THE LANGUAGE OF BUSINESS

Understanding Financial Statements

Balance Sheet/Statement of Financial Position

The balance sheet shows the financial position of a business on a certain date (usually the end of the month or year). It is also called the *statement of financial position* (or SFP). It is important to note that the date on the balance sheet is a single date. The balance sheet presents a business view of assets equal to the sum of liabilities and capital. (Needles, Powers, & Crosson, 2014)

ROLAND CONSULTANCY
Balance Sheet
December 31, 200A

Assets	
Cash	₱3,120,000.00
Accounts Receivable	200,000.00
Supplies	100,000.00
Land	2,000,000.00
Building	5,000,000.00
Total Assets	**₱10,420,000.00**
Liabilities and Owner's Equity	
Accounts Payable	₱120,000.00
Total Liabilities	₱120,000.00
R. Tista, Capital	₱10,300,000.00
Total Liabilities and Owner's Equity	**₱10,420,000.00**

The following are the primary functions of a balance sheet:

- **Business funds.** The statement of financial position shows the capital contribution of owners and outside lenders. It also presents the acquired assets of the business.
- **Business value.** The statement of financial position provides a starting point for assessing a firm's value since it lists all the assets and business claims.
- **Business assets and claims.** It can be helpful to look at relationships between various statements of financial position items, for example, the relationship between how much wealth is tied up in current assets and how much is owed in the short-term (current liabilities).
- **Business performance.** The effectiveness of a business in generating wealth can be assessed against the amount of investment involved. Thus, the relationship between profit earned during a period and the value of the net assets invested can be helpful to users, particularly owners and managers (Atrill & McLaney, 2018).

Income Statement

The income statement summarizes the revenues earned and expenses incurred by a business over an accounting period. It is also called the *profit-and-loss (P&L) statement.* Many consider it the most important financial report because it shows whether a business achieved its profitability goal (whether it earned an acceptable income).

ROLAND CONSULTANCY
Income Statement
For the year ended December 31, 200A

Revenue:		
Consulting fees earned		₱700,000.00
Expenses:		
Equipment rental expense	₱140,000.00	
Wages expense	80,000.00	
Utility expense	60,000.00	
Total expenses		280,000.00
Net Income		**₱420,000.00**

The income statement may help in providing information on:

- **Wealth generation.** Assessing how much wealth has been created is vital for businesses. The income statement reveals the firm's profit for a given period. It provides a measure of the wealth created for the owners. Gross profit and operating profit are also useful measures of wealth creation.
- **Profit derivative.** The income statement also provides information needed to gauge business performance. It reveals the level of sales revenue and the nature and amount of expenses incurred, which can help understand how profit was derived (Atrill & McLaney, 2018).

Cash Flow Statement

The cash flow statement focuses on liquidity (or balancing the cash inflows and outflows to enable firms to operate and pay their bills when they are due). Cash flows are the inflows and outflows of cash into and out of business. Net cash flows are the difference between inflows and outflows.

ROLAND CONSULTANCY
Statement of Cash Flows
December 31, 200A

Cash flows from operating activities		
Net income		₱420,000.00
Increase in accounts receivable	(₱200,000.00)	
Increase in supplies	(100,000.00)	
Increase in accounts payable	120,000.00	(180,000.00)
Net cash flows from operating activities		₱240,000.00
Cash flows from investing activities		
Purchase of land	(2,000,000.00)	
Purchase of building	(5,000,000.00)	
Net cash flows used by investing activities		(₱7,000,000.00)
Cash flows from financing activities		
Investments by owner	10,000,000.00	
Withdrawals	(120,000.00)	
Net cash flows from financing activities		₱9,880,000.00
Net increase (decrease) in cash		₱3,120,000.00
Cash, Beginning		0
Cash, Ending		₱3,120,000.00

Financial Ratios

The following are the common types of ratios:

Return on Investments (ROI)

$$Return\ on\ investments = \frac{Income\ after\ Income\ Tax}{Average\ Stockholder's\ Equity}$$

The return on investments (ROI) generally means the return on the owner's equity; hence, it is sometimes referred to as return on equity (ROE). ROI relates income or profit after income tax to the total stockholder's equity (preferably on the average stockholder's equity). Average stockholder's equity is computed by adding the beginning and the ending balances and dividing it by two (2).

Profit Margin/Return on Sales (ROS)

$$Profit\ Margin = \frac{Income}{Net\ Sales}$$

The profit margin, or return on sales, is the income-to-net sales ratio. On a basic level, a low profit margin can be interpreted as indicating that a company's profitability is not secure. Suppose a company with a low profit margin experiences a decline in sales. In that case, its profit margin will decline, leading to a very low, neutral, or negative profit margin.

