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FINANCIAL RATIO ANALYSIS

THE COMPLETE FINANCIAL STATMEENT ANALYSIS

MODULE 3: THE BALANCE SHEET RATIOS

LEARNING MATERIAL – TAKEAWAY NOTE

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THANK YOU!

Hello friends,

Congratulations! You've completed the Module 3 – The Balance Sheet Ratios. This is a learning note that we've prepared for you. It includes all key information in the lectures. You can take it away and revise the course from anywhere, on any device and at anytime you want.

If you have any concern about the lectures, feel free to send us a message, we are always here to help you!

Best regards,
Wealthy Education Team.

HOW A BALANCE SHEET WORKS

Assets (Own) = **Liabilities** (Owe) + **Owner's Equity** (Capital)

BALANCE SHEET EXAMPLE (AAPL) – As of the 1st Quarter, 2016			
ASSETS		**LIABILITIES**	
Current Assets		Current Liabilities	
Cash or Cash Equivalents	55,283	Short-term Debts	10,498
Accounts Receivable	12,229	Accounts Payable	25,098
Inventories	2,281	Other Current Liabilities	32,669
Other Current Assets	17,799	Non-current Liabilities	
Total Current Assets	$ 87,592	Long-term Debts	69,374
		Other Liabilities	37,181
Non-current Assets		Total Liabilities	$ 174,820
Property, Plant & Equipment (PPE)	23,203		
Long-term Investments	177,645	**SHAREHOLDERS' EQUITY**	$
Intangible Assets	3,843	Equity / Common Stock	29,484
Other Long-term Assets	7,745	Retained Earnings	100,973
Total Long-term Assets	$ 217,685	Total Owner's Equity	$ 130,457
Total Assets	**$ 305,277**	**Total Liabilities + Total Owner's Equity**	**$ 305,277**

CASH & CASH EQUIVALENTS

- **Cash is the most liquid asset**
- Some examples of cash and cash equivalents include:
  - Company bank accounts
  - Money market funds
  - Treasury bills
  - Marketable securities

CASE #1 – A LOW CASH BALANCE

- Having adequate cash and cash equivalents on hand is what allows a business to:
  - Settle its debts
  - Purchase new inventory
  - Buy into lucrative investments

➔ **Potential problem if your company can't meet its debt obligations**

CASE #2 – A HIGH CASH BALANCE

- A high cash balance can be an indication that:
  - Your company is waiving potential investment opportunities that would generate higher interest income
  - Your company is waiving potential opportunities to expand its business operations

➔ **Potential problem with the management**

HOW TO EVALUATE CASH & CASH EQUIVALENTS

$$\text{Cash to Current Assets} = \frac{\text{Cash \& Cash Equivalents}}{\text{Current Asset}} \times 100\%$$

- This ratio shows what percentage of a firm's total current assets is represented by cash

➔ **Criterion: Cash & Cash Equivalents ratio < 40%**

INVENTORIES

- Inventories include:
  - Raw materials for the manufacture of goods
  - Goods that are in the process of being manufactured
  - Completed goods that are ready to be sold
- **Inventory control** is one of the key areas where you can expect to see a firm's management team shine, or fall flat

FACTS ABOUT INVENTORIES

- The higher a company's inventory levels are:
  - The more quickly it can fulfill customer orders
  - The better its customer service will be in terms of always having stock on hand
  - The more attractive its displays, for those companies operating in the retail sector

FACTS ABOUT INVENTORIES

- Excess inventory levels can lead to:
  - Higher costs of storage space, insurance, and personnel
  - A loss of inventory related to goods that are perishable, or that become obsolete in the marketplace
  - The tying up of company resources in products that are only in demand intermittently

HOW TO EVALUATE INVENTORIES

$$\text{Inventory to Current Assets} = \frac{\text{Inventories}}{\text{Current Asset}} \times 100\%$$

- This ratio shows what percentage of a firm's total current assets is represented by its inventory holdings

