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Techniques for Evaluating a Company's Financial Statements for Strengths and Weaknesses

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... Business Survival:

There are two key factors for business survival:

- **Profitability**
 - **Solvency**
- Profitability is important if the business is to generate revenue (income) in excess of the expenses incurred in operating the business.
 - Solvency refers to the capacity of the business to meeting its financial obligations as they come due.

... Financial Statement Analysis

- **Financial Statement Analysis** is the process whereby business owners and other interested parties examine financial statement data in a structured manner to reveal information about essential key factors needed to understand financial performance to facilitate informed decision making.

... Financial Statement Analysis

- Financial Statement Analysis is the collective name for the tools and techniques that are intended to provide relevant information to the decision makers. The purpose of the FSA is to assess the financial health and performance of the Company.
- FSA consists of the comparison of the Company's financial performance to:
 - The Company over a period of time;
 - Different companies (competitors) in the same industry, or;
 - Other expectations (i.e., budget).

... Financial Statement Analysis

Purpose:

- To use financial statements and ratios to evaluate:
 - Financial performance
 - Financial position
 - Prediction of future performance
- To have a means of comparative analysis across time in terms of:
 - Intracompany basis (within the Company itself)
 - Intercompany basis (between companies)
 - Industry Averages
- To apply analytical tools and techniques to financial statements to obtain useful information to Management

... Financial Statement Analysis

Financial Statement Analysis involves analyzing the information included in the financial statements to:

- Provide information about an organization's:
 - Past performance
 - Present condition
 - Future performance
- Assess:
 - Earnings in terms of power, persistence, quality and growth
 - Solvency

... The Basic Financial Statements

1. Balance Sheet
2. Income Statement (or Statement of Operations)
3. Statement of Change in Stockholders' Equity
4. Statement of Changes in Cash Flows
5. Notes to the Financial Statements

... Effective Financial Statement Analysis

- To perform an effective financial statement analysis, you need to be aware of:
 - Business strategy
 - Objectives
 - Any publications providing more in depth understanding of the Company's activities, such as an annual report, on-line searches or newspaper or business review articles.

→ These are called **individual organizational factors**.



Effective Financial Statement Analysis

Requires that you:

- Understand the nature of the industry in which the Company works. This is the **industry factor**.
- Understand that the overall state of the economy may also have an impact on the performance of the Company.

→ Financial statement analysis is more than just “crunching numbers”; it involves obtaining a broader picture of a company in order to fully be able to take into account the overall qualitative as well as quantitative factors which can come to bear upon an organization’s performance.

... Standards of Comparison

1. Rule-of-thumb Indicators
 - The banking community often uses “rule-of thumb” or internal “benchmark” financial ratios and expectations.
2. Historical performance of the Company
3. Industry Standards

... Sources of Information

1. Company Reports

- Directors report
- Basic Financial Statements
- Supporting schedules
- Auditors report

2. Stock Exchanges

3. Business Periodicals

4. Information Services

... Tools of Financial Statement Analysis

The commonly used tools for Financial Statement Analysis are:

- Financial Ratio Analysis
- Comparative financial statements analysis:
 - Horizontal analysis/Trend analysis
 - Vertical analysis/Common Size analysis/ Component Percentages

... Financial Ratio Analysis

- Financial ratio analysis involves calculating and analyzing ratios that use data from one, two or more financial statements.
- Ratio analysis expresses relationships between the financial statements.
- Financial Ratios can be classified into 5 main categories:
 - Profitability
 - Liquidity/Short-Term Solvency
 - Asset Management or Activity
 - Financial Structure/Capitalization
 - Market Test (publicly-trading companies)

... Profitability Ratios

Three elements of profitability analysis:

- Analysing on sales and gross margin
 - Focus on gross profit
 - Analysis of the control over expenses
 - Focus on net profit
- Assessing the return on assets and return on equity

Profitability Ratios

- **Gross Profit %** = $\frac{\text{Gross Profit}}{\text{Net Sales}} * 100$
- **Net Profit %** = $\frac{\text{Net Profit After Tax}}{\text{Net Sales}} * 100$

Often, firms may prefer to use **net profit before tax**:

- Pre-tax Profit % = $\frac{\text{Net Profit Before Tax}}{\text{Net Sales}} * 100$
- Return on Assets = $\frac{\text{Net Profit}}{\text{Average Total Assets}} * 100$
- Return on Equity = $\frac{\text{Net Profit}}{\text{Average Total Equity}} * 100$

... Liquidity or Short-Term Solvency ratios

Short-term funds management

- Working capital management is important as it signals the firm's ability to meet short term debt obligations as they come due.

