

Financial Analysis Fundamentals



Learning Objectives



Undertake a comprehensive financial analysis using wide range of ratios



Use ratios to analyze the income statement and profitability.



Look at ratios to analyze operating assets and asset utilization.



Analyze capital structure with ratios.



Recommend how a business can improve operations, capital structure, and asset utilization.

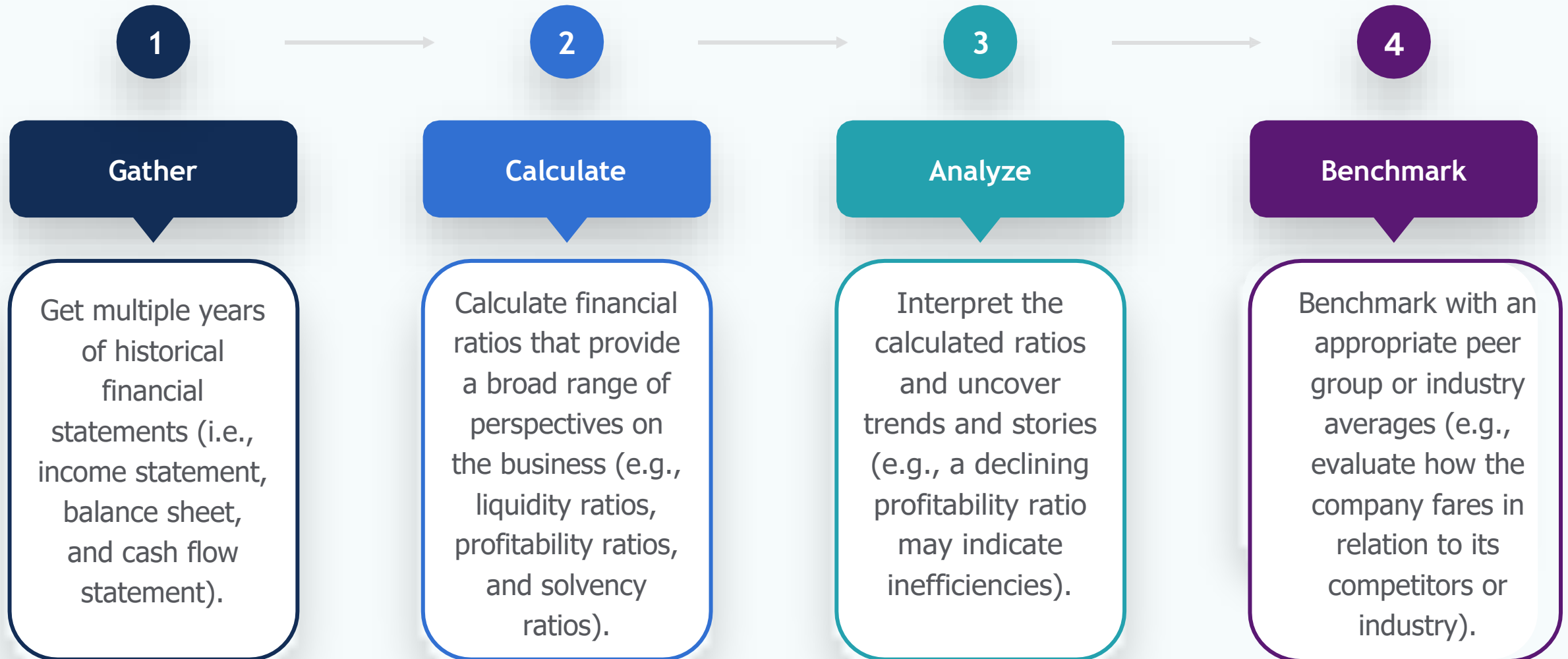


Use the DuPont Pyramid of ratios to get a more comprehensive view of a business.

