

Chapter 3 Lecture - Working with Financial Statements

Chapter 3 Lecture - Working with Financial Statements



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Learning Objectives

After studying this chapter, you should be able to:

LO 1 Standardize financial statements for comparison purposes.

LO 2 Compute and, more important, interpret some common ratios.

LO 3 Assess the determinants of a firm's profitability and growth.

LO 4 Identify and explain some of the problems and pitfalls in financial statement analysis.

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Standardized Financial Statements

- **Common-Size Balance Sheets**
 - All accounts = percent of total assets (%TA)
- **Common-Size Income Statements**
 - All line items = percent of sales or revenue (%SLS)
- **Standardized statements are useful for:**
 - Comparing financial information year-to-year
 - Comparing companies of different sizes, particularly within the same industry

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Prufrock Corporation Balance Sheets

PRUFROCK CORPORATION Balance Sheets as of December 31, 2015 and 2016 (\$ in millions)			TABLE 3.1	
	2015	2016		
Assets				
Current assets				
Cash	\$ 84	\$ 98		
Accounts receivable	165	188		
Inventory	393	422		
Total	\$ 642	\$ 708		
Fixed assets				
Net plant and equipment	\$2,731	\$2,880		
Total assets	\$3,373	\$3,588		
Liabilities and Owners' Equity				
Current liabilities				
Accounts payable	\$ 312	\$ 344		
Notes payable	231	196		
Total	\$ 543	\$ 540		
Long-term debt	\$ 531	\$ 457		
Owners' equity				
Common stock and paid-in surplus	\$ 500	\$ 550		
Retained earnings	1,799	2,041		
Total	\$2,299	\$2,591		
Total liabilities and owners' equity	\$3,373	\$3,588		

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Prufrock Corporation Common-Size Balance Sheets

TABLE 3.2

PRUFROCK CORPORATION Common-Size Balance Sheets December 31, 2015 and 2016			
	2015	2016	Change
Assets			
Current assets			
Cash	2.5%	2.7%	+ .2%
Accounts receivable	4.9	5.2	+ .3
Inventory	11.7	11.8	+ .1
Total	19.0	19.7	+ .7
Fixed assets			
Net plant and equipment	81.0	80.3	– .7
Total assets	100.0%	100.0%	0%
Liabilities and Owners' Equity			
Current liabilities			
Accounts payable	9.2%	9.6%	+ .3%
Notes payable	6.8	5.5	– 1.4
Total	16.1	15.1	– 1.0
Long-term debt	15.7	12.7	– 3.0
Owners' equity			
Common stock and paid-in surplus	14.8	15.3	+ .5
Retained earnings	53.3	56.9	+ 3.5
Total	68.2	72.2	+ 4.1
Total liabilities and owners' equity	100.0%	100.0%	0%

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Prufrock Corporation Income Statement

TABLE 3.3

PRUFROCK CORPORATION 2016 Income Statement (\$ in millions)	
Sales	\$2,311
Cost of goods sold	1,344
Depreciation	276
Earnings before interest and taxes	\$ 691
Interest paid	141
Taxable income	\$ 550
Taxes (34%)	187
Net income	\$ 363
Dividends	\$121
Addition to retained earnings	242

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Prufrock Corporation Common-Size Income Statement

PRUFROCK CORPORATION Common-Size Income Statement 2016	
Sales	100.0%
Cost of goods sold	58.2
Depreciation	11.9
Earnings before interest and taxes	29.9
Interest paid	6.1
Taxable income	23.8
Taxes (34%)	8.1
Net income	15.7%
Dividends	5.2%
Addition to retained earnings	10.5

Tells us what happened to each dollar of sales

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Ratio Analysis

- Allow for better comparison through time or between companies
- Used both internally and externally
- For each ratio, ask yourself:
 - What the ratio is trying to measure
 - Why that information is important

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Categories of Financial Ratios

- **Liquidity ratios** or Short-term solvency
- **Financial leverage ratios** or Long-term solvency ratios
- **Asset management** or Turnover ratios
- **Profitability ratios**
- **Market value ratios**

