Chapter 13

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Analyzing Financial Statements

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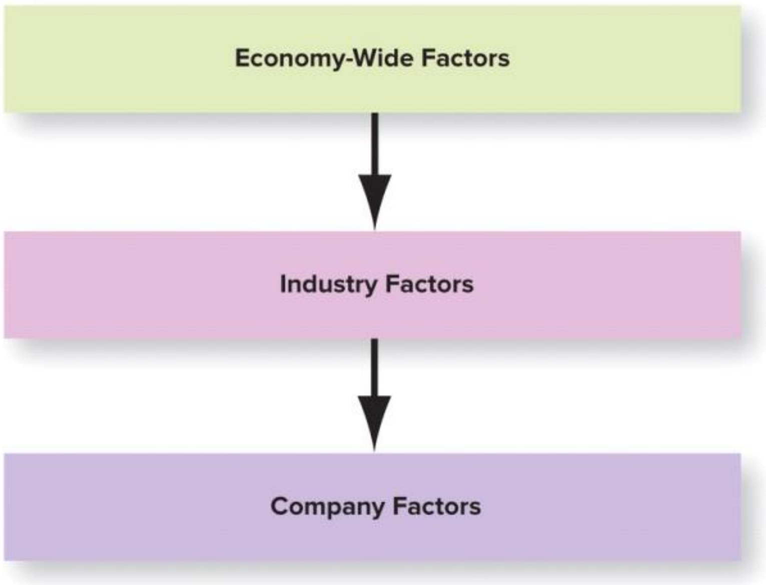
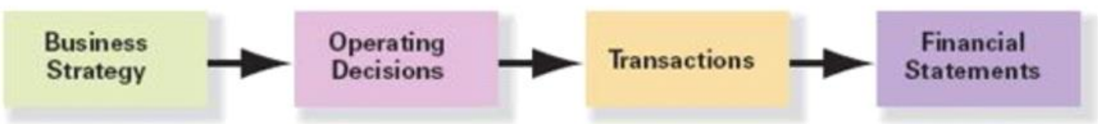
The Investment Decision



1. Economy-wide factors
   a. Overall health of economy has a direct impact on the performance of an individual company. Should consider data such as the unemployment rate.
2. Industry Factors
   a. Certain events have major impact on each company within an industry but only minor effect on other companies outside the industry.
3. Individual Company Factors
   a. Not only analyze company's financial statements, but also visit the company, buy its products, and read about it in the business press.

Understanding A Company's Strategy



Two Fundamental Strategies

1. Product Differentiation
   a. Under this strategy, companies offer products with unique benefits, such as high

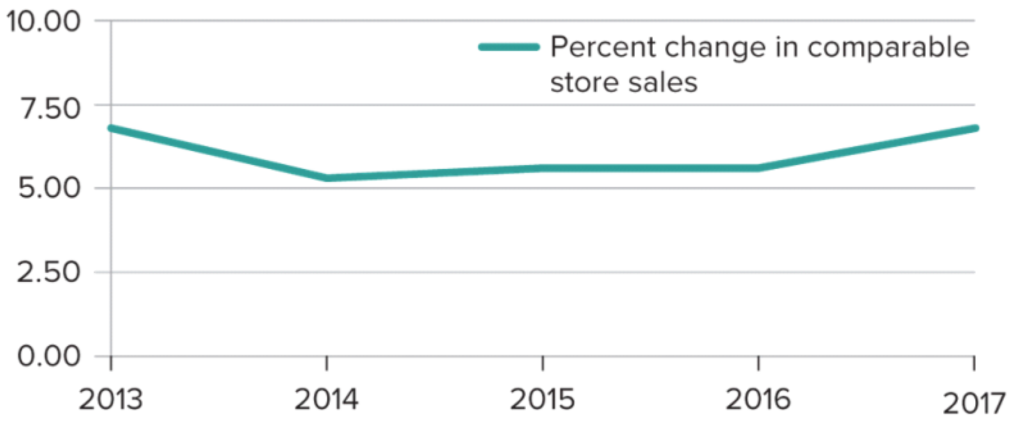
quality or unusual style or features.

2. Cost Differentiation
    a. Under this strategy, companies attempt to operate more efficiently than their competitors, which permits them to offer lower prices to attract customers.

Product Differentiation	**Cost Differentiation**
Cars: Tesla	**Cars:** Kia
Airlines: Singapore Airlines	**Airlines:** Southwest
Retail Stores: Nordstrom	**Retail Stores:** Walmart

Financial Statement Analysis

1. Comparing Across Time
    a.



2. Comparing Across Companies

Component Percentages

Expressing each item on a particular financial statement as a percentage of a single base amount.

