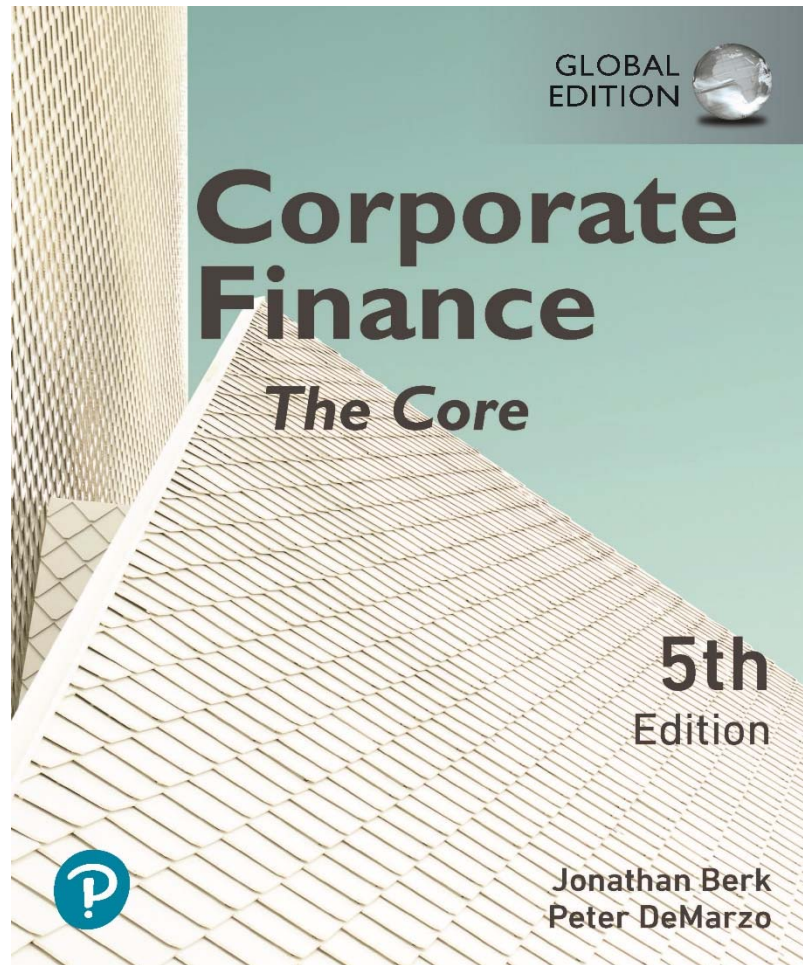


Corporate Finance: The Core

Fifth Edition, Global Edition



Chapter 2

Introduction to Financial
Statement Analysis

Chapter Outline

2.1 Firms' Disclosure of Financial Information

2.2 The Balance Sheet

2.3 The Income Statement

2.4 The Statement of Cash Flows

2.5 Other Financial Statement Information

2.6 Financial Statement Analysis

2.7 Financial Reporting in Practice

Learning Objectives (1 of 5)

- List the four major financial statements required by the SEC for publicly traded firms, define each of the four statements, and explain why each of these financial statements is valuable.
- Discuss the difference between book value of stockholders' equity and market value of stockholders' equity; explain why the two numbers are almost never the same.

Learning Objectives (2 of 5)

- Compute the following measures, and describe their usefulness in assessing firm performance: the debt-equity ratio, the enterprise value, earnings per share, operating margin, net profit margin, accounts receivable days, accounts payable days, inventory days, interest coverage ratio, return on equity, return on assets, price-earnings ratio, and market-to-book ratio.

Learning Objectives (3 of 5)

- Discuss the uses of the DuPont identity in disaggregating ROE, and assess the impact of increases and decreases in the components of the identity on ROE.
- Describe the importance of ensuring that valuation ratios are consistent with one another in terms of the inclusion of debt in the numerator and the denominator.

Learning Objectives (4 of 5)

- Distinguish between cash flow, as reported on the statement of cash flows, and accrual-based income, as reported on the income statement; discuss the importance of cash flows to investors, relative to accrual-based income.
- Explain what is included in the management discussion and analysis section of the financial statements that cannot be found elsewhere in the financial statements.

Learning Objectives (5 of 5)

- Explain the importance of the notes to the financial statements.
- List and describe the financial scandals described in the text, along with the new legislation designed to reduce that type of fraud.

