Chapter 13

Analyzing Financial Statements

Learning Objectives

After studying this chapter, you should be able to:

- 13-1 Explain how a company's business strategy affects financial statement analysis.
- 13-2 Discuss ways to analyze financial statements.
- 13-3 Compute and interpret component percentages.
- 13-4 Compute and interpret profitability ratios.
- 13-5 Compute and interpret asset turnover ratios.
- 13-6 Compute and interpret liquidity ratios.
- 13-7 Compute and interpret solvency ratios.
- 13-8 Compute and interpret market ratios.

Understanding the Business

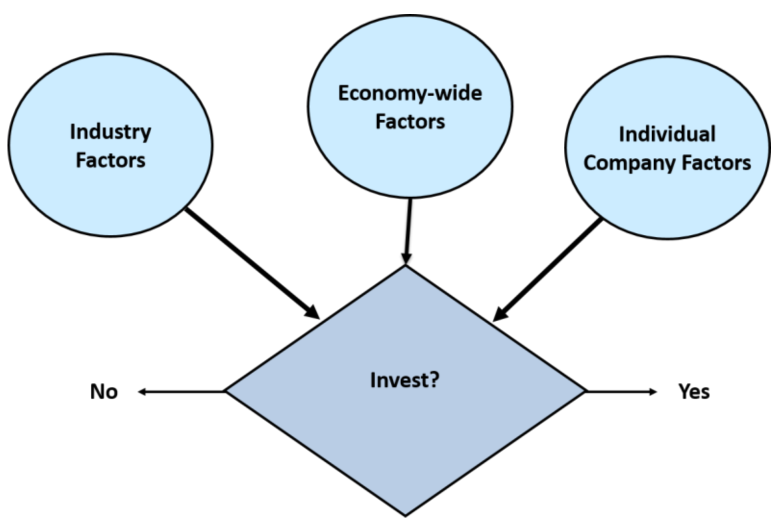
Financial statements help people make better economic decisions. Published financial statements are designed primarily to meet the needs of external decision makers.

Financial Statements → External Decision Makers Include

- Present and potential owners
- Investment analysts
- Creditors

13-3

The Investment Decision



13-4

Learning Objective 13-1

13-1 Explain how a company's business strategy affects financial statement analysis.

13-5

Understanding a Company's Strategy (1 of 2)

While financial statements reflect transactions, each of those transactions is the result of a company's operating decisions as it implements its business strategy.

13-6

Understanding a Company's Strategy (2 of 2)

Businesses can earn a high rate of return by following different strategies.

Product Differentiation and **Cost Differentiation** are two fundamental strategies.

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

Learning Objective 13-2

13-2 Discuss ways to analyze financial statements.

Financial Statement Analysis

Financial statement analysis is based on comparisons.

- **Time-series analysis**: Information for a single company is compared over time
- **Cross-sectional analysis**: Information for multiple companies is compared at a point in time

13-9

Learning Objective 13-3

13-3 Compute and interpret component percentages.

13-10

Component Percentages

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

Net sales on the income statement

Total assets on the balance sheet

The comparative income statements of The Home Depot for 2017, 2016, and 2015 appear on the next slide.

Prepare component percentage income statements where net sales equal 100 percent.

13-11

Exhibit 13.1 (1 of 2)
The Home Depot Financial Statements

Net sales will be set to 100 percent, and all other components will be expressed as a percentage of net sales.

THE HOME DEPOT, INC.
Consolidated Statements of Earnings
(*amounts in millions, except per share data*)

	Fiscal 2017	Fiscal 2016	Fiscal 2015
Net Sales	$100,904	$94,595	$88,519
Cost of Sales	66,548	62,282	58,254
Gross Profit	34,356	32,313	30,265
Operating Expenses:			
Selling, General and Administrative	17,864	17,132	17,132
Depreciation and Amortization	1,811	1,754	1,690
Total Operating Expenses	19,675	18,886	18,491
Operating Income	14,681	13,427	11,774
Interest and Other (Income) Expense:			
Interest and Investment Income	(74)	(36)	(166)
Interest Expense	1,057	972	919
Interest and Other, net	983	936	753
Earnings before Provision for Income Taxes	13,698	12,491	11,021
Provision for Income Taxes	5,068	4,534	4,012
Net Earnings	$ 8,630	$ 7,957	$ 7,009
Basic Weighted Average Common Shares	1,178	1,229	1,277
Basic Earnings per Share	$ 7.33	$ 6.47	$ 5.49
Diluted Weighted Average Common Shares	1,184	1,234	1,283
Diluted Earnings per Share	$ 7.29	$ 6.45	$ 5.46

