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FINANCIAL RATIO ANALYSIS

THE COMPLETE FINANCIAL STATEMENT ANALYSIS

MODULE 2: THE INCOME STATEMENT RATIOS

LEARNING MATERIAL – TAKEAWAY NOTE

DISCLAIMER

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THANK YOU!

Hello friends,

Congratulations! You've completed the Module 2 – The Income Statement Ratios. This is a learning note that we've prepared for you. It includes all key information in the lectures. You can take it away and revise the course from anywhere, on any device and at anytime you want.

If you have any concern about the lectures, feel free to send us a message, we are always here to help you!

Best regards,

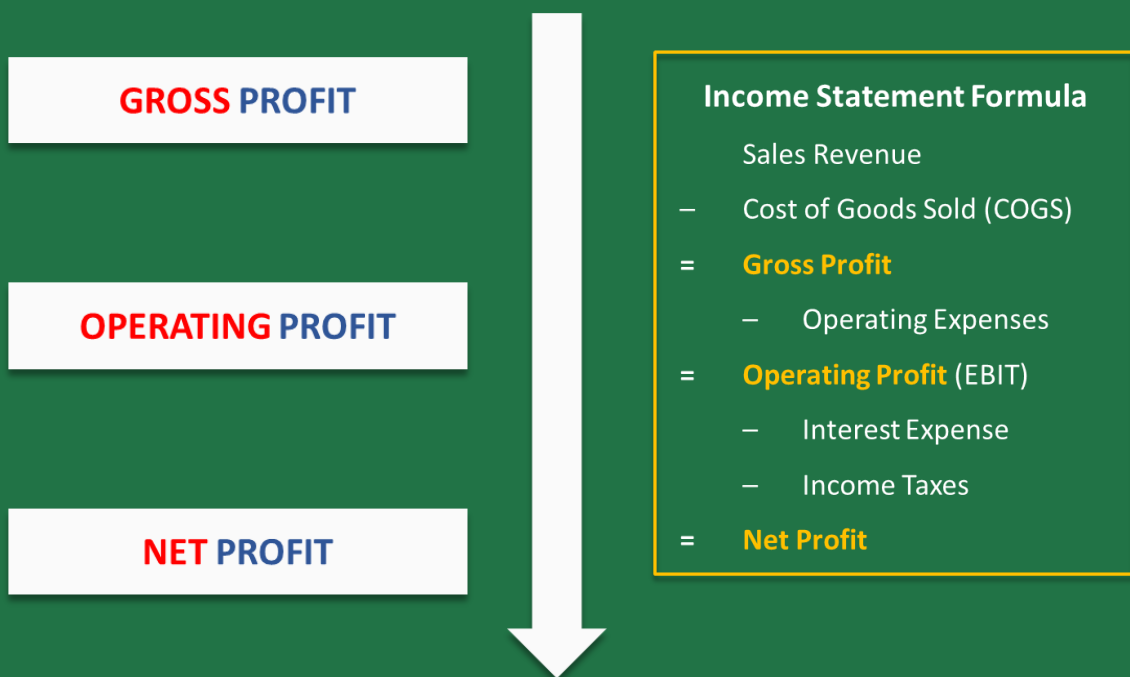
Wealthy Education Team.

INCOME STATEMENT FORMULA

Income Statement Formula

$$\begin{aligned} & \text{Sales Revenue} \\ - & \text{Cost of Goods Sold (COGS)} \\ = & \text{Gross Profit} \\ & - \text{Operating Expenses} \\ = & \text{Operating Income} \\ & - \text{Interest Expense} \\ & - \text{Income Taxes} \\ = & \text{Net Income (after taxes)} \end{aligned}$$

INCOME VALUATION RATIOS



GROSS PROFIT MARGIN RATIO

$$\text{Gross Profit Margin} = \frac{\text{Sales Revenue} - \text{COGS}}{\text{Sales Revenue}}$$

Cost of Revenue (with an arrow pointing to COGS)

❖ The higher the result, the higher a profit that business is earning from selling its goods or services.

➔ **Eliminate all businesses with a negative GPM ratio**

OPERATING PROFIT MARGIN RATIO

Gross Profit – Operating Expenses


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

- ❖ The higher the result, the more of a firm's revenues are left over to pay non-operational costs, such as interest payments, etc.

➔ **Eliminate all businesses with a negative OPM ratio**

NET PROFIT MARGIN RATIO

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

Operating Profit – Other Expenses



- ❖ The result illustrates both how profitable a company is, and how efficiently it's being run by its management team.

➔ **Eliminate all businesses with a negative NPM ratio**

RELATIONSHIP BETWEEN REVENUE & NET INCOME

Rule of Thumb:

If a company's Net Income has been growing
over the past 3-5 years,
its Sales Revenue must grow as well.

WORKING CAPITAL

- ❖ **Working Capital** = the amount of cash left over after its current debts have been subtracted from its current assets.

$$\text{Working Capital} = \text{Accounts Receivable} + \text{Inventory} - \text{Accounts Payable}$$

- ❖ Accounts Receivable & Inventory (Balance sheet, current assets)
- ❖ Accounts Payable (Balance sheet, current liabilities)

SALES TO WORKING CAPITAL

❖ **Decrease in Sales:**

- ☐ The company has tightened its credit policy
- ☐ The company has reduced its inventory level

❖ **Increase in Sales:**

- ☐ The company has loosened its credit policy
- ☐ The company has increased its inventory level

LIMITATIONS OF SALES TO WORKING CAPITAL RATIO

- ❖ Cannot be used for evaluating companies with a negative WC

- ☐ Negative WC = Current Liabilities exceed Current Assets

➔ **Avoid companies with a negative working capital**

- ❖ This is not always true:

- ☐ Decrease in sales = Increase in the Sales to WC ratio

- ☐ Increase in sales = Decrease in the Sales to WC ratio

EARNINGS PER SHARE (EPS)

- ❖ The EPS tells us how much of a company's net earnings are available to be paid out to shareholders as dividends.

$$\text{Earnings per Share} = \frac{\text{Net Income} - \text{Preferred Dividends}}{\text{Number of Shares Outstanding}}$$

- ❖ **Criterion:** Most recent quarter's EPS should be higher than the EPS reported on the same quarter of the previous year.

COMMON SIZE ANALYSIS

- ❖ Two important reasons for using the common size analysis:
 - ❑ Compare a company's financial performance with that of its competitors in the same industry
 - ❑ Compare a company's financial performance for the current year with that of previous years

➔ What Does Common-Size Analysis Reveal?

COMMON SIZE ANALYSIS

- ❖ Using common-size analysis will help you:
 - ❑ Spot performance trends
 - ❑ Highlight various strategies that your business is using to generate sales, or increase its market share
- ❖ The Balance Sheet, the Income Statement, and the Cash Flow Statement can be converted into their common-size counterpart



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THANK YOU!

FOR MORE INFORMATION:

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