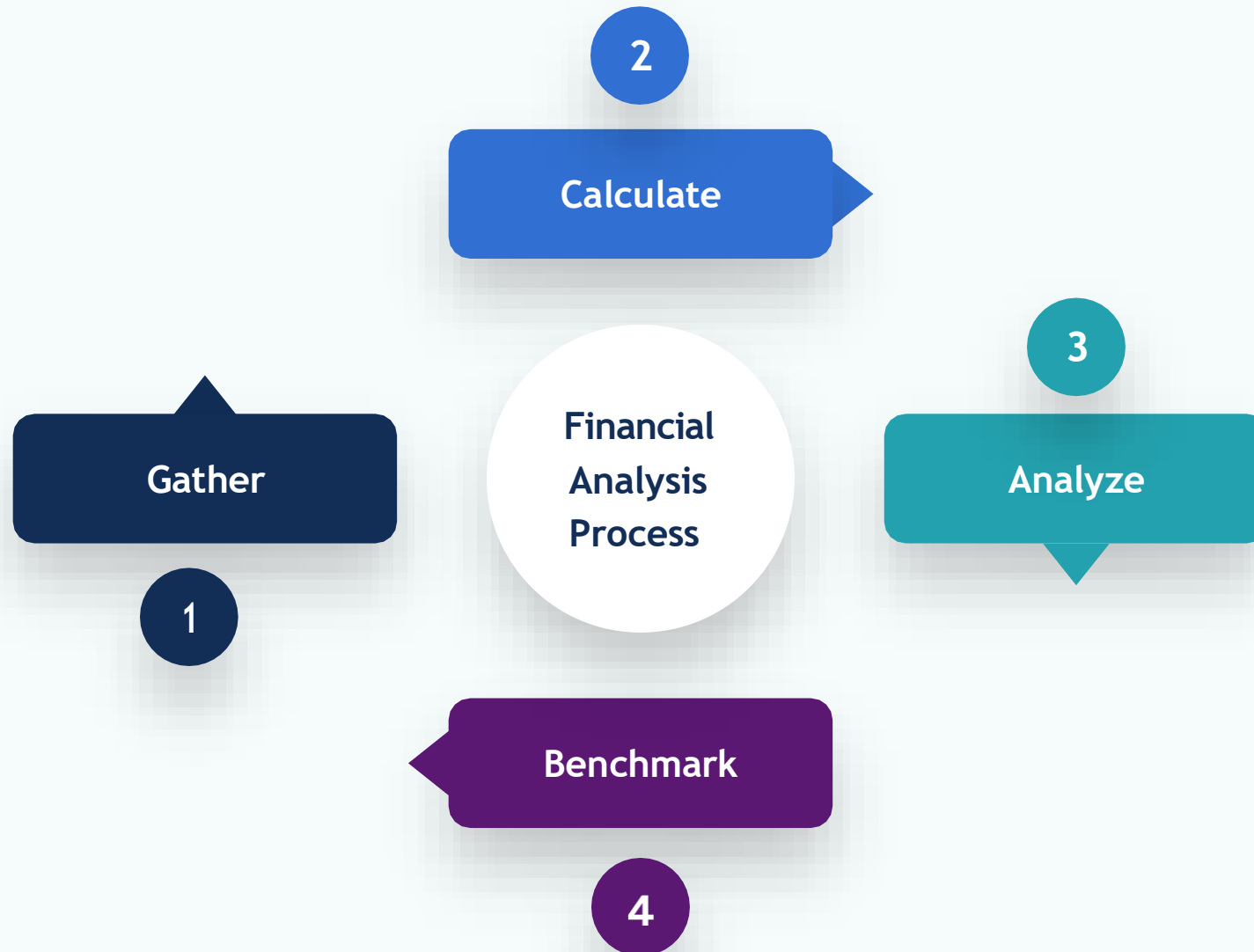
Asset Utilization Analysis



What Is Best Practice Financial Analysis



What Is Best Practice Financial Analysis



Critical Tips for Effective Financial Analysis



- Gather a minimum of five years of historical financial performance to better identify trends over time.



Make your calculations in Excel transparent so that you can trace from financial statements to ratios.



Need to identify an appropriate peer group, which is broader in scope, as it is rare to find two companies that are exactly similar.