➔ **Criterion: Inventory to Current Assets ratio < 40%**

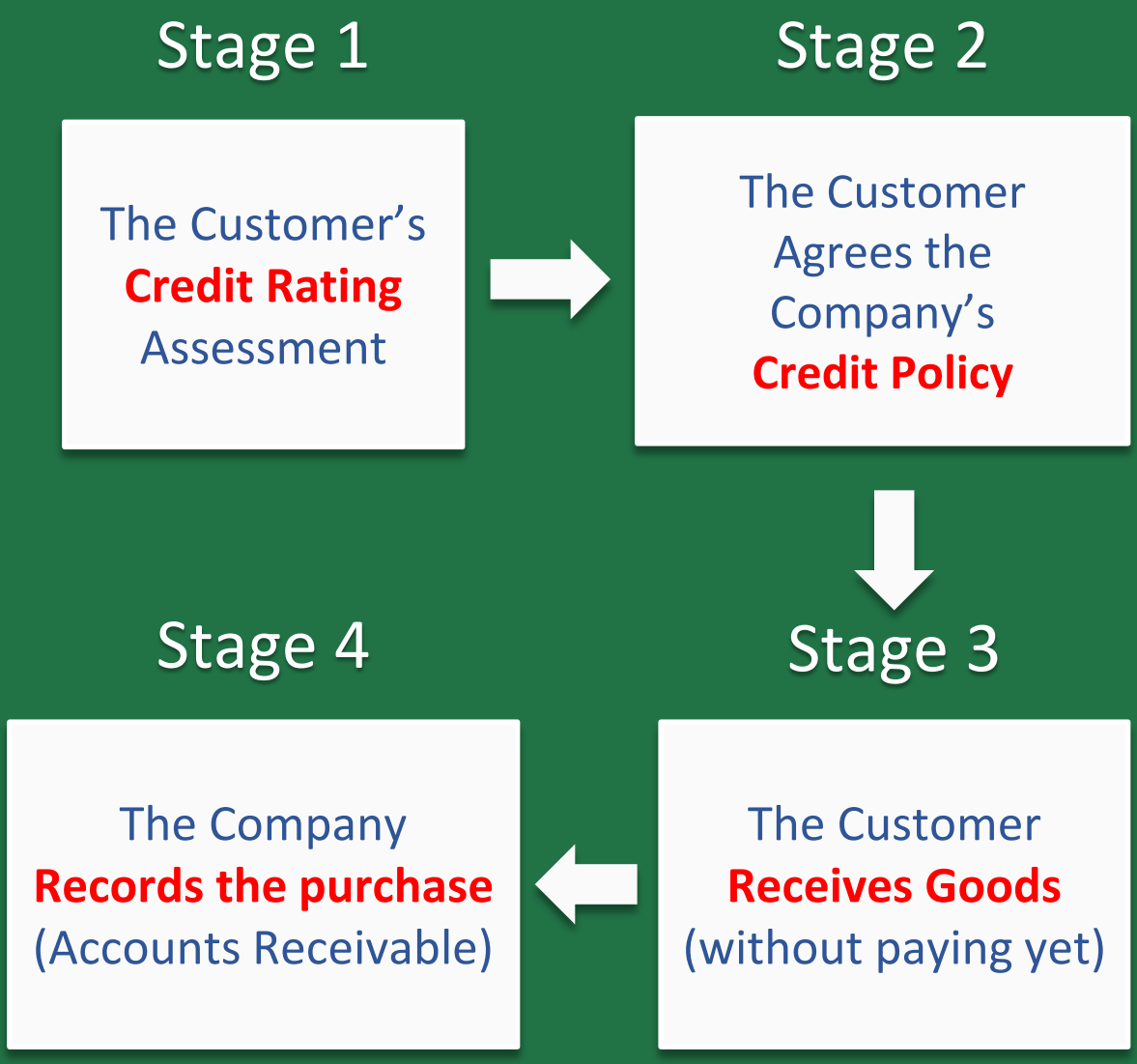
ACCOUNTS RECEIVABLE

- *Accounts Receivable* is the term used to signify the monies owed to a company from its various customers.
- These payment terms represent a company's credit policy

➔ **Cannot collect money owed by customers = bad debts**

➔ A company's Accounts Receivable is considered to be one of the most important parts of its current assets

ACCOUNTS RECEIVABLE



CREDIT POLICY

- Changes in credit policy will significantly affect sales and profits:
  - When a company's credit policy is *loose*, and encourages customers to pay on credit, it can cause sales to increase
  - When a company's credit policy is *strict*, and makes it difficult or unappealing for customers to pay on credit, it can cause sales to drop off

CASE #1
A LOOSE CREDIT POLICY

- Abuse the customer credit policy to drive up sales
- **Potential problems:**
  - An inability to collect outstanding payments from customers
  - The conversion of accounts receivables into bad debts that must be written off

  ➔ A loss or decrease in profits over the long term

CASE #1
A STRICT CREDIT POLICY

- Enforce a more stringent credit policy to reduce potential bad debts
- **Potential problems:**
  - Reduced sales, as fewer customers qualify for credit and qualified customers seek more accommodating payment terms with other companies

