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“Regimented Financial Reporting and Key Financial Ratios”

The single most important focus a business should have is on their financial reporting. Regardless of where a business is in their life cycle and whether they are big or small, they should always have a process in place to ensure they maintain solid financial reporting. Successful business owners establish and maintain a consistent regimen that documents and preserves the integrity of their financial performance. A solid regimen will most likely yield three key reports: Income Statement or Profit and Loss (P&L), Balance Sheet, and Cash Flow Statement. These reports will not only aid the business owner in monitoring company performance, they may also be used by external business partners to evaluate the strengths and weaknesses of the business. External partners that may show interest in reviewing a company’s financial reporting may include but are certainly not limited to the following: company board members, investors, corporate and/or personal accountant and banker, insurance agent, and company vendors. Solid financial reporting will aid these sources in determining the financial health of the company as they analyze key financial ratios that help evaluate the company’s performance within their industry.

The reports mentioned above have separate functions however they are all related. The income statement by definition is a report that evaluates financial performance over a specified time frame. The income statement provides a summary of how revenues are earned and expenses incurred through both operating and non-operating activities. The end result of this statement is to show the net profit or loss realized by the company over the specified time frame. The balance sheet is a report that discloses a company’s assets, liabilities and owner’s equity/net worth. A balance sheet outlines the means used to operate the company which will equal the company’s financial responsibilities and equity investment. Simply put the balance sheet shows that the assets equal liabilities plus shareholder’s equity. A cash flow statement will summarize the cash inflows a company will experience from its operations and investment sources as well as any cash outflows related to business activities within a given time period.

Internal and external parties will use the financial reporting tools listed above to analyze a company’s performance in three key areas. The first is determining a company’s liquidity or how much cash the company has on hand to satisfy immediate needs. The key ratios that illustrate liquidity are the current ratio and quick ratio. The current ratio shows the relationship between a company’s current assets and current liabilities. Current assets are assets that are typically cash equivalent or are expected to convert to cash within twelve months. Similarly, current liabilities are obligations that will come due within twelve months. When dividing current assets by current liabilities, it may be determined if a company has a sufficient amount of cash to satisfy its debt obligations. The resulting ratio also indicates how efficiently a company operates. The quick ratio is calculated in a similar fashion however the inventory is subtracted from a company’s current assets. This is done primarily because it takes longer to convert inventory to cash and provides a more conservative view of a company’s liquidity. The second area to analyze is a company’s leverage. Leverage may be determined by looking at debt to worth and inventory turnover ratio. Debt to worth is calculated by dividing a company’s total debt by their total net worth. This reveals whether a company is able to satisfy their debt obligations by either selling the business or liquidating company assets. Ultimately, this equation reveals the level of balance in risk between the owners and creditors. A company’s inventory turnover ratio equals cost of goods sold divided by average inventory and helps determine if a business is able to efficiently manage inventory and maximize profit potential. The third area to consider when reviewing a company’s financials is profitability. Profitability may be determined by figuring gross profit margin, operating profit margin and return on sales. Gross profit margin is simply your sales minus your overall production costs or net sales minus cost of goods sold divided by net sales. A company’s operating profit yields their main source of cash flow and is expressed as operating profit over net sales. One of the most widely used efficiency ratios returns on sales. This is how a company measures how much profit they generated per each dollar sold.

Establish a strict financial reporting routine, manage the process consistently, and understand what the keys financial ratios mean to your business. Please contact me by email at bhessing@p-s-b.com or by phone at 309-693-9494 if you have any questions.



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