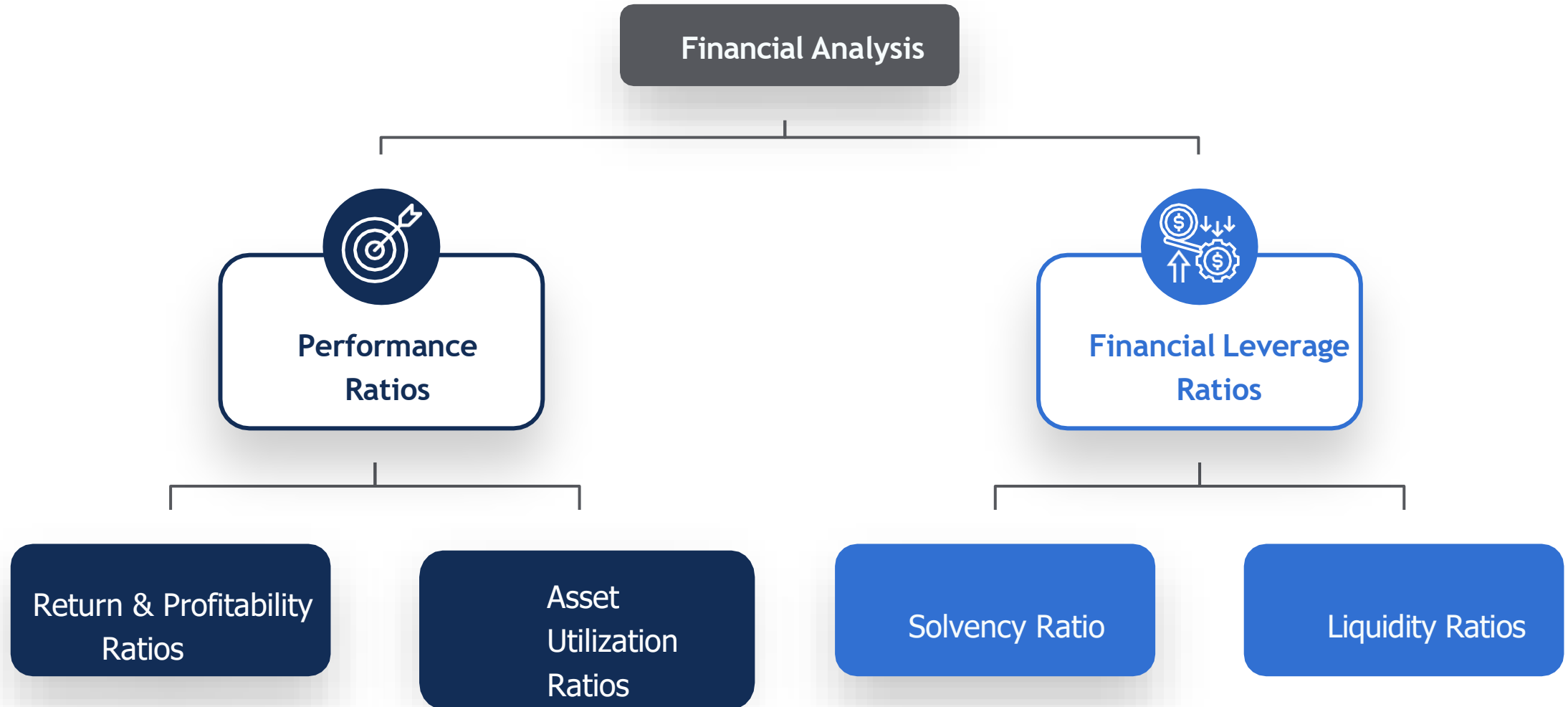


Keep adjustments of ratios to a minimum, as there is more room for error to creep in.



Averages are typically more academically sound, but in practice, virtually everyone uses closing balances.

Financial Analysis Ratio Categories



Quick Recap of the Three Financial Statements

Let's do a quick Recap of the three financial statements.