13-12

Exhibit 13.1 (2 of 2)

The Home Depot Financial Statements

Net sales will be set to 100 percent, and all other components will be expressed as a percentage of net sales.

2017 Cost of Sales ÷ 2017 Net Sales
$66,548 ÷ $100,904 = 0.6595 or 65.95%

2017 Gross Profit ÷ 2017 Net Sales
$34,356 ÷ $100,904 = 0.3405 or 34.05%

2017 Selling, G&A ÷ 2017 Net Sales
$17,864 ÷ $100,904 = 0.1770 or 17.70%

THE HOME DEPOT, INC.
Consolidated Statements of Earnings
(amounts in millions, except per share data)

	Fiscal 2017	Fiscal 2016	Fiscal 2015
Net Sales	**$100,904**	[illegible]	[illegible]
Cost of Sales	**66,548**	[illegible]	[illegible]
Gross Profit	**34,356**	[illegible]	[illegible]
Operating Expenses:			
Selling, General and Administrative	**17,864**	17,132	16,801
Depreciation and Amortization	**1,811**	1,754	1,690
Total Operating Expenses	**19,675**	18,886	18,491
Operating Income	**14,681**	13,427	11,774
Interest and Other (Income) Expense:			
Interest and Investment Income	**(74)**	[illegible]	[illegible]
Interest Expense	**1,057**	[illegible]	[illegible]
Interest and Other, net	**983**	[illegible]	[illegible]
Earnings before Provision for Income Taxes	**13,698**	12,491	11,021
Provision for Income Taxes	**5,068**	4,534	4,012
Net Earnings	**$ 8,630**	$ 7,957	$ 7,009
Basic Weighted Average Common Shares	**1,178**	1,229	1,277
Basic Earnings per Share	**$ 7.33**	$ 6.47	$ 5.49
Diluted Weighted Average Common Shares	**1,184**	1,234	1,283
Diluted Earnings per Share	**$ 7.29**	$ 6.45	$ 5.46

13-13

Exhibit 13.2

Component Percentages for The Home Depot

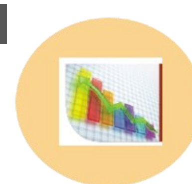
	COMPONENT PERCENTAGES*		
Income Statement	**Fiscal 2017**	**Fiscal 2016**	**Fiscal 2015**
Net Sales	100.00%	100.00%	100.00%
Cost of Sales	65.95	65.84	65.81
Gross Profit	34.05	34.16	34.19
Operating Expenses:			
Selling, General, and Administrative	17.70	18.11	18.98
Depreciation and Amortization	1.79	1.85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

**Numbers are rounded.*

13-14

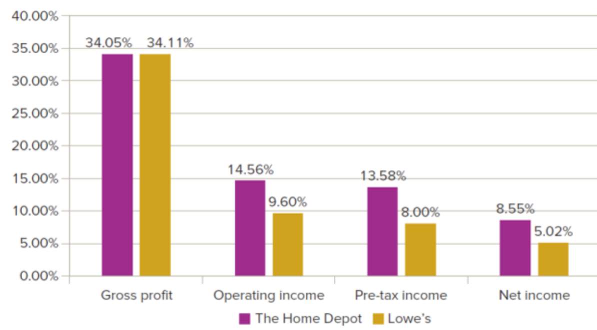
Using Graphs to Assess Company's Performance

DATA ANALYTICS



Many analysts use graphics software to help them analyze a company's financial data.

This bar chart visually displays key income percentages for **The Home Depot** along with its competitor, **Lowe's**.



Ratio Analysis

Ratio analysis helps decision makers **identify significant relationships** and **make meaningful comparisons**.

Financial statement analysis involves a lot of judgment.

