Finance for the Non-Financial

By Kenneth B. Collins

If you've ever run a business, you understand what the P&L or Income Statement is all about. I liken it to a motion picture or a video camera that captures business activity over a period of time, a month, a quarter, or a year. Basically, the P&L tracks just three components over time:

- **Sales Revenue**: What came in – whether measured in terms of what was invoiced (accrual basis) or simply in terms of payments received (cash basis).
- **Expenses**: What went out – payroll, materials, rent, insurance, benefits, etc. – and again measured either by using sophisticated systems of matching expenses with revenues (accrual basis) or simply in terms of payments made (cash basis).
- **Profit**: What's left – revenues minus expenses. Positive or negative. The ratio of profit to sales revenue (ROS) is one measure of profitability along with the ratio of profit to the balance sheet's shareholder equity, which is a measure of return on investment or ROI.

I am surprised by how many business professionals do not know how to read a Balance Sheet. Think of it as a snapshot or still camera that measures the health of a business at a specific point in time, for example at month-end or year-end. Like the P&L, there are just three components of the balance sheet:

- **Assets**: All of the things the business *owns* – including cash, accounts receivable, and inventory (the current assets) as well as fixed assets such as property, plant and equipment.
- **Liabilities**: All of the things the business *owes* – including accounts payable and accrued expenses as well as any portion of bank debt or taxes payable due within 12 months (the current liabilities) plus any long-term liabilities such as bank debt.
- **Shareholder Equity**: It is the book value of the business when you subtract all liabilities from total assets. It is called a balance sheet

because the total amount of assets (typically shown on the left) is always equal to the sum of all liabilities plus equity (displayed on the right).

Like a check-up at the doctor, involving a number of tests and analyses, the balance sheet measures the fiscal health of the business. For example, the amount of working capital in the business – i.e., current assets minus current liabilities – is one measure of the capacity of a company to meet its obligations, expand its volume, and take advantage of opportunities.

There are lots of other ratios and financial measurements – too numerous to explain here. Two of my favorites:

- **Account Receivable - Days Sales Outstanding (DSO)** – measures the average number of days elapsed between customer billings and collections. It is calculated as accounts receivable divided by annual(ized) sales, times 365 days. The lower the DSO the better, depending on terms of sale. It is also common to calculate DSO for accounts payable to measure the average number of days between receipt of supplier invoices and payment.
- **Inventory Turnover** – measures the adequacy and balance of inventory by calculating the number of times in a year that the investment in inventory is used up or turned over to satisfy the sales for that year. By comparing the year's cost of goods sold expense with the average amount of inventory on hand throughout the year, we can calculate the turnover or efficiency of the investment in inventory.

One more: **Debt/Equity Ratio**, which generally measures the ratio of long-term debt to shareholder equity. This ratio is also a measure of "leverage" and can vary widely by industry, the owners' appetite for debt, and the individual company's ability to support it. If a lot of debt is used to finance increased operations, the company could potentially generate more earnings than it could without the outside financing. However, the cost of debt financing may outweigh the return that the company generates on the debt through investment and business activities, resulting in the company's inability to meet its obligations – often leading to bankruptcy.

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