Income Statement

Revenues

Expenses

Profit Or loss



Balance Sheet

Assets

Liabilities

Equity



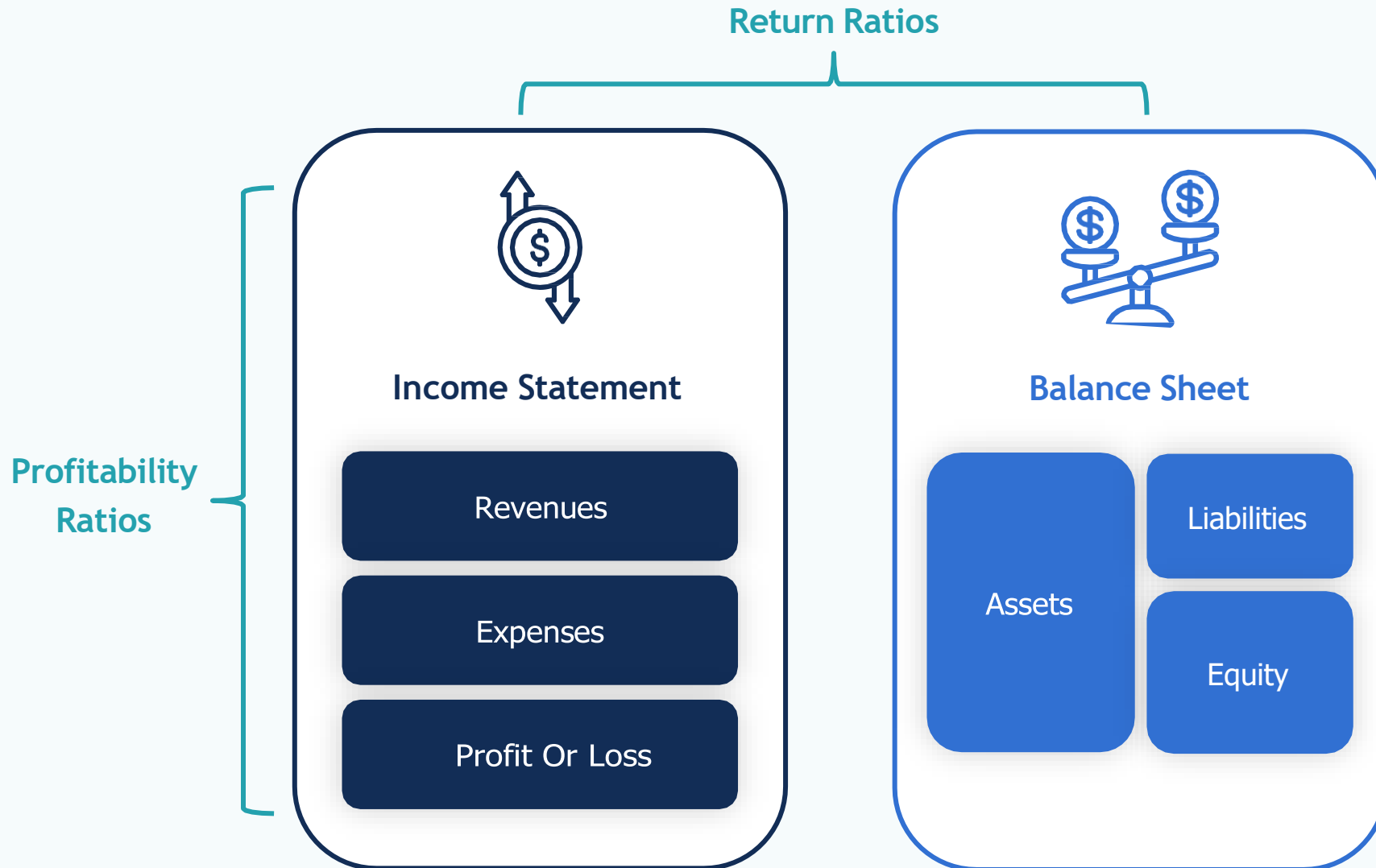
Statement of Cash Flows

Operating

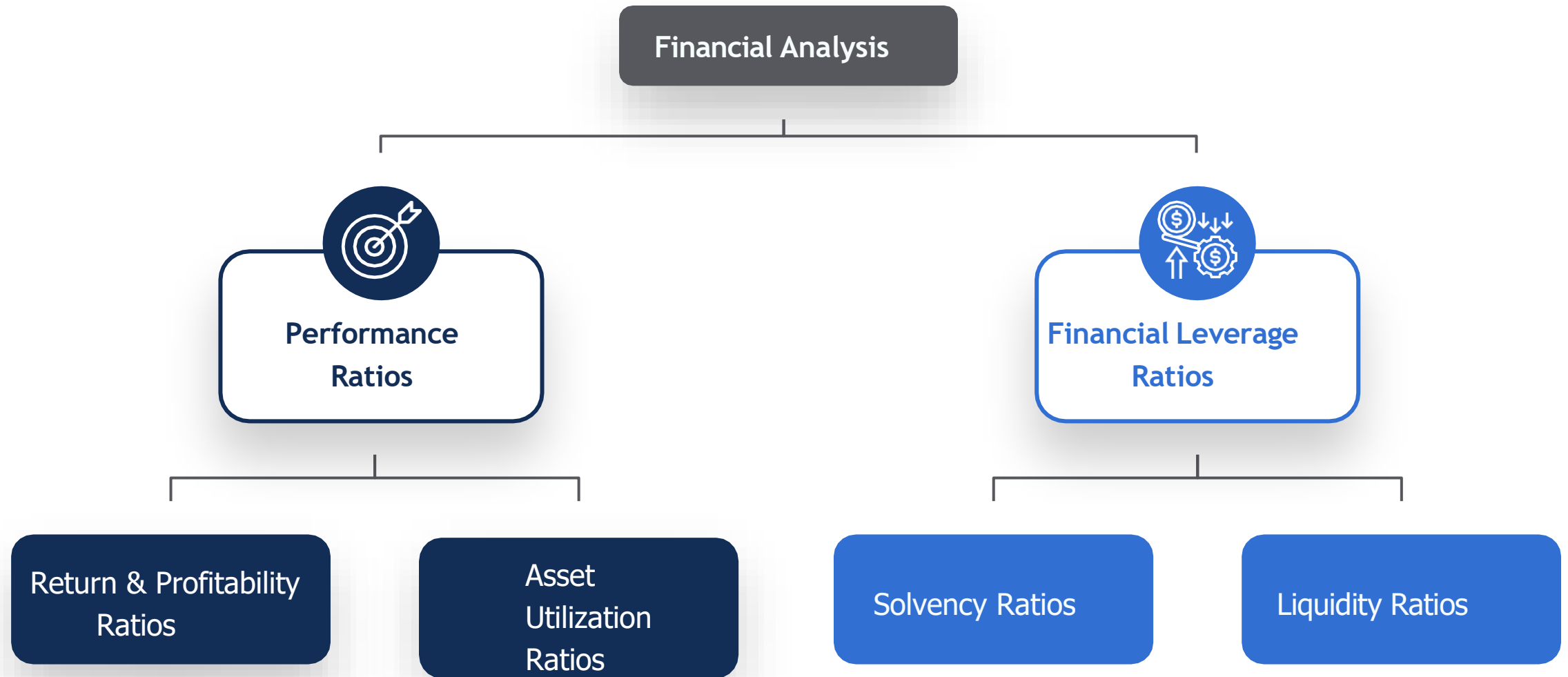
Investing

Financing

Quick Recap of the Three Financial Statements



Introduction to Asset Utilization Ratios



Introduction to Asset Utilization Ratios



When using balance sheet figures, some analysts will look at **averages over two years.**



However, two-year averages are rarely used, and it is **quicker and easier to use the current year.**



Most analysts focus on **total assets, cash, accounts receivable, PP&E, and accounts payable.**

Asset Turnover Ratios

Asset Turnover

Revenues

Total Assets



This ratio shows how efficiently a company uses all assets to produce sales.

