

Visual Learning Maps

Introductory Financial Accounting



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VIRTUAL TEXT BOOK

Financial Strength... **PLS GROW** - 1 of 2

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.

Stability

“How stable or erratic is the financial performance of the business?”

Financial measurements use the word “volatile” instead of “erratic.”

Stability analysis looks at profitability and liquidity ratios over time; a minimum of five years. These are usually plotted on a spreadsheet and a graph – then analysts look for how sharp or smooth the peaks and troughs are.

If the ratios over time are fairly smooth – the business has low volatility, and therefore high stability. If the peaks and troughs have significant swings from year to year; the business reflects high volatility; and therefore lower stability.

PURPOSE OF STABILITY ANALYSIS

The purpose of stability analysis is:

- To estimate the risk and change in risk in a business over time
- To assess risk in one business compared to another.

From risk estimation, decisions can be made by investors and analysts as to where to invest funds to get the best return with the least amount of risk.

Caution: There are other factors besides ratio analysis that affect investment decisions that are important; such as

- Changes in technology coming soon
- Changing geographic markets
- Demographics and Psychographics

Financial Strength...**PLS GROW** - 2 of 2

Stability...continued

Here are two analytical Examples:

Business A – Profitability Analysis – Reflecting Stability

<u>Ratio Item</u>	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>
Return on Assets	8.8%	9.3%	9.4%	8.9%	9.2%
Return on Equity	12.2%	12.8%	13.1%	12.9%	13.2%
Profit Margin	18.1%	17.8%	17.7%	18.2%	17.4%
Revenue per Employee	\$35,000	\$34,300	\$34,700	\$35,200	\$34,800

Business B – Profitability Analysis – Reflecting Low Stability

<u>Ratio Item</u>	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>
Return on Assets	8.8%	12.3%	7.4%	5.9%	14.2%
Return on Equity	14.2%	19.8%	11.1%	21.9%	10.2%
Profit Margin	11.1%	19.8%	10.7%	21.2%	7.4%
Revenue per Employee	\$41,000	\$19,300	\$26,700	\$14,200	\$31,800

Plot these two sets of figures on a graph and you will see how Business A does not have the volatility of business B.