

Dr. Minor: Financial Statement Analysis
Van Horne Chapter 6. Financial Statement Analysis and
Berk Chapter 2. Introduction to Financial Statement Analysis

Earnings per Share = Net Income/No. of shares of common stock = 91/45 = 2.02

Assume Basket Wonders has 45 million outstanding shares

Reported quarterly, Earnings per Share are generally considered to be one of the most important variables in determining a share's price. Earnings per share are an important barometer to gauge a company's profitability per unit of shareholder ownership. There are two shortcomings to EPS:

1. Because companies have the option to buy back their own shares, they can improve their earnings per share by reducing their number of shares outstanding without actually increasing their net income.
2. Earnings per share does not consider the capital needed to generate the earnings in question.

Financial Statement Analysis Summary

1. Ratio Analysis

Expression of logical relationships between items in a financial statement of a single period (e.g., percentage relationship between revenue and net income)

Categories of Ratios
Balance Sheet Ratios

Liquidity Ratios

- Current Ratio
- Acid-Test (Quick)

Financial Leverage Ratios (Long-Term Solvency)

- Debt-to-Equity
- Debt-to-Total Assets
- Total Capitalization

Income Statement Ratios

Coverage Ratios

- Interest Coverage

Income Statement/Balance Sheet Ratios

Activity ratios

- Receivable Turnover
- Average Collection Period
- Payable Turnover (PT)
- PT in Days
- Inventory Turnover
- Total Asset Turnover

Profitability Ratios

- Net Profit Margin
- Return on Investment
- Return on Equity
- Earnings per Share

2. Horizontal Analysis

Using comparative financial statements to calculate dollar or percentage changes in a financial statement item from one period to the next.

3. Vertical Analysis

For a single financial statement, each item is expressed as a percentage of a significant total, e.g., all income statement items are expressed as a percentage of sales.

4. Common-Size Analysis

An analysis of percentage financial statements where all balance sheet items are divided by total assets and all income statement items are divided by net sales or revenues. Financial statements that show only percentages and no absolute dollar amounts.

5. Trend Percentages

Show changes over time in given financial statement items (can help evaluate financial information of several years)

6. Index Analysis

An analysis of percentage financial statements where all balance sheet or income statement figures for a base year equal 100.0 (percent) and subsequent financial statement items are expressed as percentages of their values in the base year.

Firm Financial Reporting

What's contained in a firm's financial statements?

- 1) Cover Page
- 2) Income Statement
- 3) Balance Sheet (Assets & Liabilities)
- 4) Cash Flows
- 5) Notes

Sources of Information for Financial Analysis

Published Annual Reports

1. Financial statements
2. Notes to financial statements
3. Letters to stockholders
4. Auditor's report (Independent accountants)
5. Management's discussion and analysis

Financial Statements Filed with the SEC

1. 10Q/Quarterly
2. 10K/Annual
3. Form 8-K

How do we know the firm is not "cooking" the books?

We rely on external auditors. **Auditors** are neutral third parties that checks a firm's financial statements.