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Common Financial Ratios

I. Short-term solvency, or liquidity, ratios		Days' sales in receivables = $\frac{365 \text{ days}}{\text{Receivables turnover}}$	
Current ratio = $\frac{\text{Current assets}}{\text{Current liabilities}}$		Days' costs in payables = $\frac{\text{Payables turnover}}{365 \text{ days}}$	
Quick ratio = $\frac{\text{Current assets} - \text{Inventory}}{\text{Current liabilities}}$		Total asset turnover = $\frac{\text{Sales}}{\text{Total assets}}$	
Cash ratio = $\frac{\text{Cash}}{\text{Current liabilities}}$		Capital intensity = $\frac{\text{Total assets}}{\text{Sales}}$	
II. Long-term solvency, or financial leverage, ratios		IV. Profitability ratios	
Total debt ratio = $\frac{\text{Total assets} - \text{Total equity}}{\text{Total assets}}$		Profit margin = $\frac{\text{Net Income}}{\text{Sales}}$	
Debt-equity ratio = $\frac{\text{Total debt}}{\text{Total equity}}$		Return on assets (ROA) = $\frac{\text{Net income}}{\text{Total assets}}$	
Equity multiplier = $\frac{\text{Total assets}}{\text{Total equity}}$		Return on equity (ROE) = $\frac{\text{Net income}}{\text{Total equity}}$	
Times interest earned ratio = $\frac{\text{EBIT}}{\text{Interest}}$		ROE = $\frac{\text{Net income}}{\text{Sales}} \times \frac{\text{Sales}}{\text{Assets}} \times \frac{\text{Assets}}{\text{Equity}}$	
Cash coverage ratio = $\frac{\text{EBIT} + \text{Depreciation}}{\text{Interest}}$		V. Market value ratios	
III. Asset utilization, or turnover, ratios		Price-earnings ratio = $\frac{\text{Price per share}}{\text{Earnings per share}}$	
Inventory turnover = $\frac{\text{Cost of goods sold}}{\text{Inventory}}$		Price-sales ratio = $\frac{\text{Price per share}}{\text{Sales per share}}$	
Days' sales in inventory = $\frac{365 \text{ days}}{\text{Inventory turnover}}$		Market-to-book ratio = $\frac{\text{Market value per share}}{\text{Book value per share}}$	
Receivables turnover = $\frac{\text{Sales}}{\text{Accounts receivable}}$		EBITDA ratio = $\frac{\text{Enterprise value}}{\text{EBITDA}}$	
Payables turnover = $\frac{\text{Cost of goods sold}}{\text{Accounts payable}}$			

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Liquidity Ratios

PRUFROCK Balance Sheet - 2016			
ASSETS		Liabilities & Owners Equity	
Current Assets		Current Liabilities	
Cash	\$ 98	Accounts Payable	\$ 344
Accounts Receivable	\$ 188	Notes Payable	\$ 196
Inventory	\$ 422	Total	\$ 540
Total	\$ 708	Long term debt	\$ 457
		Owners' Equity	
Fixed Assets		Common Stock and paid in surplus	\$ 550
Net Plant & Equipment	\$ 2,880	Retained Earnings	\$ 2,041
Total Assets	\$ 3,588	Total	\$ 2,591
		Total Liabilities & Owners' Equity	\$ 3,588

- **Current Ratio** = CA / CL
– 708 / 540 = 1.31 times
- **Quick Ratio** = (CA – Inventory) / CL
– “Acid Test”
– (708-422) / 540 = 0.53 times
- **Cash Ratio** = Cash / CL
– 98 / 540 = .18 times

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Financial Leverage Ratios

PRUFROCK Balance Sheet - 2016			
ASSETS		Liabilities & Owners Equity	
Current Assets		Current Liabilities	
Cash	\$ 98	Accounts Payable	\$ 344
Accounts Receivable	\$ 188	Notes Payable	\$ 196
Inventory	\$ 422	Total	\$ 540
Total	\$ 708	Long term debt	\$ 457
		Owners' Equity	
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Net Plant & Equipment	\$ 2,880	Retained Earnings	\$ 2,041
Total Assets	\$ 3,588	Total	\$ 2,591
		Total Liabilities & Owners' Equity	\$ 3,588

