The Balance Sheet and Financial Disclosures

RISK ANALYSIS

The purpose of financial reporting is to provide investors and creditors with information that can be used in making investment and/or credit decisions. The financial statements report on past events and the current position of the business entity. Third party users are more interested in using the information available to predict the future. Financial statement analysis involves ratios to interpret the information contained in published financial statements.

USING FINANCIAL INFORMATION

The financial ratios that apply to the balance sheet are liquidity ratios and financing ratios.

- **Liquidity Ratios**, measure the ability of a business entity to convert assets into cash. There are two ratios discussed below:
  - **Current Ratio**
    Working capital is calculated as total current assets less total current liabilities. The ratio that measures working capital is the current ratio. The formula for the current ratio is as follows:
    \[
    \text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}
    \]
  - **Acid-Test Ratio**
    Not all current assets can be converted into cash quickly. The liquidity of inventory is problematic as it depends on market conditions and competition. Also, prepaid expenses are deferred charges that will not result in cash flows during the next year or operating cycle. Therefore, a more conservative measure of liquidity is the acid-test ratio. The numerator contains only cash, short-term investments, and accounts receivable (quick assets), all of which can be converted into cash quickly. The formula for the acid-test ratio is as follows:
    \[
    \text{Acid-test ratio} = \frac{\text{Quick assets}}{\text{Current liabilities}}
    \]

- **Financing Ratios**, measure the business entity’s long-term solvency and stability. There are two ratios discussed below:
  - **Debt to Equity Ratio**
    This ratio compares the resources provided by creditors with those provided by equity owners. It provides a measure of creditor protection in the event of insolvency. To be meaningful the ratio should be compared with industry averages or some other standard. From an equity owner’s perspective the judicial use of financial leverage enhances the earnings of equity owners. If the business entity is able to earn a return on the borrowed funds that exceeds the cost of borrowing funds the excess enhances net income and flows to retained earnings. The formula for the debt to equity ratio is as follows:
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Debt to equity ratio       =   \frac{\text{Total liabilities}}{\text{Stockholders’ equity}}

✓ **Times Interest Earned Ratio**
This ratio compares the interest charges with the income available to pay such charges. It is a measure of the ability of the business entity to satisfy its fixed obligations. This gives creditors a measure of the margin of safety of their securities as a result of corporate earnings. The formula for the times interest earned ratio is as follows:

\[
\text{Times interest earned ratio} = \frac{\text{Net income} + \text{Interest expense} + \text{Taxes}}{\text{Interest expense}}
\]