The more clearly you define the questions you want answered, the easier it is to select the most appropriate ratios to compute.

The 2017 and 2016 balance sheets for The Home Depot are presented on the next slides. We will be referring to these financial statements throughout the ratio analyses.

Exhibit 13.1
The Home Depot Financial Statements (1 of 2)

THE HOME DEPOT, INC.
Consolidated Balance Sheets
(*amounts in millions, except per share data*)

	End of Fiscal 2017	End of Fiscal 2016
Assets		
Current Assets:		
Cash and Cash Equivalents	**$ 3,595**	$ 2,538
Receivables, net	**1,952**	2,029
Merchandise Inventories	**12,748**	12,549
Other Current Assets	**638**	608
Total Current Assets	**18,933**	17,724
Net Property and Equipment	**22,075**	21,914
Goodwill	**2,275**	2,093
Other Assets	**1,246**	1,235
Total Assets	**$44,529**	$42,966

13-17

Exhibit 13.1
The Home Depot Financial Statements (2 of 2)

	End of Fiscal 2017	End of Fiscal 2016
Liabilities and Stockholders' Equity		
Current Liabilities:		
Short-Term Debt	**$ 1,559**	$ 710
Accounts Payable	**7,244**	7,000
Accrued Salaries and Related Expenses	**1,640**	1,484
Sales Taxes Payable	**520**	508
Deferred Revenue	**1,805**	1,669
Income Taxes Payable	**54**	25
Current Installments of Long-Term Debt	**1,202**	542
Other Accrued Expenses	**2,170**	2,195
Total Current Liabilities	**16,194**	14,133
Long-Term Debt, excluding current installments	**24,267**	22,349
Deferred Income Taxes	**440**	296
Other Long-Term Liabilities	**2,174**	1,855
Total Liabilities	**43,075**	38,633
Stockholders' Equity		
Common Stock, par value $0.05; authorized: 10,000 shares; issued: 1,780 shares at January 28, 2018, and 1,776 at January 29, 2017	**89**	88
Paid-in Capital	**10,192**	9,787
Retained Earnings	**39,935**	35,519
Accumulated Other Comprehensive Loss	**(566)**	(867)
Treasury Stock, at cost, 622 shares at January 28, 2018, and 573 shares at January 29, 2017	**(48,196)**	(40,194)
Total Stockholders' Equity	**1,454**	4,333
Total Liabilities and Stockholders' Equity	**$44,529**	$42,966

13-18

Learning Objective 13-4

13-4 Compute and interpret profitability ratios.

Profitability Ratios

Profitability ratios focus on net income and how it compares to other amounts reported on the financial statements.

Profitability Ratios

1. Return on equity (ROE) $\dfrac{\text{Net Income}}{\text{Average Total Stockholders' Equity}}$
2. Return on assets (ROA) $\dfrac{\text{Net Income}}{\text{Average Total Assets}}$
3. Gross profit percentage $\dfrac{\text{Gross Profit}}{\text{Net Sales Revenue}}$
4. Net profit margin $\dfrac{\text{Net Income}}{\text{Net Sales Revenue}}$
5. Earnings per share (EPS) $\dfrac{\text{Net Income}}{\text{Weighted Average Number of Common Shares Outstanding}}$
6. Quality of Income $\dfrac{\text{Cash Flows from Operating Activities}}{\text{Net Income}}$

We will be referring to the financial statements of The Home Depot throughout our discussion of profitability ratios.

Return on Equity (ROE)

Return on Equity relates income earned to the investment made by the owners. Investors expect to earn a return on the money they invest.

The ROE ratio for The Home Depot for fiscal 2017 is computed as follows:

$$\text{Return on Equity} = \frac{\text{Net Income}}{\text{Average Stockholders' Equity}}$$

$$\begin{array}{c}\text{The Home}\\ \text{Depot 2017}\end{array} = \frac{\$8,630}{\$2,894*} = 298.25\%$$

$$\frac{*(\$4,333+\$1,454)}{2} = \$2,894$$

	2017	2016	2015
ROE	298.25%	149.44%	89.64%

On average, for every $1.00 equity investors contributed to The Home Depot, the company earned $2.98 in fiscal 2017.