For example: **Current ratio**

- The ideal benchmark for the current ratio is 2:1, where there are two dollars of current assets (CA) to cover every one dollar of current liabilities (CL). The acceptable benchmark is 1:1, and a ratio below 1:1 reflects liquidity riskiness, as there are insufficient current assets to cover current liabilities.

... Liquidity or Short-Term Solvency ratios

- Working Capital = Current assets – Current Liabilities
- Current Ratio = $\frac{\text{Current Assets}}{\text{Current Liabilities}}$
- Quick Ratio = $\frac{\text{Current Assets} - \text{Inventory} - \text{Prepayments}}{\text{Current Liabilities} - \text{Bank Overdraft}}$

... Asset Management or Activity Ratios

Portrays the efficiency of asset usage

- How well the assets used to generate revenues will impact on the overall profitability of the business.

For example: **Average Collection Period**, also known as **“Accounts Receivable Turnover”**

- This ratio represents the average number of days an account receivable remains outstanding before collection.
- Useful to match against **Accounts Payable Turnover**.

Asset Management or Activity Ratios

- Asset Turnover =
$$\frac{\text{Net Sales}}{\text{Average Total Assets}}$$
- Inventory Turnover =
$$\frac{\text{Cost of Goods Sold}}{\text{Average Ending Inventory}}$$
- Average Collection Period =
$$\frac{\text{Average accounts Receivable}}{\text{Average daily net credit sales}^*}$$

** Average daily net credit sales = net credit sales / 365*

... Financial Structure or Capitalization Ratios

Long term funds management

- Measures the riskiness of business in terms of debt gearing.

For example: **Debt/Equity** or **“Leverage” Ratio**

- Measures the relationship between debt and equity, or how heavily “leveraged” a company is. A ratio of 1:1 indicates that debt and equity funding are equal (i.e. there is \$1 of debt to \$1 of equity) whereas a ratio of 2:1 indicates there is twice as much debt for every dollar of owner’s equity.
 - Higher leverage is usually interpreted as bringing in more financial risk for the business, particularly if the business has profitability or cash flow problems.

Financial Structure or Capitalization Ratios

- Debt/Equity ratio = Debt / Equity
- Debt/Total Assets ratio = $\frac{\text{Debt}}{\text{Total Assets}} * 100$
- Equity ratio = $\frac{\text{Equity}}{\text{Total Assets}} * 100$
- Times Interest Earned = $\frac{\text{Earnings before Interest and Tax}}{\text{Interest}}$

... Market Test Ratios

- Based on the share market's perception of the Company.

For example: **Price-Earnings ratio**

- The higher the ratio, the higher the perceived quality of the earnings by the share market.

... Market Test Ratios

- Earnings per share =
$$\frac{\text{Net Profit after tax}}{\text{Weighted average common shares}}$$
- Dividends per share =
$$\frac{\text{Dividends}}{\text{Weighted average common shares}}$$
- Dividend payout ratio =
$$\frac{\text{Dividends per share}}{\text{Earnings per share}} * 100$$
- Price-Earnings ratio =
$$\frac{\text{Market price per share}}{\text{Earnings per share}}$$



Horizontal analysis / Trend analysis

- Trend percentage
- Line-by-line item analysis
- Items are expressed as a percentage of a base year
- Expressed as a time-series analysis
- For example, a line item could look at increase in sales turnover comparatively over a five-year period.

Vertical analysis/Common size analysis Component Percentages

- All items are expressed as a percentage of a common base item within a financial statement:
 - Financial Performance – Net Sales
 - Financial Position – Total Assets

... Financial Statement Analysis

- Review of handouts to see examples of the application of these concepts

Questions



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