	COMPONENT PERCENTAGES*		
Income Statement	**Fiscal 2017**	**Fiscal 2016**	**Fiscal 2015**
Net Sales	100.00%	100.00%	100.00%
Cost of Sales	65.95	65.84	65.81
Gross Profit	34.05	34.16	34.19
Operating Expenses:			
Selling, General, and Administrative	17.70	18.11	18.98
Depreciation and Amortization	1.79	1.85	1.91
Total Operating Expenses	19.49	19.96	20.89

Total Operating Expenses	19.49	19.96	20.89
Operating Income	14.56	14.20	13.30
Interest and Other (Income) Expense:			
Interest and Investment Income	(0.07)	(0.04)	(0.19)
Interest Expense	1.05	1.03	1.04
Interest and Other, Net	0.98	0.99	0.85
Earnings, before Provision for Income Taxes	13.58	13.21	12.45
Provision for Income Taxes	5.03	4.80	4.53
Net Earnings	8.55%	8.41%	7.92%

Ratio Analysis

In previous chapters, we have introduced several ratios to help analyze the performance of a company. Here we will list all of them.

RATIO	BASIC COMPUTATION*
Profitability Ratios	
1. Return on equity (ROE)	$\frac{\text{Net Income}}{\text{Average Total Stockholders' Equity}}$
2. Return on assets (ROA)	$\frac{\text{Net Income}}{\text{Average Total Assets}}$
3. Gross profit percentage	$\frac{\text{Gross Profit}}{\text{Net Sales Revenue}}$
4. Net profit margin	$\frac{\text{Net Income}}{\text{Net Sales Revenue}}$
5. Earnings per share (EPS)	$\frac{\text{Net Income}}{\text{Weighted Average Number of Common Shares Outstanding}}$
6. Quality of Income	$\frac{\text{Cash Flows from Operating Activities}}{\text{Net Income}}$
Asset Turnover Ratios	
7. Total asset turnover ratio	$\frac{\text{Net Sales Revenue}}{\text{Average Total Assets}}$
8. Fixed asset turnover ratio	$\frac{\text{Net Sales Revenue}}{\text{Average Net Fixed Assets}}$
9. Receivable turnover ratio	

Average Net Fixed Assets

9. Receivable turnover ratio

$$\frac{\text{Net Credit Sales}}{\text{Average Net Receivables}}$$

10. Inventory turnover ratio

$$\frac{\text{Cost of Goods Sold}}{\text{Average Inventory}}$$

Liquidity Ratios

11. Current ratio

$$\frac{\text{Current Assets}}{\text{Current Liabilities}}$$

12. Quick ratio

$$\frac{\text{Cash \& Cash Equivalents} + \text{Net Accounts Receivable} + \text{Marketable Securities}}{\text{Current Liabilities}}$$

13. Cash ratio

$$\frac{\text{Cash \& Cash Equivalents}}{\text{Current Liabilities}}$$

Solvency Ratios

14. Times interest earned ratio

$$\frac{\text{Net Income} + \text{Interest Expense} + \text{Income Tax Expense}}{\text{Interest Expense}}$$

15. Cash coverage ratio

$$\frac{\text{Cash Flows from Operating Activities}}{\text{Interest Paid}}$$

16. Debt-to-equity ratio

$$\frac{\text{Total Liabilities}}{\text{Total Stockholders' Equity}}$$

Market Ratios

17. Price/Earnings (P/E) ratio

$$\frac{\text{Market Price per Share}}{\text{Earnings per Share}}$$

18. Dividend yield ratio

$$\frac{\text{Dividends per Share}}{\text{Market Price per Share}}$$

Other Financial Information

Understanding the broader economic environment in which a company operates is important when interpreting its ratios. Some things that analysts commonly consider are

1. **Rapid growth.**
   a. Growth in total sales does not always indicate that a company is successful.
   b. Total sales can increase as a result of a company selling more at its existing stores, it can increase as a result of a company opening new stores, or it can increase as a result of a company purchasing another company.
   c. To help analysts sort out what is driving sales growth, companies often report a

stores, it can increase as a result of a company opening new stores, or it can increase as a result of a company purchasing another company.
    c. To help analysts sort out what is driving sales growth, companies often report a figure we discussed at the beginning of this chapter called "**comparable store sales**." This figure captures the growth in sales for stores that have been in existence for some period of time, typically 13 months or more.
2. **Uneconomical expansion.**
    a. In the pursuit of growth, some companies will open stores in less desirable locations. These poor locations can cause a company's average productivity to decline.
    b. One measure of productivity in the retail industry is **sales volume per square foot of selling space**.
3. **Subjective factors.**
    a. Remember that analyzing a company involves much more than simply analyzing its financial statements and ratios.
    b. To get a sense for how a company is implementing its strategy, analysts will often visit individual stores and perhaps talk to customers and suppliers.