2.1 Firms' Disclosure of Financial Information

- Financial Statements
 - Firm-issued accounting reports with past performance information
 - Filed with the SEC
 - 10Q
 - Quarterly
 - 10K
 - Annual
 - Must also send an annual report with financial statements to shareholders

Preparation of Financial Statements

- Generally Accepted Accounting Principles (GAAP)
- Auditor
 - Neutral third party that checks a firm's financial statements

Types of Financial Statements

- Balance Sheet
- Income Statement
- Statement of Cash Flows
- Statement of Stockholders' Equity

2.2 Balance Sheet (1 of 2)

- A snapshot in time of the firm's financial position
- The Balance Sheet Identity:

$$\text{Assets} = \text{Liabilities} + \text{Stockholder's Equity}$$

2.2 Balance Sheet (2 of 2)

- Assets
 - What the company owns
- Liabilities
 - What the company owes
- Stockholder's Equity
 - The difference between the value of the firm's assets and liabilities

Assets (1 of 2)

- Current Assets: Cash or expected to be turned into cash in the next year
 - Cash
 - Marketable Securities
 - Accounts Receivable
 - Inventories
 - Other Current Assets
 - Example: Pre-paid expenses

Assets (2 of 2)

- Long-Term Assets
 - Net Property, Plant, and Equipment
 - Depreciation (and Accumulated Depreciation)
 - $\text{Book Value} = \text{Acquisition Cost} - \text{Accumulated Depreciation}$
 - Goodwill and intangible assets
 - Amortization
 - Other long-term assets
 - Example: Investments in Long-Term Securities

Table 2.1 Global Conglomerate Corporation Balance Sheet (1 of 2)

GLOBAL CONGLOMERATE CORPORATION		
Consolidated Balance Sheet		
Year Ended December 31 (in \$ million)		
Assets	2018	2017
Current Assets		
Cash	21.2	19.5
Accounts receivable	18.5	13.2
Inventories	15.3	14.3
Other current assets	2.0	1.0
Total current assets	57.0	48.0
Long-Term Assets		
Land	22.2	20.7
Buildings	36.5	30.5
Equipment	39.7	33.2
Less accumulated depreciation	(18.7)	(17.5)
Net property, plant, and equipment	79.7	66.9
Goodwill and intangible assets	20.0	20.0
Other long-term assets	21.0	14.0
Total long-term assets	120.7	100.9
Total Assets	177.7	148.9

Liabilities (1 of 3)

- Current Liabilities: Due to be paid within the next year
 - Accounts Payable
 - Short-Term Debt/Notes Payable
 - Current Maturities of Long-Term Debt
 - Other Current Liabilities
 - Taxes Payable
 - Wages Payable

Liabilities (2 of 3)

- Net Working Capital
 - Current Assets – Current Liabilities

Liabilities (3 of 3)

- Long-Term Liabilities
 - Long-Term Debt
 - Capital Leases
 - Deferred Taxes

Table 2.1 Global Conglomerate Corporation Balance Sheet (2 of 2)

GLOBAL CONGLOMERATE CORPORATION		
Consolidated Balance Sheet		
Year Ended December 31 (in \$ million)		
Liabilities and Stockholders' Equity	2018	2017
Current Liabilities		
Accounts payable	29.2	24.5
Notes payable/short-term debt	3.5	3.2
Current maturities of long-term debt	13.3	12.3
Other current liabilities	2.0	4.0
Total current liabilities	48.0	44.0
Long-Term Liabilities		
Long-term debt	99.9	76.3
Capital lease obligations	—	—
Total debt	99.9	76.3
Deferred taxes	7.6	7.4
Other long-term liabilities	—	—
Total long-term liabilities	107.5	83.7
Total Liabilities	155.5	127.7
Stockholders' Equity	22.2	21.2
Total Liabilities and Stockholders' Equity	177.7	148.9

Stockholder's Equity

- Book Value of Equity
 - Book Value of Assets – Book Value of Liabilities
 - Could possibly be negative
 - Many of the firm's valuable assets may not be captured on the balance sheet

Market Value Versus Book Value (1 of 2)

- Market Value of Equity (Market Capitalization)
 - $\text{Market Price per Share} \times \text{Number of Shares Outstanding}$
 - Cannot be negative
 - Often differs substantially from book value

