Financial Status of the Enterprise

Contents

Introduction

Financial ratios are used in financial analysis to extract or deduce a relationship between two related figures, helping to understand the enterprise's position for analysis.

Ratios are classified into several categories, including:

According to Information Sources:	Based on Representation of Reality:	Based on Ratio Components:	Based on Performance Evaluation:
Income Statement Ratios or Activity Ratios	Efficiency Ratios	Simple Ratios (relationship between two elements)	Liquidity Ratios
Financial Position Ratios or Capitalization Ratios	Typical Ratios	Composite Ratios (relationship between several elements)Typical Ratios	Solvency Ratios

Financial Statement Analysis Ratios:

It evaluates the financial status of diverse enterprises through the role of the responsible accountant. This includes analyzing profits and losses, monitoring managerial decisions, and contributing to the preparation of financial data. Financial statement analysis is defined as the process that aids in applying a review of all financial statements related to the enterprise, such as the general budget, contributing to understanding the enterprise's financial status and assisting in making effective decisions.

Types of Financial Statement Analysis:

Financial analysis is divided into three main sections:

Horizontal Analysis: Compares the financial performance of the enterprise over two or more years.

Vertical Analysis: Calculates each item in the financial statements as a percentage of the total.

Ratio Analysis: Provides financial analysts the ability to compare individual financial statement items.

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Steps in Financial Statement Analysis:

The success of applying financial statement analysis relies on key steps, including:

- **Understanding Economic Characteristics:** Activities related to production, industry, and product distribution.
- **Identifying Enterprise Strategies:** Understanding the nature of products or services offered and studying profit margins.
- **Analyzing Profitability and Risks:** Assisting financial analysts in evaluating the enterprise and its financial data.
- **Preparing Financial Data:** Involves preparing assumptions for financial analysts to predict the enterprise's future.
- **Evaluating Financial Data:** Reviewing all financial data within the accounting standards associated with this field.

Objectives of Financial Statement Analysis:

Financial statement analysis contributes to achieving various objectives in the workplace, including:

01 Understanding the financial status of enterprises.

02 Providing insight into the nature of operational and financial performance.

03 Assessing the ability to meet short-term or long-term commitments and repay debts.

04 Contributing to the preparation of future internal control plans.

05 Identifying weaknesses in enterprises and proposing solutions.

06 Financial statements are elements that illustrate the financial status of companies and institutions.

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Ratios Based on Performance Evaluation

First:

Liquidity Ratios or Financial Strength Ratios Liquidity refers to the enterprise's ability to meet its short-term obligations without resorting to borrowing or selling fixed assets. There are several indicators of liquidity, including:

1. Working Capital

It is the difference between the enterprise's current assets and its short-term liabilities, meaning that the total current assets exceed the total short-term liabilities. In other words, short-term liabilities can be covered by current assets, with a surplus amount.

Working Capital = Total Current Assets - Total Current Liabilities

2. Turnover Ratio

It is the ratio of current assets to total current liabilities. If current assets are significantly less than current liabilities, it indicates that the enterprise may face difficulties in repaying its obligations.

Turnover Ratio = Current Assets ÷ Total Current Liabilities

3. Quick Turnover Ratio

It is the ratio of quick current assets (total current assets excluding inventory) to total current liabilities. This ratio is similar to the turnover ratio but excludes inventory, assuming that it takes time to convert it into cash.

Quick Turnover Ratio = Quick Current Assets ÷ Total Current Liabilities

4. Current Ratio

It is the ratio of current assets to short-term current liabilities. The resulting ratio generally indicates the number of times current assets cover short-term liabilities.

Current Ratio = Total Current Assets ÷ Total Short-Term Liabilities

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Ratios Based on Performance Evaluation

5. Quick Ratio

Quick Ratio = (Quick Current Assets – (Inventory + Prepaid Expenses) + Total Current Liabilities x 100

(Inventory + Prepaid Expenses) + Total Current Liabilities x 100

Ratios of Solvency

These ratios measure the enterprise's ability to continue in the long-term, and lenders and stakeholders are interested in these indicators because they help assess the enterprise's sustainability and its ability to meet long-term obligations. Among them:

Debt-to-Asset Ratio:

These ratios measure the enterprise's ability to continue in the long-term, and lenders and stakeholders are interested in these indicators because they help assess the enterprise's sustainability and its ability to meet long-term obligations.