PP&E Turnover

Revenues

PPE



This ratio shows how efficiently a company strictly uses its PP&E to generate sales.



Example

Asset Turnover = 1.27x (Not 127%)

PP&E Ratio = 1.52x



For every dollar invested in assets, the business gets **\$1.27 of annual revenue.**



For every dollar invested strictly in PP&E, the business gets **\$1.52 of annual revenue.**



For these ratios, the **larger the better.**

Cash Turnover and Days

Cash Turnover

Revenues

Cash



This ratio reveals the number of times cash is turned over in a period.

Cash Days

Cash

×

365

Revenues



This ratio shows how many days cash turns over or how many days cash reserves cover net revenue.



Example

Cash Turnover = 40x



For every dollar we have in cash, we generate \$40 of revenue.

Cash Days = $365 / 40 = 9.125$ days



The current cash turns over every 9.125 days.



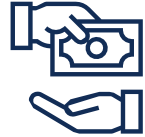
Generally, **a low number is better**, but cash days are driven by industry factors.

A/R Turnover and Days

A/R Turnover

revenues

Accounts Receivable



Measures how efficiently a company is collecting revenue and using assets..

A/R Days

A/R

×

365

Revenues



Shows the average number of days it takes a customer to pay the company for sales on credit.



Example

A/R Turnover = 12x



For every dollar in accounts receivable, the company generates \$12 of revenue.

A/R Days = $365 / 12 = 30$ days



Customers take 30 days on average to pay the company.



Generally, the **higher the A/R turnover or lower A/R days, the better**, but industries offer different standard credit terms.

Inventory Turnover and Days

Inventory Turnover

Cost of Goods Sold

Inventory



Shows the number of times a business sells and replaces its stock of goods during a period.

Inventory Days

Inventory

×

365

Cost of Goods Sold



Shows the average number of days it takes a company to sell and replace its inventory.

Inventory Turnover and Days

Inventory Turnover

Revenues

Inventory



Shows the number of times a business sells and replaces its stock of goods during a period.

Inventory Days

Inventory

×

365

Revenues



Shows the average number of days it takes a company to sell and replace its inventory.



Revenue can be used as the numerator of the inventory turnover ratio.

Inventory Turnover and Days

Inventory Turnover

Cost of Goods Sold

Inventory



Shows the number of times a business sells and replaces its stock of goods during a period.

Inventory Days

Inventory

×

365

Cost of Goods Sold



Shows the average number of days it takes a company to sell and replace its inventory.



Example

Inventory Turnover = 4x



This means inventory turns over only 4 times a year.

Inventory Days = $365 / 4 = 91.25$ days



The inventory is sold and replaced every 91.25 days.



Higher inventory turnover or lower inventory days is generally better, but it is business-dependent.

A/P Turnover and Days

A/P Turnover

Cost of Goods Sold

Account Payable



Measures how many times a company is able to pay its creditors over a period of time.

A/P Days

A/P

×

365

Cost of Goods Sold



Shows the average number of days it takes a company to pay its creditors..

A/P Turnover and Days

A/P Turnover

Revenues

Account Payable



Measures how many times a company is able to pay its creditors over a period of time.

A/P Days

A/P



365

Revenues



Shows the average number of days it takes a company to pay its creditors.



Some analysts use **revenues** in the A/P Turnover ratio

It is more precise to use **cost of goods sold**.

It represents **the price we need to pay our suppliers**.

Working Capital Defined



Simple Definition:

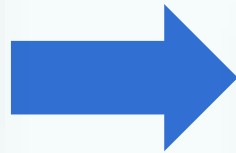
Working capital is the difference between a company's current assets and current liabilities.