Market Value Versus Book Value (2 of 2)

- Market-to-Book Ratio
 - aka Price-to-Book Ratio

$$\text{Market-to-Book Ratio} = \frac{\text{Market Value of Equity}}{\text{Book Value of Equity}}$$

- Value Stocks
 - Low M/B ratios
- Growth stocks
 - High M/B ratios

Enterprise Value

- aka Total Enterprise Value (TEV)

Enterprise Value = Market Value of Equity + Debt – Cash

- Can be interpreted as the cost to take over the business

Textbook Example 2.1 (1 of 2)

Market Versus Book Value

Problem

- If Global has 3.6 million shares outstanding, and these shares are trading for a price of \$14 per share, what is Global's market capitalization?
- How does the market capitalization compare to Global's book value of equity in 2018?

Textbook Example 2.1 (2 of 2)

Market Versus Book Value

Solution

Global's market capitalization is $(3.6 \text{ million shares}) \times (\$14/\text{share}) = \$50.4 \text{ million}$. This market capitalization is significantly higher than Global's book value of equity of \$22.2 million. Thus, investors are willing to pay $50.4/22.2 = 2.27$ times the amount Global's shares are "worth" according to their book value.

2.3 Income Statement

- aka the “statement of financial performance”
- aka the “bottom line”

Earnings Calculations (1 of 6)

- Total Sales/Revenues
 - **minus**
- Cost of Sales
 - **equals**
- Gross Profit

Earnings Calculations (2 of 6)

- Gross Profit
 - **minus**
- Operating Expenses
 - Selling, General, and Administrative Expenses
 - R and D
 - Depreciation and Amortization
 - **equals**
- Operating Income

Earnings Calculations (3 of 6)

- Operating Income
 - **plus/minus**
- Other Income/Other Expenses
 - **equals**
- Earnings Before Interest and Taxes (EBIT)

Earnings Calculations (4 of 6)

- Earnings Before Interest and Taxes (EBIT)
 - **plus/minus**
- Interest Income/Interest Expense
 - **equals**
- Pre-Tax Income

Earnings Calculations (5 of 6)

- Pre-Tax Income
 - **minus**
- Taxes
 - **equals**
- Net Income

Table 2.2 Global Conglomerate Corporation Income Statement Sheet

GLOBAL CONGLOMERATE CORPORATION		
Income Statement		
Year Ended December 31 (in \$ million)		
	2018	2017
Total sales	186.7	176.1
Cost of sales	(153.4)	(147.3)
Gross Profit	33.3	28.8
Selling, general, and administrative expenses	(13.5)	(13.0)
Research and development	(8.2)	(7.6)
Depreciation and amortization	(1.2)	(1.1)
Operating Income	10.4	7.1
Other income	—	—
Earnings Before Interest and Taxes (EBIT)	10.4	7.1
Interest income (expense)	(7.7)	(4.6)
Pretax Income	2.7	2.5
Taxes	(0.7)	(0.6)
Net Income	2.0	1.9
Earnings per share:	\$0.556	\$0.528
Diluted earnings per share:	\$0.526	\$0.500

Earnings Calculations (6 of 6)

- Earnings per Share

$$\text{EPS} = \frac{\text{Net Income}}{\text{Shares Outstanding}}$$

- Stock Options
- Convertible Bonds
- Dilution
 - Diluted EPS

2.4 Statement of Cash Flows (1 of 2)

- Net Income typically does NOT equal the amount of cash the firm has earned.
 - Non-Cash Expenses
 - Depreciation and Amortization
 - Uses of Cash Not on the Income Statement
 - Investment in Property, Plant, and Equipment

2.4 Statement of Cash Flows (2 of 2)

- Three Sections
 - Operating Activity
 - Investment Activity
 - Financing Activity

Operating Activity

- Adjusts net income by all non-cash items related to operating activities and changes in net working capital
 - Depreciation – add the amount of depreciation
 - Accounts Receivable – deduct the increases
 - Accounts Payable – add the increases
 - Inventories – deduct the increases

Investment Activity

- Capital Expenditures
- Buying or Selling Marketable Securities

Financing Activity

- Payment of Dividends
 - $\text{Retained Earnings} = \text{Net Income} - \text{Dividends}$
- Changes in Borrowings