Debt-to-Asset Ratio = Total Liabilities (Short-term + Long-term + Total Assets (Current + Fixed

However, it is important to be aware of two types of insolvency briefly:

- Insolvency from Balance Sheet Reality: Indicates that the volume of liabilities exceeds the size of assets or when the capital is equal to zero or negative.
- Insolvency from Cash Flow Reality: Depends on the enterprise's financial inability to pay its financial obligations when due or requested. In this case, the enterprise may appear solvent on the balance sheet but lacks sufficient liquidity to meet its obligations at a specific time.

here is a close relationship between these two conditions, and achieving either one means that the enterprise is on the path to economic distress, if it has not already occurred.

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Profitability Ratios:

Gross Profit Margin:

It is the ratio of gross profit to net sales. The higher this ratio compared to competitors indicates operational efficiency because the cost of goods sold as a percentage of net sales is lower than competitors.

Net Sales + (Net Sales - Cost of Goods Sold) = Gross Profit Margin

Net Profit Margin

It is the ratio of net profit to net sales, indicating the company's ability to achieve profit from sales. Note that a high gross profit margin may coexist with a low net profit margin, indicating additional costs not included in the cost of goods sold.

Net Profit + Total Sales = Net Profit Margin

Return on Assets (ROA)

It is the ratio of net profit to total assets (the sum of current and fixed assets). Comparing this ratio between companies in different industries may not provide a meaningful indication, but comparing it within the same company year after year or against similar companies in terms of business nature does.

Net Profit + Total Assets = Average Return on Assets

Return on Equity (ROE)

It is the ratio of net profit to average equity. Since equity at the beginning of the year differs from the end of the year, we use the average equity.

Average Equity} = 0.5 x (Average Equity at the Beginning of the Year + Average Equity at the End of the Year)

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Profitability Ratios:

All information is found in the financial statements:

Financial statements contain crucial numbers, but they need to be analyzed in the context of various variables, such as market fluctuations, entry of new competitors, initiation of investments in new projects, and the presence of temporary financial burdens, among others. For example, a successful company may incur losses after it was making profits because it started a new project that will yield results in the coming years. Similarly, a company may achieve profit due to a surge in demand for its product, and expectations of the continuity or collapse of this demand determine our view of the expected performance of the company in the coming years.

There are many other ratios:

We have limited our explanation of financial ratios to the most commonly used ones, but there are many other ratios that you may encounter. In light of understanding the financial ratios mentioned here, we can comprehend the utility of any financial ratio. Additionally, we may introduce financial ratios that illustrate the company's performance in a specific aspect. For example, to determine if a company is spending on research like other companies, we measure it by the ratio of research expenses to net sales. If we also want to know if spending on marketing is excessive, we compare the ratio of marketing expenses to net sales with competing companies.

Use multiple methods to analyze company performance:

Most often, absolute, historical, and relative analyses are used, and none of them is dispensed with the other. For example, a company operating in a highly distressed sector may be one of the best companies and incur the least losses. In this case, we cannot ignore the poor performance of the company and that it incurs losses because the entire sector is troubled. If a company achieves good financial ratios but falls significantly below the average of competing companies, it means the company's performance is poor. Therefore, using all three methods gives us a more comprehensive picture. The method of comparing results with a planned scheme is a matter specific to company management, and investors are generally not concerned with it.

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Profitability Ratios:

Use the numbers and financial ratios that affect your decision:

Depending on the goal of financial analysis, some numbers and financial ratios are more important. If you are going to lend to this company, you care about liquidity ratios, and if you are thinking of buying its shares, you are more interested in profitability ratios and market value ratios than other ratios. If you are comparing your company with competitors, you are interested in most ratios. If you are concerned with comparing the company's performance in core operations such as manufacturing, you are interested in the gross profit margin ratio and so on. Therefore, analyzing all numbers and ratios in every financial analysis is not necessary. Instead, the analysis focuses on the numbers and ratios relevant to the goal of financial analysis.

Beware of differences in the definition of financial ratios:

There are some differences in defining financial ratios, such as using the average total assets or the average assets at their book value in the current year's budget when calculating the return on assets. When using financial ratios from a website or publications and comparing them with financial ratios from another source, it is important to ensure that the financial ratios are calculated in both cases using the same method.

Profitability Ratios

Maintaining Profitability

Profit is the primary goal of economic activity for an enterprise, and to achieve it, all decisions are made. Cash liquidity is the means to achieve this goal because liquidity cannot be an end in itself. Rational investors seek to achieve profit rather than liquidity.

Examples of decisions that help maintain this balance include:

- Optimal inventory management, ensuring that excess inventory is not held beyond necessity, maximizing possible sales value.
- Extending the payment period for the company's outstanding liabilities without adversely affecting the relationship with suppliers.
- Shortening the collection period for receivables without adversely affecting sales.