Return on Assets (ROA)

This ratio compares income to the total assets used to generate the income .

$$\begin{array}{c}\text{Return on}\\ \text{Assets}\end{array} = \frac{\text{Net Income}}{\text{Average Total Assets}}$$

$$\begin{array}{c}\text{The Home}\\ \text{Depot 2017}\end{array} = \frac{\$8,630}{\$43,748*} = 19.73\%$$

$$\frac{*(\$42,966+\$44,529)}{2} = \$43,748$$

On average, for every $1.00 of assets reported on The Home Depot’s balance sheet, the company earned just under 20 cents in fiscal 2017.

Gross Profit Percentage

The gross profit percentage (also referred to as the gross profit margin) reflects gross profit as a percent of sales.

If not shown separately on a company's income statement, gross profit is computed by subtracting cost of sales from net sales.

$$\text{Gross Profit Percentage} = \frac{\text{Gross Profit}}{\text{Net Sales Revenue}}$$

$$\text{The Home Depot 2017} = \frac{\$34,356}{\$100,904} = 34.05\%$$

After subtracting the direct costs associated with selling products, The Home Depot had approximately 34 cents of each dollar of sales remaining to cover other expenses.

13-23

Net Profit Margin

This ratio reflects net income as a percentage of sales.

$$\text{Net Profit Margin} = \frac{\text{Net Income}}{\text{Net Sales Revenue}}$$

$$\text{The Home Depot 2017} = \frac{\$8,630}{\$100,904} = 8.55\%$$

For fiscal 2017, each dollar of The Home Depot's sales generated over 8 cents of profit. For each dollar of sales, The Home Depot is subtracting just under 92 cents in expenses.

13-24

Earnings per Share (EPS)

The earnings per share ratio is a measure of return on investment that is based on the number of common shares outstanding.

$$\text{EPS} = \frac{\text{Net Income}}{\text{Weighted Average Number of Shares Outstanding}}$$

$$\begin{array}{c}\text{The Home} \\ \text{Depot 2017}\end{array} = \frac{\$8,630}{1,178} = \$7.33$$

Average number of shares outstanding is reported on the bottom of the income statement

Earnings per share is probably the single most widely reported financial ratio, and it is the only ratio required by GAAP

13-25

Quality of Income

$$\begin{array}{c}\textbf{Quality of} \\ \textbf{Income}\end{array} = \frac{\textbf{Cash Flows from Operating Activities}}{\textbf{Net Income}}$$

The Home Depot 2017:

$$\frac{\$12,031}{\$8,630} = 1.39$$

A ratio higher than 1 indicates high-quality income because each dollar of income is supported by one or more dollars of cash flows.

CASH FLOWS FROM OPERATING ACTIVITIES:	
Net Earnings	$8,630
Reconciliation of Net Earnings to Net Cash Provided by Operating Activities:	
Depreciation and Amortization	2,062
Stock-Based Compensation Expense	273
Changes in Assets and Liabilities, net of the effects of acquisitions:	
Receivables, net	139
Merchandise Inventories	(84)
Other Current Assets	(10)
Accounts Payable and Accrued Expenses	352
Deferred Revenue	128
Income Taxes Payable	29
Deferred Income Taxes	92
Other	420
Net Cash Provided by Operating Activities	12,031

13-26

Learning Objective 13-5

13-5 Compute and interpret asset turnover ratios.

Asset Turnover Ratios

Profitability ratios focus on net income and how it compares to other amounts reported on the financial statements.

Asset Turnover Ratios

7. Total asset turnover ratio $\dfrac{\text{Net Sales Revenue}}{\text{Average Total Assets}}$

8. Fixed asset turnover ratio $\dfrac{\text{Net Sales Revenue}}{\text{Average Net Fixed Assets}}$

9. Receivable turnover ratio $\dfrac{\text{Net Credit Sales}}{\text{Average Net Receivables}}$

10. Inventory turnover ratio $\dfrac{\text{Cost of Goods Sold}}{\text{Average Inventory}}$

We will be referring to the financial statements of The Home Depot throughout our discussion of asset turnover ratios.