Table 2.3 Global Conglomerate Corporation Statement of Cash Flows

GLOBAL CONGLOMERATE CORPORATION		
Statement of Cash Flows		
Year Ended December 31 (in \$ million)		
	2018	2017
Operating activities		
Net income	2.0	1.9
Depreciation and amortization	1.2	1.1
Other non-cash items	0.2	1.0
Cash effect of changes in		
Accounts receivable	(5.3)	(0.3)
Accounts payable	4.7	(0.5)
Inventory	(1.0)	(1.0)
Other net operating assets	(3.0)	(2.0)
Cash from operating activities	(1.2)	0.2
Investment activities		
Capital expenditures	(14.0)	(4.0)
Acquisitions and other investing activity	(7.0)	(2.0)
Cash from investing activities	(21.0)	(6.0)
Financing activities		
Dividends paid	(1.0)	(1.0)
Sale (or purchase) of stock	—	—
Increase in borrowing	24.9	5.5
Cash from financing activities	23.9	4.5
Change in cash and cash equivalents	1.7	(1.3)

Textbook Example 2.2 (1 of 2)

The Impact of Depreciation on Cash Flow

Problem

- Suppose Global had an additional \$1 million depreciation expense in 2018. If Global's tax rate on pretax income is 26%, what would be the impact of this expense on Global's earnings?
- How would it impact Global's cash balance at the end of the year?

Textbook Example 2.2 (2 of 2)

Solution

Depreciation is an operating expense, so Global's operating income, EBIT, and pretax income would fall by \$1 million. This decrease in pretax income would reduce Global's tax bill by $26\% \times 26\% \times \$1 \text{ million} = \$0.26 \text{ million}$. Therefore, net income would fall by $1 - 0.26 = \$0.74 \text{ million}$.

On the statement of cash flows, net income would fall by \$0.74 million, but we would add back the additional depreciation of \$1 million because it is not a cash expense. Thus, cash from operating activities would rise by $-0.74 + 1 = \$0.26 \text{ million}$. Thus, Global's cash balance at the end of the year would increase by \$0.26 million, the amount of the tax savings that resulted from the additional depreciation expense.

2.5 Other Financial Statement Information

- Several other pieces of information contained in the financial statements warrant mention:
 - The statement of stockholders' equity
 - The management discussion and analysis
 - Notes to the financial statements

Statement of Stockholders' Equity

$$\begin{aligned}\text{Change in Stockholders' Equity} &= \text{Retained Earnings} \\ &+ \text{Net sales of stock} \\ &= \text{Net Income} \\ &- \text{Dividends} \\ &+ \text{Sales of stock} \\ &- \text{Repurchase of Stock}\end{aligned}$$

Management Discussion and Analysis

- Off-Balance Sheet Transactions
 - Transactions or arrangements that can have a material impact on the firm's future performance yet do not appear on the balance sheet

Notes to the Financial Statements

- In addition to the four financial statements, companies provide extensive notes with further details on the information provided in the statements.
- For example, the notes document important accounting assumptions that were used in preparing the statements.

Textbook Example 2.3 (1 of 2)

Problem

In the Segment Results section of its financial statements, Hormel Foods Corp (HRL) reported the following sales revenues by reportable segment/product category (\$ million):

	2017	2016
Grocery Products	\$1,761	\$1,684
Refrigerated Foods	4,404	4,647
Jennie-O Turkey Store	1,663	1,741
Specialty Foods	795	939
International and Other	545	511

Which category showed the highest percentage growth? If Hormel has the same percentage growth by category from 2017 to 2018, what will its total revenues be in 2018?

Textbook Example 2.3 (2 of 2)

Solution

The percentage growth in the sales of grocery products was $1,761/1,684 - 1 = 4.6\%$. Similarly, growth in Refrigerated Foods was -5.2% , Jennie-O Turkey Store was -4.5% , Specialty Foods was -15.4% , and International and Other categories were 6.7% . Thus, International and Other category showed the highest growth.

If these growth rates continue for another year, sales of Grocery Products will be $1,761 \times 1.046 = \$1,842$ million, and the other categories will be \$4,173 million, \$1,589 million, \$672 million, and \$581 million, respectively, for total revenues of \$8.9 billion, a 3.4% decrease from 2017.

