

Financial Statement Analysis

The analysis of financial data employs various techniques to emphasize the comparative and relative importance of the data presented and to evaluate the position of the firm.

These techniques include ratio analysis, common size analysis, review of descriptive material, and comparisons of results with other types of data. The information derived from these types of analyses should be blended to determine the overall financial position. No one type of analysis supports overall findings or serves all types of users.

Financial statement analysis is a judgmental process. One of the primary objectives is identification of major changes (turning points) in trends, amounts and relationships and investigation of the reasons underlying those changes.

1. Ratio Analysis

Ratio analysis is the calculation and comparison of ratios which are derived from the information in a company's financial statements. Financial ratios are usually expressed as a percent or as times per period.

a) Liquidity Ratios

Liquidity ratios measure a firm's ability to meet its current obligations. These include:

- Current Ratio
- Acid Test Ratio
- Sales to Working Capital
- Working capital

b) Leverage Ratios

Leverage ratios measure the degree of protection of suppliers of long term funds.

These include:

- Time Interest Earned
- Fixed Charge Coverage
- Debt Ratio
- Debt / Equity Ratio
- Debt to Tangible Net worth Ratio
- Current Worth / Net worth Ratio
- Total Capitalization Ratio
- Fixed Ratio / Equity Ratio
- Long term Assets versus Long term Debt
- Debt Coverage Ratio

c) Profitability Ratios

Profitability ratios measure the earning ability of a firm.

These include:

- Net Profit Margin
- Return on Assets
- DuPont Return on Assets

- Operating Income Margin
- Operating Assets Turnover
- Return on Operating Assets
- Sales to Fixed Assets
- Return on Investment (ROI)
- Return on Total Equity
- Gross Profit Margin

d) Activity Ratios

Activity ratios measure a firm's ability to convert different accounts within their balance sheets into cash or sales.

These include:

- Accounts Receivable Turnover
- Average collection period
- Accounts payable turnover
- Average payment period
- Inventory Turnover
- Average age of inventory
- Operating cycle
- Total Asset Turnover

e) Market Ratios

Market ratios measure investor response to owning a company's stock and also the cost of issuing stock

- Dividend per share
- Earning per Share
- Price/Earning Ratio
- Percentage of Earning Retained
- Dividend Payout
- Dividend Yield
- Book Value per Share

f) Statements of Cash Flow

Cash flow ratios indicate liquidity, borrowing capacity or profitability.

These include:

- Operating Cash Flow/Current Maturities of Long Term Debt and Current Notes Payable
- Operating Cash Flow/Total Debt
- Operating Cash Flow per Share
- Operating Cash Flow/Cash Dividends

2. Common Size Analysis (Vertical and Horizontal)

Common size analysis includes:

a) Horizontal Analysis

It is a procedure in fundamental analysis in which an analyst compares ratios or line items in a company's financial statements over a certain period of time. The analyst will use his or her discretion when choosing a particular timeline; however, the decision is often based on the investing time horizon under consideration.

b) Vertical Analysis

It is a method of financial statement analysis in which each entry for each of the three major categories of accounts (assets, liabilities and equities) in a balance sheet is represented as a proportion of the total account. The main advantages of analyzing a balance sheet in this manner are that the balance sheets of businesses of all sizes can easily be compared. It also makes it easy to see relative annual changes in one business.

3. Review of Descriptive Information

The descriptive information found in an annual report, in trade periodicals, and in industry reviews helps in understanding the financial position of a firm. Descriptive material might discuss the role of research and development in producing future sales, present data on capital expansion and the goal related such as minority hiring or union negotiations, or help explain the dividend policy of the firm.

4. Comparisons

Absolute figures or ratios appear meaningless unless compared to other figures or ratios. Several types of comparisons offer insight, e.g.

a) Trend Analysis

Trend analysis studies the financial history of a firm for comparison. By looking at the trend of a particular ratio, one sees whether the ratio is falling, rising, or remaining relatively constant. This helps to detect problems or observe good management.

b) Industry Averages and Comparisons with Competitors

The analysis of an entity's financial statements is more meaningful if the results are compared with industry averages and with results of competitors.

Instructions:

- You are required to provide scanned copies of all the financial statements you are using in your analysis. Without scanned copies of original financial statements, your working shall not be considered authentic.
- You are required to provide complete working of ratios (i.e. formula, working and interpretation of each ratio) as well. **Skipping any required information will cause deduction of marks.**
- You can get financial reports from Stock exchanges, company or from company's website.