- **Total Debt Ratio** = (TA – TE) / TA
– (3,588 – 2,591) / 3,588 = 0.28 times
- **Debt/Equity** = TD / TE
– (0.28 / 0.72) = 0.38 times
- **Equity Multiplier** = TA/TE = 1 + D/E
– (\$1 / 0.72) = (1 + 0.38) = 1.38

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Financial Leverage Ratios

PRUFROCK Income Statement - 2016	
Sales	\$ 2,311
COGS	\$ 1,344
Depreciation	\$ 276
EBIT	\$ 691
Interest	\$ 141
Taxable Income	\$ 550
Taxes	\$ 187
Net Income	\$ 363
Dividends	\$ 121
Addition to RE	\$ 242

- **Times Interest Earned** = EBIT / Interest
– $691 / 141 = 4.9$ times
- **Cash Coverage** = (EBIT + Depreciation) / Interest
– $(691 + 276) / 141 = 6.9$ times

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Asset Management: Inventory Ratios

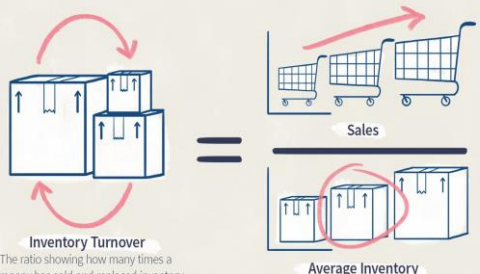
PRUFROCK Balance Sheet - 2016		PRUFROCK Income Statement - 2016	
ASSETS		Liabilities & Owners Equity	
Current Assets		Current Liabilities	
Cash	\$ 98	Accounts Payable	\$ 344
Accounts Receivable	\$ 188	Notes Payable	\$ 196
Inventory	\$ 422	Total	\$ 540
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		Owners' Equity	
		Common Stock and paid in surplus	\$ 550
		Retained Earnings	\$ 2,041
Fixed Assets		Total	\$ 2,591
Net Plant & Equipment	\$ 2,880	Total Liabilities & Owners' Equity	\$ 3,588
Total Assets	\$ 3,588		

- **Inventory Turnover** = COGS / Inventory
– $1,344 / 422 = 3.2$ times
- **Days' Sales in Inventory** = 365 / Inventory Turnover
– $365 / 3.2 = 115$ days

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What Is Inventory Turnover?



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Asset Management: Receivables Ratios

PRUFROCK Balance Sheet - 2016		PRUFROCK Income Statement - 2016	
ASSETS		Liabilities & Owners Equity	
Current Assets		Current Liabilities	
Cash	\$ 98	Accounts Payable	\$ 344
Accounts Receivable	\$ 188	Notes Payable	\$ 196
Inventory	\$ 422	Total	\$ 540
Total	\$ 708	Long term debt	\$ 457
		Owners' Equity	
		Common Stock and paid in surplus	\$ 550
		Retained Earnings	\$ 2,041
Fixed Assets		Total	\$ 2,591
Net Plant & Equipment	\$ 2,880	Total Liabilities & Owners' Equity	\$ 3,588
Total Assets	\$ 3,588		

- **Receivables Turnover** = Sales / AR
– $2,311 / 188 = 12.3$ times
- **Days' Sales in Receivables** = 365 / Receivables Turnover
– $365 / 12.3 = 30$ days

The accounts receivable turnover ratio is used to measure how effective your company is at collecting accounts receivable (money owed by clients). Typically measured on an annual basis, a high receivables turnover ratio may mean that your company's accounts receivable process is effective, and that you have large numbers of high-quality clients who are happy to pay their debt quickly.