2.6 Financial Statement Analysis

- Used to:
 - Compare the firm with itself over time
 - Compare the firm to other similar firms

Profitability Ratios (1 of 2)

- Gross Margin

$$\text{Gross Margin} = \frac{\text{Gross Profit}}{\text{Sales}}$$

- Operating Margin

$$\text{Operating Margin} = \frac{\text{Operating Income}}{\text{Sales}}$$

Profitability Ratios (2 of 2)

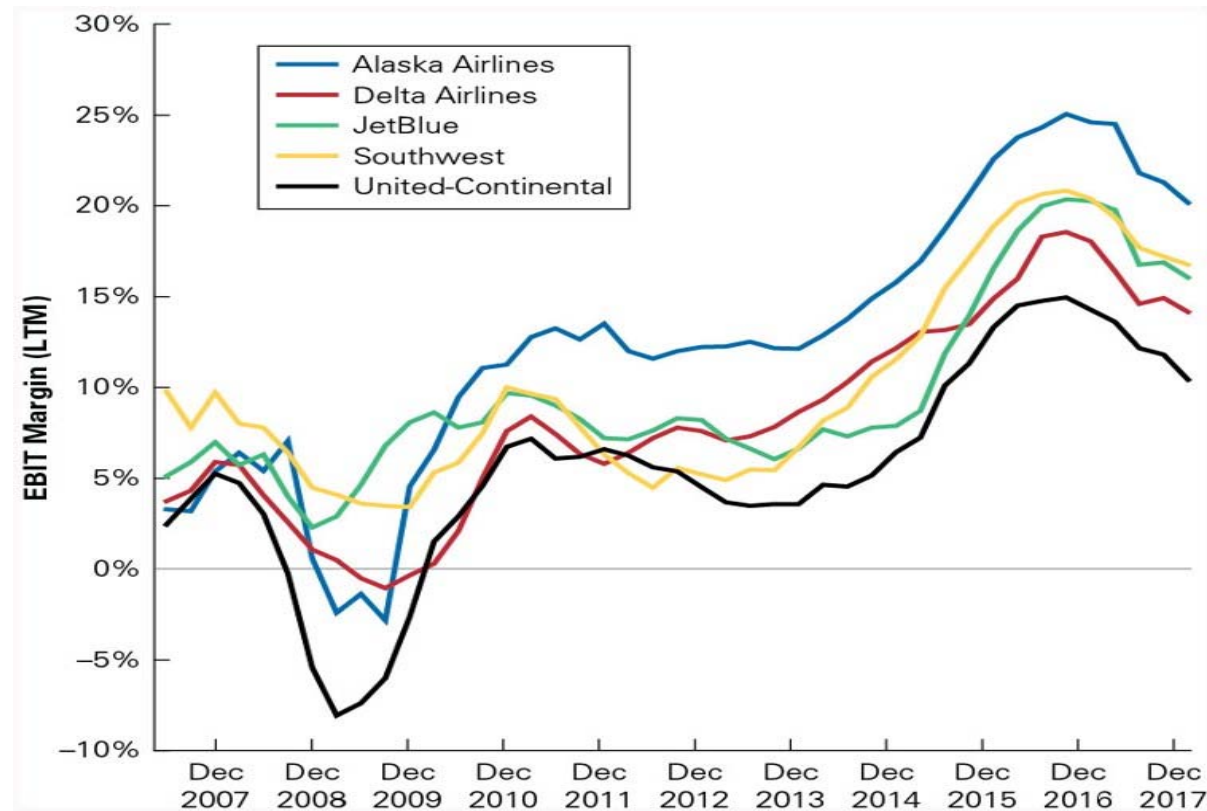
- EBIT Margin

$$\text{EBIT Margin} = \frac{\text{EBIT}}{\text{Sales}}$$

- Net Profit Margin

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

Figure 2.1 EBIT Margins for Five U.S. Airlines



Source: Capital IQ

Liquidity Ratios

- Current Ratio

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

- Quick Ratio

$$\frac{(\text{Cash} + \text{Short-Term Investments} + \text{A/R})}{\text{Current Liabilities}}$$

- Cash Ratio

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

Textbook Example 2.4 (1 of 2)

Computing Liquidity Ratios

Problem

Calculate Global's quick ratio and cash ratio. Based on these measures, how has its liquidity changed between 2017 and 2018?