Total Asset Turnover Ratio

This ratio captures how well a company uses its assets to generate revenue.

$$\text{Total Asset Turnover} = \frac{\text{Net Sales Revenue}}{\text{Average Total Assets}}$$

$$\text{The Home Depot 2017} = \frac{\$100,904}{\$43,748*} = 2.31$$

$$\frac{*(\$42,966 + \$44,529)}{2} = \$43,748$$

	2017	2016	2015
Total Asset Turnover	2.31	2.23	2.27

The Home Depot has improved its total asset turnover ratio from fiscal 2015 to fiscal 2017. On average, every dollar of assets on The Home Depot's balance sheet generates $2.31 of revenue.

13-29

Fixed Asset Turnover Ratio

This ratio measures a company's ability to generate sales given an investment in fixed assets.

$$\text{Fixed Asset Turnover} = \frac{\text{Net Sales Revenue}}{\text{Average Net Fixed Assets}}$$

$$\text{The Home Depot 2017} = \frac{\$100,904}{\$21,995*} = 4.59$$

$$\frac{*(\$21,914 + \$22,075)}{2} = \$21,995$$

For each dollar The Home Depot invested in property, plant, and equipment, the company was able to generate $4.59 in sales revenue.

13-30

Receivable Turnover Ratio

This ratio measures how quickly a company collects its accounts receivable.

$$\text{Receivable Turnover Ratio} = \frac{\text{Net Credit Sales}^1}{\text{Average Net Receivables}}$$

$$\text{The Home Depot 2017} = \frac{\$100,904}{\$1,991^*} = 50.69 \text{ times}$$

$$\frac{^*(\$2,029 + \$1,952)}{2} = \$1,991$$

A high receivable turnover ratio suggests that a company collects its accounts receivable many times during a year. On average, The Home Depot collects its accounts receivable over 50 times a year.

[1] *If credit sales are not reported separately, use total net sales as an approximation*

13-31

Receivable Turnover Ratio – Converted to Days

The receivable turnover ratio often is converted to reflect the number of days, on average, it takes a company to collect its receivables.

$$\text{Average Days to Collect Receivables} = \frac{\text{Days in a Year}}{\text{Receivable Turnover Ratio}}$$

$$\text{The Home Depot 2017} = \frac{365}{50.69} = 7.20 \text{ days}$$

The Home Depot's average days to collect receivables ratio implies that it takes the company an average of just over seven days to collect its accounts receivable.

Many of The Home Depot customers pay with a credit card, which is the equivalent of a cash sale. As a result, net sales does not approximate net credit sales so this ratio analysis is less meaningful.

13-32

Inventory Turnover Ratio

This ratio measures how quickly the company sells its inventory.

$$\textit{Inventory Turnover Ratio} = \frac{\text{Cost of Goods Sold}}{\text{Average Inventory}}$$

$$\text{The Home Depot 2017} = \frac{\$66,548}{\$12,649*} = 5.26 \text{ times}$$

$$\frac{*(\$12,549 + \$12,748)}{2} = \$12,649$$

An increase in this ratio is usually favorable. However, if the ratio is too high, it may be an indication that sales were lost because desired items were not in stock. A company must balance the cost of holding inventory with the potential cost of losing a sale. On average, The Home Depot's inventory was acquired and sold to customers just over 5 times during the year.

Inventory Turnover Ratio – Converted to Days

The inventory turnover ratio often is converted to reflect the number of days, on average, it takes a company to sell its inventory.

$$\text{Average Days to Sell Inventory} = \frac{\text{Days in a Year}}{\text{Inventory Turnover Ratio}}$$

$$\text{The Home Depot 2017} = \frac{365}{5.26} = 69.39 \text{ days}$$

The Home Depot's average days to sell inventory ratio implies that, on average, it takes the company just over sixty-nine days to sell its inventory.

Using Ratios to Analyze the Operating Cycle

The **operating cycle** is the time it takes for a company to pay cash to its suppliers, sell goods to its customers, and collect cash from its customers. Analysts are interested in the operating cycle because it helps them evaluate a company's cash needs and is a good indicator of operating efficiency.

The operating cycle for most companies involves three distinct phases:

1) the acquisition of inventory
2) the sale of the inventory
3) the collection of cash from the customer.

