### Chapter 3

· Working With Financial Statements

- Financial Analyst use different tools to analyse the financial position of the company
  - Financial ratio analysis is a way to analyse and evaluate a company's performance.

3-1

### Ratio Analysis

- Know how to compute and interpret important financial ratios
- The ratio must be compared with other firms, or averages, in the same industry during the same time period.
  - Ratios allow for better comparison of the financial performance of the company;
    - through time (current and past performance of the company)
    - between companies
    - or between firms different divisions
- Ratios are used both internally and externally

future cash flows

• External uses

Creditors

Internal uses

- Suppliers
- Customers

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### **Categories of Financial Ratios**

- 1. Short-term Solvency (Liquidity Ratios)
- 2. Long-term Solvency (Financial Leverage Ratios)
- 3. Asset Management (Turnover Ratios)
- 4. Profitability Ratios
- 5. Market Value Ratios

Acceptability of values depends on the industry in which the firm operates.

# 1. Liquidity Ratios (Short-Term Solvency)

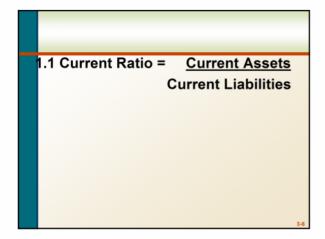
Performance evaluation – compensation and

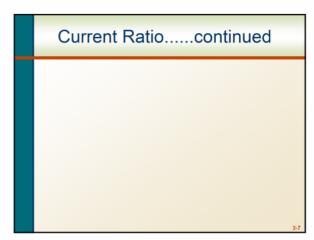
Planning for the future – guide in estimating

comparison between divisions

- Measures capacity to meet S-T liabilities out of its liquid assets (i.e. ability to pay bills in the short-run)
  - These ratios focus on c/a and c/l, which are converted to cash within 12 months
  - S-T creditor (bankers and other S-T lenders) are interested in these ratios.
    - Current Ratio
    - Quick Ratio
    - Cash Ratio

2.0

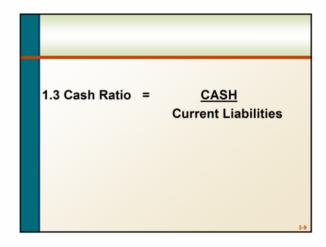




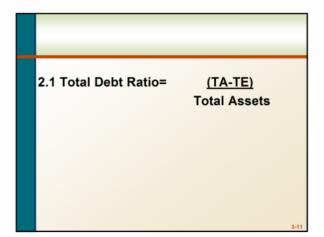
1.2 Quick Ratio =

(Current Assets-Inventory)

Current Liabilities



2. Leverage ratios (Long-Term Solvency Measure)



Eg. 0.475 : 47.5%	
3-12	2.2 Debt To Equity Ratio = <u>Tot. Debt</u> Tot. Equity

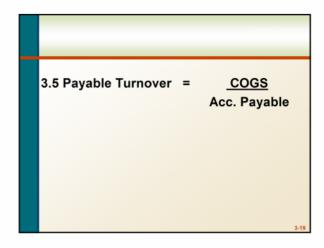
2.3 Times Interest Earned = <u>EBIT</u> Interest 3. Asset Management or Turnover Ratios (Activity Ratios)

"How effective is the company to using its assets"

3.1 Inventory Turnover = COGS Inventory

3.2 Days' sales in = 365
Inventory Inventory Turnover

3.3 Receivables Turnover = <u>Sales</u> Acc. Rec. 3.4 Days' sales in = 365
receivables Rec. Turn.
Turnover



3.6 Days Sales in = <u>365</u> Payable Payable Turnover 3.7 Total Asset Turnover = <u>Sales</u>
Total Assets

3.8 Fixed Asset Turnover = <u>Sales</u>
Net Fixed Assets

4. Profitability Ratios

"Measures the success of the firm in earning, such as return on sales, return on asset employed or return on the level of equity investment"

4.1 Profitability Margin = Net Income Sales

4.2 Return on Assets (ROA) = Net Income
Tot. Assets

4.3 Return on Equity (ROE) = <u>Net Income</u> Tot. Equity

#### 5. Market Measures

5.1 Earning Per Share (EPS) =

Number of shares outstanding

5.2 Price Earning Ratio =

<u>Market Price per share</u>

EPS

5.3 Market to Book Value = MV per share
BV per share

BV per share = <u>Total Equity</u>
 the number of shares outstanding

Eg. Market to Book Value=1.40

3.28

## Suggested Problems

• 1-4, 6, 10, 17,19, 26.