

Visual Learning Maps

Introductory Financial Accounting



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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.

Profitability

The question is “How strong are the earnings of the business?” In other words; did the business make any money?

There are standard ratio / percentage measurements to evaluate profitability to: **1)** evaluate and compare profitability of a business year over year; **2)** to compare these measurements to the industry average; and **3)** comparisons to other businesses in other industries.

Profitability Measurements

- | | | |
|-----------------------------|---|---|
| 1) Profit Margin on Sales | $\frac{\text{Net Income} \times 100}{\text{Net Sales}} = \%$ | <i>This is calculated from the Income Statement</i> |
| 2) Rate of Return on Assets | $\frac{\text{Net Income} \times 100}{\text{Average Assets}} = \%$ | <i>These are calculated from the Income Statement & the Balance Sheet</i> |
| 3) Rate of Return on Equity | $\frac{\text{Net Income} \times 100}{\text{Average Equity}} = \%$ | |

For Proprietorships and Partnerships - Average Equity is equal to average capital

For corporations - Average equity is equal to average common stockholders' equity

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Profitability...continued

$$4) \text{ Revenue per Employee } \frac{\text{Net Sales}}{\text{Average number of Employees}}$$

This is **not strictly** in the category of "Profitability," but is used in conjunction with other profitability measurements and in the context of other analytical data.

From these calculations - there are no fixed percentages, ratios or numbers that provide fixed points for judgments in the realm of good, bad or ugly. It depends on the business, the industry; and how the economy is doing.

The Rate of Return on Equity is invariably compared to the "**risk free rate**" – this is the rate that governments pay on bonds and treasury bills. If the rate on government bonds is, say 6% - it is reasonable to expect a business to be earning above this. Otherwise the investment in the business could be redeployed into government bonds with no business risk.

On the other hand, the business may be new and anticipates strong growth in sales, profits AND rates of return.

Corporations... More Profitability Measurements

Because corporations have a different equity structure, compared to proprietorships and partnerships, there are additional measurements unique to corporations.

- **Earnings Per share**

- What did the company earn for its owners?**

- Corporations have an ownership structure. It is based on common shares issued – all the common shareholders own the company. There can be one shareholder or 10 million shareholders.

- EPS is calculated simply by dividing the earnings that would be available to common shareholders if it were to be paid (but isn't) to the common shareholders...divided by the number of common shareholders.

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Corporations EPS...continued

Earnings available to common shareholders are calculated:

Net Income – Preferred Dividends

Preferred shareholders must be paid first; that is one of the reasons they are called preferred.

EPS is then calculated:

$$\frac{\text{Net Income Available to Common Shareholders}}{\text{Number of common Shares Issued and Outstanding}} = \$ \text{ per share}$$

This will **always** be a monetary figure per share. It could be \$.10 per share, or it could be \$1000.⁰⁰ per share.

EPS is looked at and compared to previous years to see how consistent the earnings are, or are not.

▪ **P / E (Price to Earnings) Multiple (Ratio)**

How is the company doing in the stock market?

The “Price” means the price being paid for one share of common stock in public trading on stock exchanges.

The “Earnings” means the EPS calculated above.

$$\frac{\text{Market Price for One Common Share}}{\text{Earnings Per Share}} = \#$$

Whatever this number is, say 6, it is compared to the same calculation for companies in the same industry to see how the market perceives the business.

If one company is 6, it means that it is trading at 6 times its EPS. If another company is trading at 10 times its EPS; the market place perceives the two companies differently – so more analysis is needed.