Textbook Example 2.4 (2 of 2)

Solution

In 2017, Global's quick ratio was $(19.5 + 13.2)/44 = 0.74$ and its cash ratio was $19.5/44 = 0.44$. In 2018, these ratios were 0.83 and $21.2/48 = 0.44$, respectively. Thus, Global's cash ratio remained stable over this period, while its quick ratio improved slightly. But although these liquidity measures have not deteriorated, a more worrisome indicator for investors regarding Global's liquidity might be its ongoing negative cash flow from operating and investing activities, shown in the statement of cash flows.

Working Capital Ratios (1 of 2)

- Accounts Receivable Days

$$\text{Accounts Receivable Days} = \frac{\text{Accounts Receivable}}{\text{Average Daily Sales}}$$

- Accounts Payable Days

$$\text{Accounts Payable Days} = \frac{\text{Accounts Payable}}{\text{Average Daily Cost of Sales}}$$

- Inventory Days

$$\text{Inventory Days} = \frac{\text{Inventory}}{\text{Average Daily Cost of Sales}}$$

Working Capital Ratios (2 of 2)

- Accounts Receivable Turnover

$$\text{Accounts Receivable Turnover} = \frac{\text{Annual Sales}}{\text{Accounts Receivable}}$$

- Accounts Payable Turnover

$$\text{Accounts Payable Turnover} = \frac{\text{Annual Cost of Sales}}{\text{Accounts Payable}}$$

- Inventory Turnover

$$\text{Inventory Turnover} = \frac{\text{Annual Cost of Sales}}{\text{Inventory}}$$

Interest Coverage Ratios

- EBIT/Interest
- EBITDA/Interest
 - $\text{EBITDA} = \text{EBIT} + \text{Depreciation and Amortization}$

Textbook Example 2.5 (1 of 2)

Computing Interest Coverage Ratios

Problem

Assess Global's ability to meet its interest obligations by calculating interest coverage ratios using both EBIT and EBITDA

Textbook Example 2.5 (2 of 2)

- **Solution**

In 2017 and 2018, Global had the following interest coverage ratios:

$$2017: \frac{\text{EBIT}}{\text{Interest}} = \frac{7.1}{4.6} = 1.54 \text{ and } \frac{\text{EBITDA}}{\text{Interest}} = \frac{7.1+1.1}{4.6} = 1.78$$

$$2018: \frac{\text{EBIT}}{\text{Interest}} = \frac{10.4}{7.7} = 1.35 \text{ and } \frac{\text{EBITDA}}{\text{Interest}} = \frac{10.4 + 1.2}{7.7} = 1.51$$

In this case Global's low—and declining—interest coverage could be a source of concern for its creditors.

Leverage Ratios (1 of 2)

- Debt-Equity Ratio

$$\text{Debt-Equity Ratio} = \frac{\text{Total Debt}}{\text{Total Equity}}$$

- Debt-to-Capital Ratio

$$\text{Debt-to-Capital Ratio} = \frac{\text{Total Debt}}{\text{Total Equity} + \text{Total Debt}}$$

Leverage Ratios (2 of 2)

- Net Debt
 - Total Debt - Excess Cash & Short-Term Investments
- Debt-to-Enterprise Value

$$\text{Debt-to-Enterprise Value Ratio} = \frac{\text{Net Debt}}{\text{Market Value of Equity} + \text{Net Debt}}$$

- Equity Multiplier

$$\frac{\text{Total Assets}}{\text{Book Value of Equity}}$$

Valuation Ratios

- P/E Ratio

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

- Enterprise Value to EBIT

$$\text{Enterprise Value to EBIT} = \frac{\text{Market Value of Equity} + \text{Debt} - \text{Cash}}{\text{EBIT}}$$

- Enterprise Value to Sales

$$\text{Enterprise Value to Sales} = \frac{\text{Market Value of Equity} + \text{Debt} - \text{Cash}}{\text{Sales}}$$

Textbook Example 2.6 (1 of 3)

Computing Profitability and Valuation Ratios

Problem

Consider the following data as of February 2017 for Walmart and Target Corporation (in \$ billion):

	Walmart (WMT)	Target (TGT)
Sales	485.9	69.5
EBIT	22.8	5.0
Depreciation and Amortization	10.1	2.3
Net Income	13.6	2.7
Market Capitalization	213.2	37.1
Cash	6.9	2.5
Debt	46.6	12.7

Compare Walmart's and Target's EBIT margins, net profit margins, P/Eratios, and the ratio of enterprise value to sales, EBIT, and EBITDA.