Low profit margins may also reveal certain matters about the industry or the broader economic conditions. For example, suppose a company's profit margin is low. In that case, it may indicate that it has lower sales than other companies in the industry (a low market share) or that the industry in which the company operates is suffering. Perhaps because of waning consumer interest (or increasing popularity and/or availability of alternatives). It could also result from hard economic times or recession.

The profit margin may also indicate a company's ability to manage expenses. High expenditures relative to revenue (i.e., a low profit margin) may suggest that a company struggles to keep its costs low, perhaps due to management problems. It is an indication that costs need to be under better control. High expenditures may occur for many reasons. These could be expenditures from too much inventory (relative to the firm's sales), too many employees, and inappropriate operating spaces (i.e., large offices requiring higher rent pay). On the other hand, a higher profit margin indicates a more profitable company with better control over its costs than its competitors.

Profit margin can also illuminate certain aspects of a company's pricing strategy. For example, a low profit margin may indicate a company is underpricing its goods (Segal, 2023).

Return on Assets (ROA)

$$Return\ on\ Assets = \frac{Income}{Average\ Total\ Assets}$$

This profitability measure shows how effectively the company has utilized its assets. In other words, it is a measure of asset utilization. This time, the operating income is used instead of the income after tax because the asset utilization pertains to the operations. ROA is equal to operating income divided by average total assets. The average of total assets is used to better gauge asset utilization.

Current Ratio

$$\textbf{Current Ratio} = \frac{Current\ Assets}{Current\ Liabilities}$$

The current ratio relates current assets to current liabilities and shows a firm's immediate solvency and liquidity. Solvency is the ability of a firm to meet long-term obligations, while liquidity refers to an enterprise's ability to pay short-term bills and debts. The current ratio tells how much current assets are available to meet the current liabilities. If the current ratio is 2:1, the company has P2 worth of current assets to meet every peso of current liability. The higher the current ratio, the more solvent or liquid a company is.

Quick Ratio (Acid-Test Ratio)

$$Quick\ Ratio = \frac{Quick\ Assets}{Current\ Liabilities}$$

The quick ratio indicates a company's short-term liquidity and measures its ability to meet its short-term obligations with its most liquid assets.

While a quick ratio lower than one (1) does not necessarily mean the company is going into default or bankruptcy, it could rely heavily on inventory or other assets to pay its short-term liabilities. The higher the quick ratio, the better the company's liquidity position. However, a quick ratio that is too high may indicate that the company has too much cash sitting in its reserves. It may also mean that the company has a high accounts receivable, indicating that it may be having problems collecting its account receivables. (Seth, 2023)

Debt Ratio

$$Debt\ Ratio = \frac{Total\ Liabilities}{Total\ Assets}$$

The debt ratio compares a company's total debt to its total assets. It gives creditors and investors a general idea of the amount of leverage a company uses. The lower the percentage, the less leverage a company uses and the stronger its equity position. In general, the higher the ratio, the more risk that company is considered to have taken on (Hayes, What Is the Debt Ratio?, 2023).

Stockholder's Ratio

$$Stockholder's\ Ratio = \frac{Total\ Stockholder's\ Equity}{Total\ Assets}$$

While the relationship between creditors' claims on total assets is essential for creditors, the total claims of stockholders on total assets are equally important, as the stockholder's ratio indicates the firm's financial stability in the long run. It measures how much of a company's assets are funded by issuing stock rather than borrowing money (Hayes, Investopedia, 2022). Instead of using the formula above, the stockholder's ratio can be computed alternatively as follows:

$$Stockholder's\ Ratio = 100\% - Debt\ Ratio$$

Debt-Equity Ratio

$$Debt - Equity\ Ratio = \frac{Total\ Liabilities}{Total\ Stockholder's\ Equity}$$

The debt-equity ratio measures the percentage of the company's balance sheet financed by suppliers, lenders, creditors, and obligors versus what the shareholders have committed. It provides another vantage point on a company's leverage position: it compares total liabilities to shareholders' equity instead of total assets in the debt ratio. Similar to the debt ratio, a lower percentage means that a company uses less leverage and has a stronger equity position.
Interest Coverage Ratio $$Interest\ Coverage\ Ratio = \frac{Operating\ Income}{Interest\ Expense}$$ The interest coverage ratio indicates a company's ability to meet its interest payment obligations. It is computed by dividing the operating income by the interest expense. It shows how many times the company earns its annual interest expense. From the creditor's point of view, the higher the ratio, the better. Generally, it is regarded that an interest coverage ratio of 4:1 or more is desirable. A drop in this ratio drops the credit rating of the company.

References:

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