a measure of a company's short-term financial health and its efficiency in managing its operational cycle. Working capital signifies the liquidity available to a business for day-to-day operations—it's a snapshot of the company's operational efficiency and short-term financial stability.

Formula **Working Capital = Current Assets - Current Liabilities**

Example: Let's say Company A has current assets totaling \$500,000, which include cash, accounts receivable, and inventory. Its current liabilities, comprising accounts payable and short-term debt, amount to \$300,000. Applying the formula we have a working capital of \$200,000, indicating that the company has sufficient short-term assets to cover its short-term liabilities, with a surplus to fund ongoing operations.

## 2. Current Ratio

The **current ratio** is a liquidity ratio that measures a company's ability to pay off its short-term liabilities with its short-term assets. This financial metric provides insights into its capacity to fulfill its debts and obligations due within a year. A higher current ratio indicates a better liquidity position, suggesting that the company has more than enough short-term asset value to cover its short-term debt.

Formula **Current Ratio = Current Assets / Current Liabilities**

Example: Suppose Company B has current assets of \$600,000, including cash, marketable securities, inventory, and accounts receivable. The current liabilities, such as accounts payable, short-term loans, and other financial obligations due within a year, total \$300,000. Using the formula the current ratio is 2.0 implying that Company B has twice as many current assets as it has current liabilities, which is typically seen as a strong liquidity position. It indicates that the company should be able to cover its short-term obligations twice over with its current assets.

## 3. Quick Ratio (Acid-Test Ratio)

The **quick ratio**, also known as the acid-test ratio, is a stringent indicator of a company's short-term liquidity. The quick ratio measures the ability of a company to meet its short-term obligations with its most liquid assets. Therefore, it excludes inventory and sometimes also other less liquid current assets from the equation because these items may not be quickly converted to cash without a loss of value.

Formula **Current Ratio = (Current Assets - Inventory - Prepaid Expenses) / Current Liabilities**

Example: Suppose Company C has a quick ratio of 1.0. It signifies that Company C has exactly the same amount of quick assets as it has current liabilities. A ratio of 1 or higher generally indicates that a company should be able to fulfill its short-term liabilities without having to sell its inventory or rely on additional income generation.

## 4. Cash Conversion Cycle (CCC)

The **Cash Conversion Cycle (CCC)** is a key metric that reflects the time span between a company's outlay of cash for the purchase of inventory and the collection of cash from its customers for the sale of that inventory. It is a vital indicator of a company's efficiency in managing its working capital and its cash flow. The CCC helps businesses understand how long their cash is tied up in inventory and receivables before it is converted back into cash.

**Formula**  $\text{Cash Conversion Cycle} = \text{DIO (Days Inventory Outstanding)} + \text{DSO (Days Sales Outstanding)} - \text{DPO (Days Payable Outstanding)}$

Where:

- DIO measures how long a company holds inventory before selling it. **Formula:**  $(\text{Average Inventory} / \text{COGS}) \times 365$
- DSO measures how long it takes for a company to collect payments from its customers. **Formula:**  $(\text{Average AR} / \text{Annual Sales}) \times 365$
- DPO measures how long a company takes to pay its suppliers. **Formula:**  $(\text{Average AP} / \text{Purchases}) \times 365$

**Example:** Suppose Company D has a DIO of 100 days, a DSO of 36.5 days, and a DPO of 73 days. The CCC will be equal to 63.5. Company D's Cash Conversion Cycle is 63.5 days, which means it takes approximately 63.5 days from paying for inventory to collecting cash from customers. This information is crucial for Company D to understand its cash flow and identify areas for improvement in its working capital management.

## 5. Return on Assets (ROA)

**Return on Assets (ROA)** is a financial metric used to quantify how profitable a company is relative to its total assets. It gives an idea of how effective a company is at using its assets to generate earnings. ROA is particularly useful for comparing the performance of companies in the same industry, and a powerful indicator of a company's efficiency to assess whether a company is utilizing its assets effectively to produce profit.

**Formula**  $\text{ROA} = \text{Net Income} / \text{Average Total Assets}$

**Example:** Let's consider Company E has a Net Income of \$150,000, Total Assets at the beginning of the year of \$1,000,000 and Total Assets at the end of the year of \$1,200,000 (so an average Total Assets of \$1,100,000). Now, we apply the ROA formula and get 0.136 or 13.6%. This means that for every dollar of assets Company E owns, it generates 13.6 cents in profit. A higher ROA indicates a more efficient use of company assets.

## 6. Debt-to-Asset Ratio

The **debt-to-assets** ratio is a leverage ratio that provides insight into the financial structure of a company by showing the proportion of a company's assets that are financed by debt. It is a measure of the degree to which a company is taking on debt as a means of leveraging its assets. A higher ratio indicates that a greater proportion of the company's assets are funded by debt, which could imply higher financial risk.