Several ratios are helpful when evaluating a company's operating cycle:

Ratio*	Operating Activity
Accounts payable turnover ratio	Purchase of inventory
Inventory turnover ratio	Sale of inventory
Receivable turnover ratio	Collection of cash from customers

**We discussed the accounts payable turnover ratio in Chapter 9. The inventory turnover ratio and the receivable turnover ratio are discussed in this chapter.*

13-35

The DuPont Model

FINANCIAL ANALYSIS

The **DuPont model** is used by analysts to better assess how a company is implementing its business strategy. The model is broken down into three components:

$$$

ROE = Net Profit Margin × Total Asset Turnover × Financial Leverage

$$\frac{\text{Net Income}}{\text{Average Total Stockholders' Equity}} = \frac{\text{Net Income}}{\text{Net Sales Revenue}} \times \frac{\text{Net Sales Revenue}}{\text{Average Total Assets}} \times \frac{\text{Average Total Assets}}{\text{Average Total Stockholders' Equity}}$$

13-36

Learning Objective 13-6

13-6 Compute and interpret liquidity ratios.

Liquidity Ratios

Liquidity ratios measure a company's ability to meet its short-term obligations.

Liquidity Ratios

11. Current ratio $$\frac{\text{Current Assets}}{\text{Current Liabilities}}$$

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

13. Cash ratio $$\frac{\text{Cash \& Cash Equivalents}}{\text{Current Liabilities}}$$

We will be referring to the financial statements of The Home Depot throughout our discussion of liquidity ratios.

Current Ratio

This ratio measures the ability of the company to pay current debts as they become due.

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

$$\text{The Home Depot 2017} = \frac{\$18,933}{\$16,194} = 1.17$$

A ratio greater than 1 implies that a company's current assets are sufficient to cover its current liabilities. If a company's current ratio is less than 1, analysts will want to understand how the company intends to meet its short-term obligations. At the end of fiscal 2017, The Home Depot had $1.17 in current assets for each $1.00 in current liabilities.

13-39

Quick Ratio

This ratio is a more stringent test of short-term liquidity than the current ratio.

$$\text{Quick Ratio} = \frac{\text{Quick Assets}}{\text{Current Liabilities}}$$

$$\text{The Home Depot 2017} = \frac{(\$3,595 + \$1,952 + \$0)}{\$16,194} = 0.34$$

Cash and Cash Equivalents	$3,595
Net Accounts Receivable	1,952
Marketable Securities	–
Quick Assets	$5,547

Quick assets are defined as cash and near-cash assets (net accounts receivable and marketable securities). Inventory and Prepaid expenses are omitted from quick assets. At the end of fiscal 2017, The Home Depot has 34 cents in cash and near-cash assets for every $1.00 in current liabilities.

13-40

Cash Ratio

This ratio measures the adequacy of available cash.

$$\text{Cash Ratio} = \frac{\text{Cash} + \text{Cash Equivalents}}{\text{Current Liabilities}}$$

$$\text{The Home Depot 2017} = \frac{\$3,595}{\$16,194} = 0.22$$

At the end of fiscal 2017, The Home Depot has 22 cents of cash for each $1.00 of current liabilities.

Learning Objective 13-7

13-7 Compute and interpret solvency ratios.

Solvency Ratios

Solvency ratios measure a company's ability to meet its long-term obligations.

Solvency Ratios

14. Times interest earned ratio	$\dfrac{\text{Net Income + Interest Expense + Income Tax Expense}}{\text{Interest Expense}}$
15. Cash coverage ratio	$\dfrac{\text{Cash Flows from Operating Activities}}{\text{Interest Paid}}$
16. Debt-to-equity ratio	$\dfrac{\text{Total Liabilities}}{\text{Total Stockholders' Equity}}$

We will be referring to the financial statements of The Home Depot throughout our discussion of solvency ratios.

13-43

Times Interest Earned Ratio

This ratio compares the income available to pay interest in a period to a company's interest obligation for the same period.

This ratio indicates a margin of protection for creditors.

