CHAPTER 10

Financial Statement Analysis

FINANCIAL STATEMENTS

All financial statements are historical documents. They summarize what has happened during a particular period. However, most users of financial statements are concerned with what will happen in the future. For example, stockholders are concerned with future earnings and dividends and creditors are concerned with the company's future ability to repay its debts. While financial statements are historical in nature, they can still provide users with valuable insights. These users rely on financial statement analysis, which involves examining trends in key financial data, comparing financial data across companies, and analyzing financial ratios to assess the financial health and future prospects of a company.

LIMITATIONS OF FINANCIAL STATEMENT ANALYSIS

1. Comparing Financial Data across Companies
2. Looking beyond Ratios

STATEMENTS IN COMPARATIVE AND COMMON-SIZE FORM

An item on a balance sheet or income statement has little meaning by itself. Suppose a company's sales for a year were $250 million. In isolation, that is not particularly useful information. How does that stack up against last year's sales? How do the sales relate to the cost of goods sold? In making these kinds of comparisons, three analytical techniques are widely used:

1. Dollar and percentage changes on statements (horizontal analysis).
2. Common-size statements (vertical analysis).
3. Ratios.

DOLLAR AND PERCENTAGE CHANGES ON STATEMENTS

Horizontal analysis (also known as trend analysis) involves analyzing financial data over time, such as computing year-to-year dollar and percentage changes within a set of financial statements.

COMMON-SIZE STATEMENTS

Horizontal analysis, which was discussed in the previous section, examines changes in financial statement accounts over time. Vertical analysis focuses on the relations among financial statement accounts at a given point in time. A common-size financial statement is a vertical analysis in which each financial statement account is expressed as a percentage. In income statements, all items are usually expressed as a percentage of sales. In balance sheets, all items are usually expressed as a percentage of total assets.

RATIO ANALYSIS—THE COMMON STOCKHOLDER

Common stockholders use financial ratios related to net income, dividends, and stockholders' equity to assess a company's financial performance. This section describes seven of those ratios. All calculations will be performed for this year

1. Earnings per Share
2. Price-Earnings Ratio
3. Dividend payout ratio
4. Dividend yield ratio
5. Return on Total Assets
6. Return on Common Stockholders' Equity
7. Book Value per Share

RATIO ANALYSIS—THE SHORT-TERM CREDITOR

Short-term creditors, such as suppliers, want to be repaid on time. Therefore, they focus on the company's cash flows and on its working capital because these are the company's short-term primary sources of cash. All calculations in this section will be performed for this year.

1. Working Capital
2. Current Ratio
3. Acid-Test (Quick) Ratio
4. Accounts Receivable Turnover

RATIO ANALYSIS—THE LONG-TERM CREDITOR

Long-term creditors are concerned with a company's ability to repay its loans over the long run.

1. Times Interest Earned Ratio

QUESTIONS

1. What are the limitations of financial statement analysis?
2. What are the methods for analyzing financial statements?
3. How Many Methods Are Used in Ratio Analysis? - Common Shareholders

REFERENCE

- Garrison, R. H., Noreen, E. W., & Brewer, P. C. (2012). Managerial accounting. (14th ed). https://www.netsuite.com/portal/resource/articles/accounting/job-costing.shtml