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Profitability Ratios:

Use the numbers and financial ratios that affect your decision:

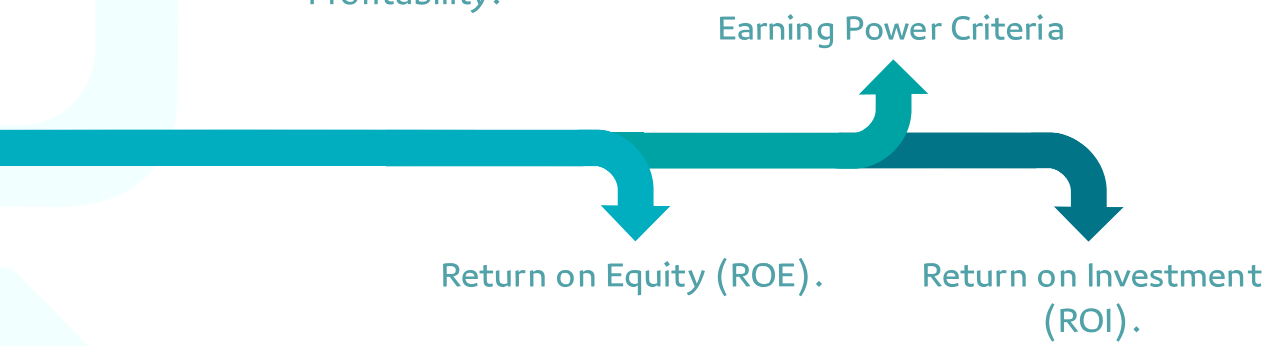
Comprehensive Net Profit Approach (Net profit after interest and taxes):

Under this approach, all revenue and cost elements, whether operational or non-operational, are considered essential to determine net profit. This includes profits earned by the company from resources unrelated to its core business or costs incurred in areas unrelated to its core activities, such as profits or losses when selling fixed assets or settling losses from previous years.

Operating Net Profit Approach (Net profit before interest and taxes):

Under this approach, only operational revenue and cost elements are considered because they represent important factors in determining net profit. The perspective here is that operational aspects measure the company's ability to generate profits, making comparisons with other companies or comparing results for a specific year with results for other years of the same company possible.

Criteria for Measuring and Evaluating Profitability:



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Sales Discounts

Commercial enterprises usually have inventory available for sale to customers. The inventory at the beginning of the accounting period is called the Beginning Inventory, and the inventory at the end of the accounting period is called the Ending Inventory. Since the beginning of a new accounting period is also considered the end of the previous period, the ending inventory of a certain period is the same as the beginning inventory of the next period. There are two systems for inventory valuation: periodic inventory system and perpetual inventory system.
Commercial, Cash, and Quantity Discounts under the Periodic Inventory System:

There are various types of discounts that buyers receive from sellers.

Three types of discounts on purchases can be distinguished:

Trade Discount: This is a percentage reduction in the advertised prices given by the seller to the buyer. It appears on the invoice deducted from the original price.

Quantity Discount: A discount given by the seller to the buyer based on the volume of business over a certain period, usually expressed as increasing percentage rates.

Cash Discount: Usually, commercial enterprises deal with credit, where the seller gives the buyer a period to settle the payment, ranging from 30 to 60 days or more.

The accounting treatment of the cash discount in the purchase depends on the method followed by the enterprise. There are two methods:

- Gross Price Method: Under this method, purchases are recorded at the gross price on the date of purchase. The acquired discount is recorded in the books only when paid within the discount period.

- Net Price Method: Under this method, purchases are recorded at the net price, excluding the cash discount. If payment is made within the discount period, there is no issue, and the amount paid matches the amount recorded in the books. If payment is not made within the discount period, the discount is recorded as a lost discount.

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Expenses Management

Expenses are the burdens borne by the project in order to perform various aspects of its activities, whether related to the purchasing function, selling function, or general administration functions such as procurement expenses, packaging and wrapping expenses, agent commissions, or rent and salaries.

Most of the expenses recorded in the income statement are based on estimates and assumptions, which can have an impact on income in a way that may make it conservative or non-conservative depending on the situation.
Consumption is one of those cases, and there are three decisions to be made for calculating consumption expenses: the method of consumption, the useful life, and the value of the asset at the end of its assumed useful life. The difference in choosing consumption methods results in differences and fluctuations in profits.

Expenses are divided according to administrative functions into:

Operating Expenses

Those spent on the operation section of the enterprise,

such as: The replacement and renewal of spare parts - Equipment maintenance

Selling and Marketing Expenses

Expenses spent on product sales,

such as: Advertising expenses - Packaging material expenses

Financing Expenses

The cost incurred by the enterprise to provide operating financing from partners'

current account interest and loan interest.

General and Administrative Expenses

The majority of expenses related to management,

such as: Senior management expenses - Expenses for security and secretarial staff

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