00312 From Strategy to Practice
Financial Analysis

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Reading Financial Statements

Where can you find out how the company is doing?

- Income Statement
- Balance Sheet
- Cash Flow Statement (Sources and Uses of Cash)

- Note that the income statement contains **noncash** items. The most important of these is depreciation.

Why evaluate financial statements?

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Internal Uses:

- performance evaluation (managers often evaluated and compensated eg based on profit margin or return on equity)
- comparison of different divisions in the firm
- planning purposes (historical information is useful for generating projections about the future)

External Uses:

- financial statements are a prime source of information about a firm's financial health
- outside parties eg. creditors and potential investors are interested in the financial statements when deciding whether to grant credit to a new customer
- credit-rating agencies rely on financial statements in assessing a firm's creditworthiness
- evaluating the performance of competitors
- when thinking of acquiring another firm, when deciding what to offer

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The Health Triangle

Do they have enough money to pay their bills?

Is the capital structure healthy? Are they indebted?

LIQUIDITY

SOLVENC
Y

PROFITABILITY

How much profit do they make? Is it enough?

Are they growing? Are they growing too fast?

GROWTH

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Financial Statements:

Income Statement

- How good the company is at making money

Cash Flow Statement

- How they are paying for their operations and their future growth

Balance Sheet

- What the company owns and owes

- ***All three statements give a different view of a business and each is critical to the overall health of your business.***
- ***Even profitable companies can fail to adequately manage their cash flow, which is why the cash flow statement is important: it helps investors see if a company is having trouble with cash***

The primary financial statements

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Income Statement (US)

- also referred to as Profit and Loss Account or Statement of Earnings
- shows the result of a company's operations over a certain period of time (ie profit/loss = revenues - expenses)

Balance Sheet

- shows what the company owns (assets) and what the company owes (liabilities)
- shows the financial situation of the company at a particular date

Cash Flow Statement

- how did the company receive cash and how did it use its cash?
- records cash inflows and cash outflows

Income Statement

Turnover (net sales)
\+ Other operating income
\- Operating expenses
  materials and services
  personnel
  depreciation
  other operating expenses

= **Operating profit/loss (EBIT)**
+/- Financial income and expenses

= Profit before extraordinary items
+/- Extraordinary items

= **Profit before taxes**
\- Income tax

= **Profit for the financial period**

Balance Sheet

ASSETS	LIABILITIES
Fixed assets	Shareholders' Equity
Current assets Inventories Financial assets	Liabilities Long-term Short-term (=current)

How do we measure profitability ?

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$$\textbf{Profit margin} = \frac{\text{Net profit}}{\text{Turnover}} \times 100$$

Operating profit:
good > 10 %
fair 5-10 %
bad < 5%

- A high profit margin is obviously desirable
- You have to be careful when comparing the profitability of two companies operating in a different line of business: cost structure and margins are different
- From the income statement you can also analyze the cost structure of the company. Example: ”Personnel costs are 6% of net sales, last year the personnel costs accounted for only 5% of net sales.”

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Is the company giving any return on investments?

ROE = Return on equity

ROA = Return on assets

ROI = Return on investment

$$ROE = \frac{\text{Profit for financial period}}{\text{Shareholder's equity}} \times 100\ \%$$

$$ROA = \frac{\text{Profit for financial period}}{\text{Total Assets}} \times 100\ \%$$

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Is there enough cash available?

Liquidity: at any given time a company needs to have enough money or assets easily converted into money in order to manage all the company's liabilities

Quick Ratio (Acid Test) =

Liquid assets
(=Current assets – Inventory)

Short-term loans

good > 1,0
fair 0,5-0,9
bad < 0,5

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Current ratio is one of the best known and most widely used ratios

$$\textbf{Current Ratio} = \frac{\text{current assets (=liquid assets + stock)}}{\text{short-term loans}}$$

If > 2, liquidity is good

High current ratio indicates liquidity, but it may also indicate an inefficient use of cash and other short-term assets.

Is the company's **capital structure** healthy?

Equity ratio (solvency ratio) is one measure of financial structure and solidity.

$$\textbf{Equity ratio} = \frac{\text{equity capital}}{\text{total capital}} \times 100$$

good > 40 %
fair 20-40 %
bad < 20 %