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Asset Management: Payables Ratios

PRUFROCK				PRUFROCK			
Balance Sheet - 2016				Income Statement - 2016			
ASSETS		Liabilities & Owners Equity		Sales		\$ 2,311	
Current Assets		Current Liabilities		COGS		\$ 1,344	
Cash	\$ 98	Accounts Payable	\$ 344	Depreciation	\$ 276		
Accounts Receivable	\$ 188	Notes Payable	\$ 196	EBIT	\$ 691		
Inventory	\$ 422	Total	\$ 540	Interest	\$ 141		
Total	\$ 708	Long term debt	\$ 457	Taxable Income	\$ 550		
		Owners' Equity		Taxes	\$ 187		
		Common Stock and paid in surplus	\$ 550	Net Income	\$ 363		
Fixed Assets		Retained Earnings	\$ 2,041	Dividends	\$ 121		
Net Plant & Equipment	\$ 2,880	Total	\$ 2,591	Addition to RE	\$ 242		
Total Assets	\$ 3,588	Total Liabilities & Owners' Equity	\$ 3,588				

- **Payables Turnover** = COGS / AP
– 1,344 / 344 = 3.9 times
- **Days' Costs in Payables** = 365 / Payables Turnover
– 365 / 3.9 = 94 days

A higher accounts payable ratio indicates that a company pays its bills in a shorter amount of time than those with a lower ratio. Low AP ratios could signal that a company is struggling to pay its bills, but that is not always the case. It could be using its cash strategically.

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Asset Management: Asset Turnover Ratios

PRUFROCK Balance Sheet - 2016				PRUFROCK Income Statement - 2016							
ASSETS				Liabilities & Owners Equity				Sales		\$ 2,311	
Current Assets				Current Liabilities				COGS		\$ 1,344	
Cash	\$ 98			Accounts Payable	\$ 344			Depreciation	\$ 276		
Accounts Receivable	\$ 188			Notes Payable	\$ 196			EBIT	\$ 691		
Inventory	\$ 422			Total	\$ 540			Interest	\$ 141		
Total	\$ 708			Long term debt	\$ 457			Taxable Income	\$ 550		
				Owners' Equity				Taxes	\$ 187		
				Common Stock and paid in surplus	\$ 550			Net Income	\$ 363		
Fixed Assets				Retained Earnings	\$ 2,041			Dividends	\$ 121		
Net Plant & Equipment	\$ 2,880			Total	\$ 2,591			Addition to RE	\$ 242		
Total Assets	\$ 3,588			Total Liabilities & Owners' Equity	\$ 3,588						

- **Total Asset Turnover** = Sales / Total Assets
– 2,311 / 3,588 = 0.64 times
- **Capital Intensity Ratio** = 1/TAT
– 1 / 0.64 = 1.56

Generally, a higher ratio TAT is favored because it implies that the company is efficient in generating sales or revenues from its asset base. A lower ratio indicates that a company is not using its assets efficiently and may have internal problems.

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Profitability Measures

PRUFROCK Balance Sheet - 2016				PRUFROCK Income Statement - 2016			
ASSETS		Liabilities & Owners Equity		Sales		\$ 2,311	
Current Assets		Current Liabilities		COGS		\$ 1,344	
Cash	\$ 98	Accounts Payable	\$ 344	Depreciation	\$ 276		
Accounts Receivable	\$ 188	Notes Payable	\$ 196	EBIT	\$ 691		
Inventory	\$ 422	Total	\$ 540	Interest	\$ 141		
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Net Plant & Equipment	\$ 2,880	Total	\$ 2,591	Addition to RE	\$ 242		
Total Assets	\$ 3,588	Total Liabilities & Owners' Equity	\$ 3,588				

- **Profit Margin** = NI / Sales
= 363 / 2,311 = 15.70%
- **Return on Assets (ROA)** = NI / TA
= 363 / 3,588 = 10.12%
- **Return on Equity (ROE)** = NI / TE
= 363 / 2,591 = 14.01%

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Market Value Measures

- **Market Price** = \$88 per share = PPS
- **Shares outstanding** = 33 million
- **Earnings per Share** = EPS = 363 / 33 = \$11
- **PE ratio** = PPS / EPS
– \$88 / \$11 = 8 times
- **Price/Sales ratio** = PPS/Sales per share
– \$88 / (\$2,311 / 33) = 1.26 times
- **Market-to-book ratio** = PPS / Book value per share
– **Book value per share** = Total Equity/shares outstanding
= \$2,591 / 33 = \$78.52
– **Market-to-Book** = \$88 / 78.52 = 1.12 times

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Market Value Measures

- **Enterprise value = Total market value of the stock + Book value of all liabilities – Cash**

$$EV = (\$88 \times 33) + (3,588 - 2,591) - (98) = 3,803$$

Cash gets subtracted when calculating Enterprise Value because (1) cash is considered a non-operating asset AND (2) cash is already implicitly accounted for within equity value.