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

$$\text{The Home Depot 2017} = \frac{\$8,630 + ?\ 1,057\text{賤}\$5,068}{\$1,057} = 13.96\ \text{times}$$

A high ratio indicates a secure position for creditors. In fiscal 2017, The Home Depot generated $13.96 in income for each $1.00 of interest expense.

13-44

Cash Coverage Ratio

This ratio compares the cash from operations to the cash needed to make required interest payments.

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

$$\text{The Home Depot 2017} = \frac{\$12{,}031}{\$991} = 12.14 \text{ times}$$

The Home Depot's cash coverage ratio shows that the company generated $12.14 in cash for every $1.00 of interest paid, which is strong coverage.

13-45

Debt-to-Equity Ratio

This ratio measures the amount of liabilities that exists for each $1 invested by the owners.

$$\text{Debt-to-Equity Ratio} = \frac{\text{Total Liabilities}}{\text{Total Stockholders? Equity}}$$

$$\text{The Home Depot 2017} = \frac{\$43{,}075}{\$1{,}454} = 29.63$$

In fiscal 2017, for each $1.00 of stockholders' equity, The Home Depot had $29.63 of liabilities.

13-46

Learning Objective 13-8

13-8 Compute and interpret market ratios.

Market Ratios

Market ratios relate the current price per share of a company's stock to the return that accrues to stockholders.

Analysts find these ratios helpful because they are based on the current value of an owner's investment in a company.

Market Ratios

17. Price/Earnings (P/E) ratio	$\frac{\text{Market Price per Share}}{\text{Earnings per Share}}$
18. Dividend yield ratio	$\frac{\text{Dividends per Share}}{\text{Market Price per Share}}$

We will be referring to the financial statements of The Home Depot throughout our discussion of market ratios.

Price/Earnings (P/E) Ratio

This ratio measures the relationship between the current market price of a company's stock and its earnings per share.

$$\text{P/E Ratio} = \frac{\text{Current Market Price per Share}}{\text{Earnings per Share}}$$

$$\begin{array}{c}\text{The Home}\\ \text{Depot 2017}\end{array} = \frac{\$207.23^{*}}{\$7.33} = 28.27$$

* At the end of fiscal 2017, The Home Depot's stock was trading at $207.23 per share.

The P/E ratio reflects the stock market's assessment of a company's future performance. A high ratio indicates that earnings are expected to grow rapidly.

The P/E ratio for The Home Depot indicates that the market expects them to perform well in the future. This P/E ratio indicates that The Home Depot's stock was selling at a price that was just over 28 times its earnings per share.

13-49

Dividend Yield Ratio

This ratio reflects the return on investment solely due to the dividends a company pays.

$$\begin{array}{c}\text{Dividend}\\ \text{Yield Ratio}\end{array} = \frac{\text{Dividends per Share}}{\text{Market Price per Share}}$$

$$\begin{array}{c}\text{The Home}\\ \text{Depot 2017}\end{array} = \frac{\$3.56}{\$207.23} = 1.72\%$$

Investors are willing to accept low dividend yields if they expect that the price of a stock will increase while they own it. Stocks with high dividend yields often appeal to retired investors who need current income rather than future growth potential.

13-50

Interpreting Ratios and Other Analytical Considerations

Analysts must decide which ratios to use based on their decision objective.

Ratios can be interpreted only by comparing them to other ratios or a benchmark value.

Comparing ratios for two firms is appropriate only if the companies are comparable in terms of their industry, operations, and accounting policies.

Because ratios are based on the aggregation of information, they may obscure underlying factors that are of interest to the analyst.

A company's accounting policy choices will influence its ratios.

13-51

Other Financial Information

Understanding the broader economic environment in which a company operates is important when interpreting its ratios.

- Rapid growth
- Uneconomical expansion
- Subjective factors

13-52

Insider Information

QUESTION OF ETHICS

Insider Information is when someone is aware of important financial information **before it is made available to the public.**

$$$

Buying or selling stock based on insider information is **a serious criminal offense** that can result in time served in jail.

To uphold ethical standards, many public accounting firms have adopted rules that prevent their staff from investing in companies that they audit.

Determining whether something is insider information can be difficult. Not sure? Try the "newspaper headline test." How would it would feel to have your family and friends read about what you did in the newspaper?

13-53