Textbook Example 2.6 (2 of 3)

Solution

Walmart had an EBIT Margin of $22.8 / 485.9 = 4.7\%$,
a net profit margin of $13.6 / 485.9 = 2.8\%$, and a P/E ratio of
 $213.2 / 13.6 = 15.7$.

Its enterprise value was $213.2 + 46.6 - 6.9 = \$252.9$ billion,
which has a ratio of $252.9 / 485.9 = 0.52$ to sales,
 $252.9 / 22.8 = 11.1$ to EBIT, and $252.9 / (22.8 + 10.1) = 7.7$ to EBITDA.

Textbook Example 2.6 (3 of 3)

Solution

Target had an EBIT margin of $5.0/69.5 = 7.2\%$, a net profit margin of $2.7/69.5 = 3.9\%$, and a P/E ratio of $37.1/2.7 = 13.7$.

Its enterprise value was $37.1 + 12.7 - 2.5 = \$47.3$ billion, which has a ratio of $47.3/69.5 = 0.68$ to sales, $47.3/5 = 9.5$ to EBIT, and $47.3/(5 + 2.3) = 6.5$ to EBITDA.

Note that despite the large difference in the size of the two firms, their valuation multiples are comparable. Walmart trades at a somewhat higher earnings multiple, whereas Target trades at a higher multiple of sales (likely due to its higher profit margin).

Operating Returns

- Return on Equity

$$\text{Return on Equity} = \frac{\text{Net Income}}{\text{Book Value of Equity}}$$

- Return on Assets

$$\text{Return on Assets} = \frac{\text{Net Income} + \text{Interest Expense}}{\text{Book Value of Assets}}$$

- Return on Invested Capital

$$\text{Return on Invested Capital} = \frac{\text{EBIT} (1 - \text{Tax Rate})}{\text{Book Value of Equity} + \text{Net Debt}}$$

Textbook Example 2.7 (1 of 3)

Computing Operating Returns

Problem

Assess how Global's ability to use its assets effectively has changed in the last year by computing the change in its return on invested capital.

Textbook Example 2.7 (2 of 3)

Solution

In 2018, Global's ROA was $(2.0 + 7.7)/177.7 = 5.5\%$, compared to an ROA in 2017 of $(1.9 + 4.6)/148.9 = 4.4\%$.

To compute the return on invested capital, we need to calculate after-tax EBIT, which requires an estimate of Global's tax rate. Because

$\text{Net income} = \text{Pretax Income} \times (1 - \text{Tax Rate})$, we can estimate $(1 - \text{Tax Rate}) = \text{Net Income} / \text{Pretax Income}$.

Thus, $\text{EBIT} \times (1 - \text{Tax Rate}) = 10.4 \times (2.0/2.7) = 7.7$ in 2018, and $7.1 \times (1.9/2.5) = 5.4$ in 2017.

Textbook Example 2.7 (3 of 3)

Solution

To compute invested capital, note first that Global's net debt was $3.2 + 12.3 + 76.3 - 19.5 = 72.3$ in 2017 and $3.5 + 13.3 + 99.9 - 21.2 = 95.5$ in 2018. Thus, ROIC in 2018 was $7.7 / (22.2 + 95.5) = 6.5\%$, compared with $5.4 / (21.2 + 72.3) = 5.8\%$ in 2017.

The improvement in Global's ROA and ROIC from 2017 to 2018 suggests that Global was able to use its assets more effectively and increase its return over this period.

The DuPont Identity

- Expresses the ROE in terms of the firm's profitability, asset efficiency, and leverage

$$\text{ROE} = \underbrace{\left(\frac{\text{Net Income}}{\text{Sales}} \right)}_{\text{Net Profit Margin}} \times \underbrace{\left(\frac{\text{Sales}}{\text{Total Assets}} \right)}_{\text{Asset Turnover}} \times \underbrace{\left(\frac{\text{Total Assets}}{\text{Book Value of Equity}} \right)}_{\text{Equity Multiplier}}$$