- **EBITDA ratio = Enterprise value / EBITDA**

$$\begin{aligned} \text{EBITDA} &= \text{EBIT} + \text{Depreciation \& Amortization} \\ &= (691 + 276) = 967 \end{aligned}$$

$$\text{EBITDA ratio} = (3,803 / 967) = 3.93 \text{ times}$$

As a general guideline, an EV/EBITDA value below 10 is commonly interpreted as healthy and above average by analysts and investors.

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Prufrock Ratios

PRUFROCK RECAP			
Liquidity Ratios		Financial Leverage Ratios	
Current Ratio	1.31	Total Debt Ratio	0.28
Quick Ratio	0.53	Debt to Equity	0.38
Cash Ratio	0.18	Equity Multiplier	1.38
Asset Management Ratios		Times Interest Earned	4.9
Inventory Turnover	3.20	Cash Coverage	6.9
Days' Sales in Inventory	114	Profitability Measures	
Receivables Turnover	12.30	Profit Margin	15.70%
Days' Sales in Receivables	30	ROA	10.10%
Total Asset Turnover	0.64	ROE	14.00%
Capital Intensity Ratio			
Market Value Measures			
Market Price	\$88.00		
Shares Outstanding	33 m	Price/Sales Ratio	1.26
EPS	\$11.00	Book value per share	\$78.52
PE Ratio	8.0	EBITDA Ratio	3.93
Market to Book	1.12		

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Financial Information Example for 2014 for Lowe's and Home Depot (millions of dollars)

	Lowe's	Home Depot
Sales	\$56,226	\$83,176
Net Income	2,698	6,345
Current assets	10,080	15,302
Current liabilities	9,348	7,488
Total assets	31,287	39,946
Total debt	21,589	30,624
Total equity	9,968	9,322
Price per share	67.76	104.43
Book value per share	10.78	7.28
Earnings per share	2.92	4.96
Current ratio	1.08	2.04
Debt-equity ratio	2.19	3.29
Total asset turnover	1.80	2.08
Profit margin	4.80%	7.63%
ROE	27.07%	68.06%
ROA	8.48%	15.88%
Market-to-book ratio	6.29	14.34
Price-earnings ratio	23.23	21.07

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The DuPont Identity

- **Return on Equity = Net Income / Total Equity**
= Basic Formula

- **ROE = PM * TAT * EM = DuPont Identity**

$$\text{PM (profit margin)} = \text{Net Income} / \text{Sales}$$

$$\text{TAT (Total asset turnover)} = \text{Sales} / \text{Total Assets}$$

$$\text{EM (Equity Multiplier)} = \text{Total Assets} / \text{Total Equity}$$

$$ROE = \left(\frac{NI}{Sales} \right) \times \left(\frac{Sales}{TA} \right) \times \left(\frac{TA}{TE} \right) = \frac{NetIncome}{TotalEquity}$$

$$\text{Profit Margin} \quad \text{Asset Use} \quad \text{Leverage} = \text{ROE}$$

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Using the DuPont Identity

- **ROE = PM x TAT x EM**
 - **Profit margin**
 - Measures firm's operating efficiency
 - How well does it control costs
 - **Total asset turnover**
 - Measures the firm's asset use efficiency
 - How well does it manage its assets
 - **Equity multiplier**
 - Measures the firm's financial leverage
 - **EM = TA / TE = 1 + D/E ratio**

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Prufrock's DuPont Identity

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Inventory Turnover	3.20	Cash Coverage	6.9
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Receivables Turnover	12.30	ROA	10.10%
Days' Sales in Receivables	30	ROE	14.00%
Total Asset Turnover	0.64		
Capital Intensity Ratio			
Market Value Measures			
Market Price	\$88.00		
Shares Outstanding	33 m	Price/Sales Ratio	1.26
EPS	\$11.00	Book value per share	\$78.52
PE Ratio	8.0	EBITDA Ratio	3.93
Market to Book	1.12		