**Formula**  $\text{Debt-to-Assets Ratio} = \text{Total Debt} / \text{Total Assets}$

**Example:** Suppose Company F has Total Debts of \$500,000 and Total Assets of \$1,250,000. The Debt-to-Asset ratio is equal to 0.4 or 40%. This means that 40% of Company F's assets are financed through debt. Understanding this ratio helps stakeholders assess the company's leverage and risk level; typically, a lower debt-to-assets ratio is preferred as it indicates a lower level of risk.

## 7. Debt-to-Equity Ratio

The **debt-to-equity** ratio is a significant financial metric that evaluates the balance between the capital contributed by creditors and the capital contributed by shareholders. It provides a clear view of the company's financial leverage and its reliance on debt to finance its activities. A higher ratio implies that the company has been aggressive in financing its growth with debt, which can increase the risk of insolvency during economic downturns. Conversely, a lower ratio suggests that the company is utilizing less leverage and has a more conservative capital structure, which is generally perceived as lower risk.

**Formula**  $\text{Debt-to-Equity Ratio} = \text{Total Liabilities} / \text{Shareholders' Equity}$

**Example:** Consider Company G with Total Liabilities of \$600,000 and Shareholders' Equity of \$400,000. The Debt-to-Equity ratio equals 1.5. This result indicates that for every dollar of equity, Company G has \$1.50 in debt. This higher ratio suggests that Company G might be more leveraged and potentially riskier, especially if the interest rates rise or if the company faces cash flow problems.

## 8. Variants of the Debt/Equity Ratio

We have seen above the **Debt/Equity** ratio, but there are two sub-elements that we can also measure:

- **The Long Term Debt/Equity Ratio**. Formula = Long Term Debt / Shareholders Equity
- **The Short Term Debt/Equity Ratio**. Formula = Short Term Debt / Shareholders Equity

The objective of these financial ratios is to determine how a company has been financing its growth. A high ratio means that the company has been growing due to debt (being Total Debt, Long Term Debt, or Short Term Debt), or what we call **leverage**. Not all debt is bad, but remember that the company has to pay off the loan as well as interest payments. An important factor to consider then is to determine whether the returns generated from the debt exceed the cost of debt (i.e., interest).

## 9. Inventory Turnover

The **Inventory Turnover** ratio is a key performance metric that indicates how effectively a company manages its inventory. Essentially, it measures how often a company sells and replaces its inventory over a certain period, typically a year. This ratio is crucial for businesses in retail and manufacturing sectors as it provides insights into sales effectiveness, inventory management, and overall operational efficiency.

Formula **Inventory Turnover = Cost of Goods Sold (COGS) / Average Inventory**

Example: Let's say Company H reported a COGS of \$800,000 for the year. Its inventory at the beginning of the year was \$100,000, and at the end of the year, it was \$120,000. The inventory turnover is  $\approx 7.27$  which means that Company H turns over its inventory approximately 7.27 times per year. This indicates how often the company sells and restocks its inventory. A higher turnover rate can indicate strong sales and effective inventory management. However, it's important to balance: too high a turnover might lead to stockouts and lost sales, while too low a turnover might suggest excess inventory, potentially leading to obsolete stock.

Note: We can use the Inventory turnover to calculate the **Average Age of Inventory (Days) = 365 / Inventory Turnover**

## 10. Receivables Turnover

The **Accounts Receivable Turnover** ratio is a financial metric used to measure a company's effectiveness in extending credit to its customers and collecting debts. It shows how well a company manages its accounts receivable and how often these are converted into cash within a given period.

Formula **Receivable Turnover = Net Credit Sales / (Average of Current Period Receivables and Prior Period Receivables)**

Note: Net Credit Sales = Total sales on credit minus returns or Allowances

Example: Imagine company I reported net credit sales of \$500,000 for the year. The accounts receivable at the beginning of the year was \$40,000, and at the end of the year, it was \$60,000. The receivables turnover ratio = 10, which means that Company I collected its average receivables 10 times during the year. This could be interpreted as a sign of efficiency in the company's credit policies and collection efforts, assuming the period for these activities aligns with industry standards. However, a high ratio could also indicate a very strict credit policy, which might be limiting sales. Conversely, a low ratio may suggest issues with collecting receivables or that customers are taking longer to pay their debts. As always, the context and industry benchmarks are important for a full understanding of the ratios.

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### Conclusion:

Collectively, these Balance Sheet metrics paint a comprehensive picture of a company's financial health, signaling potential strengths / weaknesses in its strategy and execution. Stakeholders, including investors and management, must analyze these metrics in concert and in the context of industry benchmarks to make informed decisions and to strategize for a sustainable growth and financial resilience.