Analyzing Financial Statements

Financial Ratio Analysis…

The 3 Important Financial Statements

- The Income Statement
- The Balance Sheet
- The Statement of Cash Flows

These tell us how the company did over time, its net worth at a point in time, and where the cash came from and went.

Is the company improving in terms of profitability?

Does it have enough cash for the short-term? The long-term?

Is it managing its investments well?

Is it a good investment itself?

Ratio Analysis allows us to calculate metrics to answer these questions!

Financial Ratio Analysis…

A ratio we already know and understand…

Gross Margin: the profit margin based on the sale of a company's products and services.

$$\text{Gross Margin (\%)} = \frac{\text{Gross Profit}}{\text{Revenues}} \text{ x } 100$$

where:

$$\text{Gross Profit} = \text{Revenues } - \text{COGS}$$

Example: A company's revenues are \$90M. Its Cost of Goods Sold, COGS, is \$56M. The company's gross margin is:

$$\text{Gross Margin (\%)} = \frac{\$90\text{M } - \$56\text{M}}{\$90\text{M}} \text{ x } 100$$

$$\text{Gross Margin (\%)} = 37.8\%$$

Financial Ratio Analysis…

Why is this important?

<u>Internal View</u>

- Allows managers to keep on top of the company's performance.
- Indicates how things have changed from one period to the next.

Example: In 2022, a company saw top-line revenue growth of $2M relative to 2021, where 2021 revenues were $200M.

$$\text{Revenue Growth (\$)} = \$2\text{M}$$ *Impressive!*

$$\text{Revenue Growth (\%)}: = \frac{\$202\text{M} - \$200\text{M}}{\$200\text{M}} \text{ x } 100$$

$$\text{Revenue Growth (\%)}: = 1\%$$ *Not as Impressive!*

Financial Ratio Analysis…

Why is this important?

Internal View

- Allows managers to keep on top of the company’s performance.
- Indicates how things have changed from one period to the next.

External View

- Allows investors to compare one company with another.
- Enables bankers and other lenders to determine if the company is a good potential customer (e.g., low risk).

Financial Ratio Analysis…

Ratios worth knowing about…

1. Liquidity Ratios: can the company pay its bills?
2. Working Capital Management Ratios: how well does the company manage its day-to-day operations?
3. Profitability Measures: is the company making enough money?
4. Financial Leverage Ratios: is the company carrying too much debt?
5. Market Value Ratios: is the company a good investment?

Main Takeaways…

Financial ratios allow us to analyze a company’s financial health based on information from the income statement and the balance sheet.

Measuring the company’s performance in % rather than the absolute numbers makes it easier to compare one year to the next, and the company to others in its industry.

Ratios quickly identify where things are going well, and any red flags that might exist – and we should know about!

There are several ratios to consider, each an indicator of the company’s performance in a specific aspect of its business.

Next Time...

Liquidity Ratios

Credits & References

Slide 1: Woman counting her budget, hands with calculator by RomanR, Adobe Stock (199337772.jpeg).

Slide 6: Liquidity Ratios – Statistics/Business by MQ-Illustrations, Adobe Stock (335905242.jpeg).