- **ROE = PM x TAT x EM**
 - PM = 15.7%
 - TAT = 0.64
 - EM = 1.39
- **ROE = 0.157 x 0.64 x 1.39 = 14%**

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Payout and Retention Ratios

- **Dividend payout ratio = $\frac{\text{Cash Dividends}}{\text{Net Income}}$**
- **Retention ratio or plowback ratio**
= $\frac{\text{Addition to Retained Earnings}}{\text{Net Income}}$

Dividend payout ratio ("1 - b")
Retention ratio ("b")

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Payout and Retention Ratios

PRUFROCK Balance Sheet - 2016				PRUFROCK Income Statement - 2016	
ASSETS		Liabilities & Owners Equity			
Current Assets		Current Liabilities		Sales	\$ 2,311
Cash	\$ 98	Accounts Payable	\$ 344	COGS	\$ 1,344
Accounts Receivable	\$ 188	Notes Payable	\$ 196	Depreciation	\$ 276
Inventory	\$ 422	Total	\$ 540	EBIT	\$ 691
Total	\$ 708	Long term debt	\$ 457	Interest	\$ 141
		Owners' Equity		Taxable Income	\$ 550
		Common Stock and paid in surplus	\$ 550	Taxes	\$ 187
		Retained Earnings	\$ 2,041	Net Income	\$ 363
Fixed Assets		Total	\$ 2,591	Dividends	\$ 121
Net Plant & Equipment	\$ 2,880	Total Liabilities & Owners' Equity	\$ 3,588	Addition to RE	\$ 242
Total Assets	\$ 3,588				

- Dividend payout ratio ("1 - b")
 = Cash dividends / Net income
 = (DIV / NI) = 121 / 363 = 33.3%
- Retention ratio ("b") = (NI - DIV) / NI
 = Addition to Retained Earnings / Net income
 = \$242 / 363 = 66.7%

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Determinants of Growth

- Profit margin – operating efficiency
- Total asset turnover – asset use efficiency
- Financial leverage – choice of optimal debt ratio
- Dividend policy – choice of how much to pay to shareholders versus reinvesting in the firm

Yahoo!						DuPont analysis for Yahoo! and Google
Year	ROE	=	Profit margin	x	Total asset turnover	
2014	.4%	=	3.1%	x	.075	1.60
2013	4.5%	=	12.6%	x	.279	1.29
2012	3.9%	=	11.4%	x	.292	1.17

Google						DuPont analysis for Yahoo! and Google
Year	ROE	=	Profit margin	x	Total asset turnover	
2014	13.8%	=	21.9%	x	.503	1.25
2013	15.3%	=	24.0%	x	.501	1.27
2012	16.1%	=	25.1%	x	.491	1.31

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Why Evaluate Financial Statements?

- Internal uses
 - Performance evaluation
 - compensation and comparison between divisions
 - Planning for the future
 - guide in estimating future cash flows
- External uses
 - Creditors
 - Suppliers
 - Customers
 - Stockholders

Benchmarking

- Ratios need to be compared to something
- Time-Trend Analysis
 - How the firm's performance is changing through time
 - Internal and external uses
- Peer Group Analysis
 - Compare to similar companies or within industries
 - SIC and NAICS codes

<http://siccode.com/en/>

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Problems with Financial Analysis

- Conglomerates
 - No readily available comparables
- Global competitors
- Different accounting procedures
- Different fiscal year ends
- Differences in capital structure
- Seasonal variations and one-time events

Analysts should look beyond the ratios.



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Example: Work the Web

- The Internet makes ratio analysis much easier than it has been in the past
- Click on the Web surfer to go to www.reuters.com or <https://finance.yahoo.com/> or <https://www.investing.com/equities/>
 - Choose a company and enter its ticker symbol
 - Click on “Financial Results” and “Key Ratios” to compare the firm to its industry and the S&P 500 for various ratio categories
 - Change the ratio category using the links to the left of the chart.

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