



# VIRTUAL TEXT BOOK

## Financial Strength... **PLS GROW** - 1 of 3

**PLS GROW** is a memory trigger for the categories of measuring financial strength – Profitability, Liquidity, Stability and Growth.

Remember – no single measurement, ratio or % can be relied upon to measure the financial health of a business.

### Liquidity

The question is “How liquid is this business?” In other words; how capable is it, in meeting its obligations - its liabilities?

#### Liquidity Evaluations

1) The Current Ratio –  $\frac{\text{Current Assets}}{\text{Current Liabilities}}$

*This is calculated from the classified balance sheet.*

If this figure is less than 1 - say point 75 (3/4), it is not good news. It means that the business has current liabilities that exceed current assets; the business has only enough resources to meet 75% of its obligations.

If this figure is equal to 1, it is barely satisfactory to a reader. A figure of 1.5 or above, 2 is much better; it signals a more positive liquidity. 2 means that a business has twice as much financial resources (current assets) needed to meet its short term liabilities.

2) The Quick Ratio  
also called...  
The Acid  
Test Ratio

$\frac{\text{Quick Assets}}{\text{Current Liabilities}}$

*This is also calculated from the classified balance sheet.*

**Quick Assets =**

- Cash
- + Accounts Receivable
- + Temporary Investments

If this figure is equal to 1 or above 1 – it is good news. If it is point 5 (1/2) or less, it is an indicator of weak liquidity. Between point 5 and 1 means caution.

**Quick Assets** are also defined as:  
Current Assets  
Minus  
Inventory

## Financial Strength...Liquidity...continued - 2 of 3

### I'm Going On a **Date** – Can I Do It \$\$\$? **Current Ratio Style**

Suppose you are planning a business project over a two year implementation plan OR you are going on a date tomorrow; and you are using a spreadsheet analysis to make decisions.

#### **Project**

You can compute how much your current assets will be throughout the two year project and subtract current liabilities for the same period. If the number is consistently negative, there is not much chance of project success.

#### **Date**

If you calculate how much cash you have for the date and subtract how much the date will cost (e.g. travel to + dinner + movie + travel back) and get a negative number – the date will not happen as planned.

**OR**

You can set up the spreadsheet to automatically calculate the Current Ratio. If it is less than one – the project and the date need more planning. Options include: 1) cut expenditures 2) Get more cash or 3) shared costs.

### **Longer Term Liquidity Evaluations**

$$1) \text{ The Debt Ratio} - \frac{\text{Total Liabilities}}{\text{Total Assets}} \times 100 = \%$$

*Again, this is calculated from the balance sheet.*

This tells the reader, or the analyst, to what extent the business is in debt for the resources it has, its assets, that generate inward cash flows.

As with most things, the extremes are easy to define; less than 25% is interpreted as a positive liquidity position; over 50% is interpreted as not a positive liquidity position. Between 25% and 50% requires judgement in the context of other analytical data.

## Financial Strength...Liquidity...continued – 3 of 3

### How Heavy Is Interest Expense?

The interest cost of debt is a major cost in many businesses. Debt is needed to provide working capital and fund operations. This is needed to, for example, buy advertising, purchase equipment, and pay salaries – all the while focussing on generating sales.

Businesses measure how well operations cover the interest being paid by dividing “Income before Interest” by “Interest expense.” Whatever this number is, tells the owners or managers how many times the interest is covered – how big the cushion is.

### Times Interest - Earned

$$\frac{\text{Income Before Interest}}{\text{Interest Expense}}$$

The bigger the cushion is - the better. The higher the number is means the more times interest is “covered” by operations.

The ideal number varies slightly by industry and business, but generally 4 or above is positive and below 3 is a cause for concern.