It is important to analyze operational assets and liabilities. **without any financing assets and liabilities**



Current Liabilities → **Interest-bearing debt**
Current Assets → **Cash**



This leaves us with three **operational assets/liabilities: Accounts receivable, inventory and accounts payable**



Working Capital

=

Accounts
Receivable

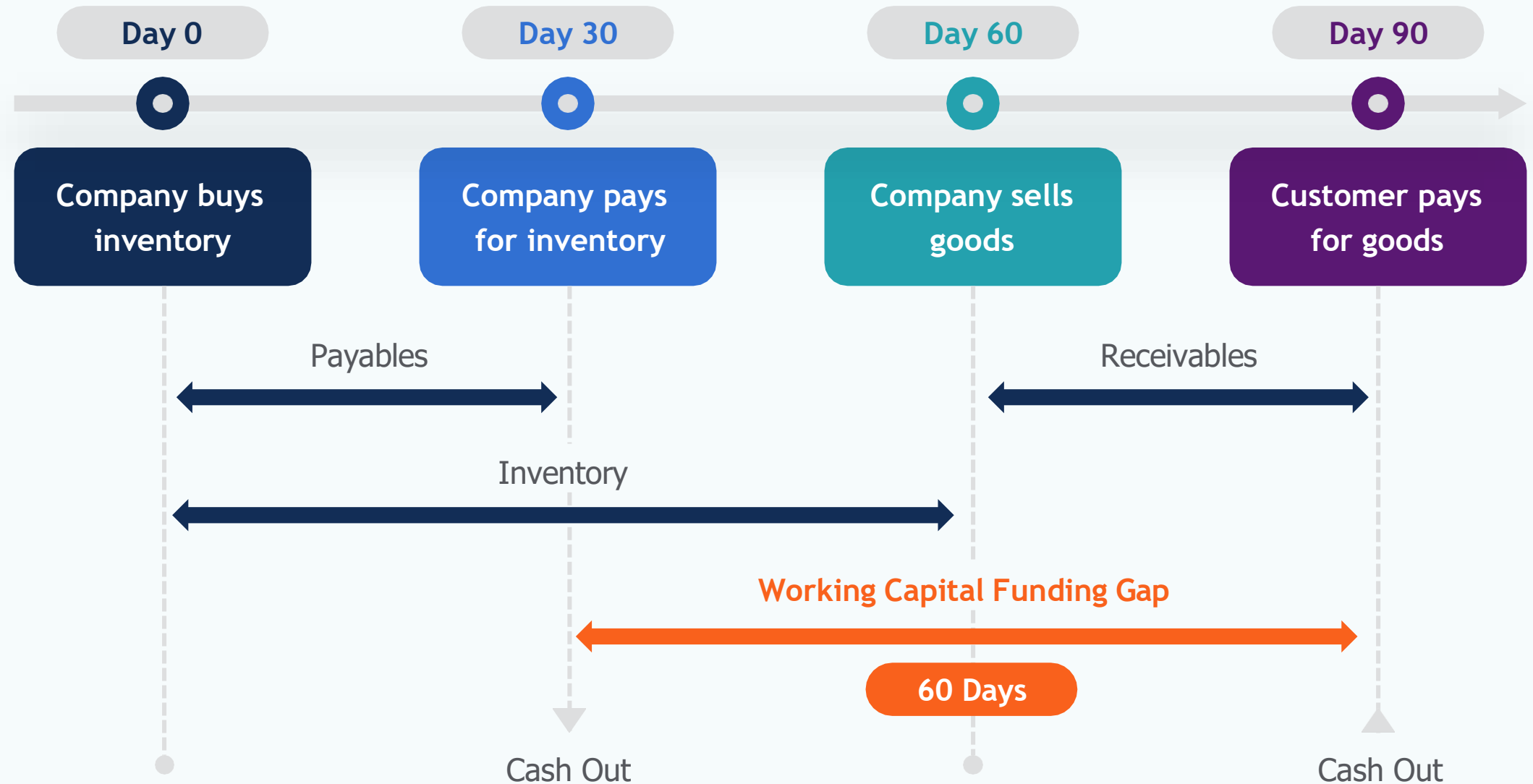
+

Inventory

-

Accounts
Payable

Combining Working Capital Days Ratios



Combining Working Capital Days Ratios