Table 2.4 Key Financial Ratios for Large U.S. Firms, Spring 2018

Profitability Ratios		Leverage Ratios (continued)	
Gross Margin [28%, 43%, 67%]	$\frac{\text{Gross Profit}}{\text{Sales}}$	Debt-to-Capital Ratio [20%, 40%, 57%]	$\frac{\text{Total Debt}}{\text{Total Equity} + \text{Total Debt}}$
Operating Margin [6%, 12%, 22%]	$\frac{\text{Operating Income}}{\text{Sales}}$	Debt-to-Enterprise Value Ratio [-3%, 10%, 25%]	$\frac{\text{Net Debt}}{\text{Enterprise Value}}$
EBIT Margin [5%, 11%, 18%]	$\frac{\text{EBIT}}{\text{Sales}}$	Equity Multiplier (book) [1.8x, 2.5x, 4.3x]	$\frac{\text{Total Assets}}{\text{Book Value of Equity}}$
Net Profit Margin [2%, 7%, 15%]	$\frac{\text{Net Income}}{\text{Sales}}$	Equity Multiplier (market) [1.0x, 1.1x, 1.4x]	$\frac{\text{Enterprise Value}}{\text{Market Value of Equity}}$
Liquidity Ratios		Valuation Ratios	
Current Ratio [1.2x, 1.8x, 2.9x]	$\frac{\text{Current Assets}}{\text{Current Liabilities}}$	Market-to-Book Ratio [1.8x, 3.1x, 6.1x]	$\frac{\text{Market Value of Equity}}{\text{Book Value of Equity}}$
Quick Ratio [0.7x, 1.2x, 2.0x]	$\frac{\text{Cash \& Short-term Investments} + \text{Accounts Receivable}}{\text{Current Liabilities}}$	Price-Earnings Ratio [16.1x, 23.7x, 37.9x]	$\frac{\text{Share Price}}{\text{Earnings per Share}}$
Cash Ratio [0.1x, 0.4x, 0.9x]	$\frac{\text{Cash}}{\text{Current Liabilities}}$	Enterprise Value to Sales [1.5x, 2.7x, 5.0x]	$\frac{\text{Enterprise Value}}{\text{Sales}}$
Working Capital Ratios		Enterprise Value to EBIT [13.9x, 18.3x, 26.9x]	$\frac{\text{Enterprise Value}}{\text{EBIT}}$
Accounts Receivable Days [33, 51, 68]	$\frac{\text{Accounts Receivable}}{\text{Average Daily Sales}}$	Enterprise Value to EBITDA [9.9x, 13.0x, 18.3x]	$\frac{\text{Enterprise Value}}{\text{EBITDA}}$
Accounts Payable Days [26, 43, 65]	$\frac{\text{Accounts Payable}}{\text{Average Daily Cost of Sales}}$	Operating Returns	
Inventory Days [28, 59, 96]	$\frac{\text{Inventory}}{\text{Average Daily Cost of Sales}}$	Asset Turnover [0.3x, 0.6x, 1.0x]	$\frac{\text{Sales}}{\text{Total Assets}}$
Interest Coverage Ratios		Return on Equity (ROE) [3%, 10%, 18%]	$\frac{\text{Net Income}}{\text{Book Value of Equity}}$
EBIT/Interest Coverage [2.5x, 5.7x, 12.8x]	$\frac{\text{EBIT}}{\text{Interest Expense}}$	Return on Assets (ROA) [-1%, 3%, 7%]	$\frac{\text{Net Income} + \text{Interest Expense}}{\text{Book Value of Assets}}$
EBITDA/Interest Coverage [4.7x, 8.6x, 17.1x]	$\frac{\text{EBITDA}}{\text{Interest Expense}}$	Return on Invested Capital (ROIC) [6%, 12%, 20%]	$\frac{\text{EBIT} (1 - \text{Tax Rate})}{\text{Book Value of Equity} + \text{Net Debt}}$
Leverage Ratios			
Debt-Equity Ratio (book) [24%, 62%, 124%]	$\frac{\text{Total Debt}}{\text{Book Value of Equity}}$		
Debt-Equity Ratio (market) [6%, 21%, 47%]	$\frac{\text{Total Debt}}{\text{Market Value of Equity}}$		

2.7 Financial Reporting in Practice

- Even with safeguards, reporting abuses still happen:
 - Enron
 - WorldCom
 - Sarbanes-Oxley Act (SOX)
 - Dodd-Frank Act