  ➔ Reduced profits, resulting from fewer sales

HOW TO EVALUATE ACCOUNTS RECEIVABLE

$$\text{Receivable to Current Assets} = \frac{\text{Accounts Receivable}}{\text{Current Asset}} \times 100\%$$

- This ratio shows what percentage of a firm's total current assets is represented by its accounts receivable

➔ **Criterion: Accounts Receivable to Current Assets ratio < 40%**

ACCOUNTS PAYABLE

- A firm's accounts payable is made up of all the money it owes to:
  - Suppliers
  - Vendors
  - Other short-term creditors, such as banks
- These debts are the result of purchasing supplies ***on credit***
- On credit = Get the product first and promise to pay later

ACCOUNTS PAYABLE

- Accounts payable can directly impact a company's profitability:

Relationships With Suppliers

Business Cash Flows

RISKS OF A HIGH ACCOUNTS PAYABLE BALANCE

- The bigger a company gets, the more challenging it can become for it to keep its accounts payable under control.
- When a business **can't meet its short-term bill payments** for whatever reason, it may have to:
  - Sell off assets to settle its debts
  - Declare bankruptcy, if all else fails

HOW TO EVALUATE ACCOUNTS PAYABLE

$$\text{Payable to Current Assets} = \frac{\text{Accounts Payable}}{\text{Current Asset}} \times 100\%$$

- This ratio shows what percentage of a firm's total current assets is represented by its accounts payable

➔ **Criterion: Accounts Payable to Current Assets ratio < 40%**

RETURN ON EQUITY (ROE)

$$\text{Return on Equity (ROE)} = \frac{\text{Net Income}}{\text{Shareholders' Equity}} \times 100\%$$

- **The higher** your company's **return on equity** is:
  - The higher a profit it's generating from the money invested by common shareholders
  - The more effectively it's using its equity to fund its regular business operations

RETURN ON EQUITY (ROE)

- When a company's ROE is equal to 1, it means that it's earning 1 dollar of net income from each dollar invested by shareholders, or a 100% return on equity.

  - Net Income = $50,000
  - Total Assets = $1,000,000
  - Total Liabilities = $500,000

$$\text{Return on Equity} = \frac{\$50{,}000}{\$1{,}000{,}000 - \$500{,}000} \times 100\% = 10\%$$

RETURN ON EQUITY (ROE)

- **Average ROE (3-5 years) > 12%**
- **Previous Year's ROE > 15%**

CAPITAL STRUCTURE

Debt Financing

Equity Financing

USEFUL DEBT RATIOS

Current Ratio

(short-term)

Interest Coverage Ratio

(long-term)

Working Capital to Debt Ratio

(total debt)

CURRENT RATIO

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

- Current ratio reflects your company's ability to pay its short-term debts, by measuring all of its current assets against all of its current liabilities.

➔ **The higher the ratio is, the better**

CURRENT RATIO

- When a company doesn't have sufficient resources to meet its debts, it simply means:
  - It's not generating enough profits to support itself
  - It's not efficient at collecting monies owed from customers
- **Investment criterion: Current Ratio > 1.50**
- Avoid businesses with the ratio of less than 0.50

INTEREST COVERAGE RATIO

Earnings Before Interest & Taxes

$$\text{Interest Coverage Ratio} = \frac{\text{EBIT}}{\text{Interest Expenses}}$$

- Known as the **Time interest earned ratio**
- This ratio allows to you examine the interest payments associated with your company's debt obligations

INTEREST COVERAGE RATIO

- The higher the company's ratio is , the healthier its financial position is in terms of:
  - Its debt-servicing ability
  - Its debt repayment capability
  - Its credit rating for any new borrowing

➔ **Investment criterion: Interest Coverage Ratio > 15**

WORKING CAPITAL TO DEBT RATIO

Current Assets – Current Liabilities

$$\text{Working Capital to Debt Ratio} = \frac{\text{Working Capital}}{\text{Short term Debt} + \text{Long term Debt}}$$

- Working Capital to Debt ratio allows us to evaluate a company's ability to reduce or even eliminate its debt load

➔ **The higher the ratio, the better**

WORKING CAPITAL TO DEBT RATIO

- Looking for companies that would be capable of:
  - Paying off all of their debt should it become necessary
  - Retaining a reasonable level of working capital were this situation ever to occur

➔ **Investment criterion: WC to Debt > 0.20**

➔ Avoid businesses with a negative working capital ratio

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THANK YOU!

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