**Financial Analysis (Part 1) Script**

Slide 1: This will be the first of two video presentations covering analysis of the financial statements. Much of Financial Accounting has to do with the preparation and accuracy of the Financial Statements. But, what do we do with the statements when they are complete? Here will look at several of the common analysis tools and cover trend and vertical analyses. In Part 2, we’ll look at Ratio Analysis.

Most often, we analyze the Income Statement and Balance Sheet, and some analyses combine information from the two, as we will see when computing ratios.

Slide 2: This slide shows some of the different methods of financial analysis. Trend analysis, as we will see, is about spotting trends in various parts of the statements. This is also called Horizontal analysis, as we move line by line and scan horizontally across periods.

Vertical Analysis expresses Income Statement items in terms of percent of revenues and Balance Sheet Items in terms of percent of assets. We can also use this approach to create what’s known as common size statements.

We can also compare our results to Budget – an excellent practice to both better understand our financials and to improve our budgeting and planning. Similarly, we can compare our results to published industry data, which is available from a wide variety of sources. We will leave these two methods for another presentation, as they are covered more in Managerial Accounting.

Finally, there are several types of Ratio Analysis we can undertake – with respect to Liquidity, Profitability, Asset Utilization, Solvency and Market Prospects. We will, as mentioned, cover these in the Part 2 presentation.

Slide 3: Let’s begin with some Trend Analysis. Here, we have three years’ worth of data for a company. If we look at each line item, we can see that most increase year over year – and that’s how we do trend analysis. Are things increasing? Decreasing? Staying the same? If Sales are increasing, we’d expect COGS to increase in proportion, along with Gross Margin. We also would expect – and hope - -Net Income increases proportionally to sales, as well.

For our example here, we see that COGS decreased between Years 1 and 2. We would definitely want to examine why – perhaps we got a price break when ordering more of our merchandise. While analysis does give us lots of information, sometimes it provides us with great questions…

Slide 4: While the previous slide gives us some information, we can amplify its impact with a few simple calculations. Basically, what we’ve done here is to add two columns to describe the amount of change from year to year.

For instance, instead of saying “Sales increased year over year,” we can say “Sales increased 54,000 from Year 1 to Year 2, and increased another 80,000 from Year 2 to Year 3.” We can similarly describe the other income statement items. If so inclined, we could perform similar analyses on Balance Sheet line items.

Slide 5: We can further enhance our trend analysis by using Percentage Change. To compute percentage change, we take the Current Period Value minus the Prior Period Value and divide the difference by the Prior Period value. Let’s look at Operating Expenses, for example. The increase in these expenses increased 20,000 between years 1 and 2 and another 20,000 between years 2 and 3 – in other words the same increase. However, that first 20,000 increase is a 10.5% increase and the second 20,000 represents a 9.5% increase. The reason for this is that the base (the prior period value) is increasing and the change remained flat.

Compare Slide 3 with this current slide and see how much more information we have here. Using a spreadsheet program, we can get much more information in a matter of seconds.

Slide 6: I’ve taken the same information we’ve been using and will now express every item in terms of sales, or dividing each number by sales. . For year 1, 836,000 divided by 836,000 equals 100%, 585,000 divided by 836,000 equals 70% 251,000 divided by 836,000 equals 30% and so on.

By looking at these numbers, we have an even deeper appreciation for the changes we saw in the previous vertical analyses. If we look at COGS, for example, our trend analysis went from 586,000 to 570,000 to 582,000; with the vertical analysis, we see that, as a percent of sales, it has been decreasing nicely from 70% of sales to 64% of sales to 60% of sales. As a result, Gross Margin, as a percent of sales, has been INCREASING nicely from 30% to 36% to 40% of sales.

Again, some quick work with a spreadsheet gives us lots of information.

Slide 7: I used the term “common size” earlier: we can use this vertical analysis to compare two companies that are of greatly different size. Let’s say Small Company wants to be like Really Big Company, but, their numbers are very, very different – Really Big’s Sales alone are over 28 times greater.

Slide 8: We can use a common size approach and see that Small’s numbers compare favorably to Really Big’s – their operating expenses are even a little better, percentage-wise.

Slide 9: We can also present the Balance Sheet in vertical form. Most often, all of these items are presented as a percentage of Total Assets, as we have done here. The reason some do this is that some of the ratios we’ll see in part two require expressing items in terms of total…

…once we have the percentages in place, we can examine how, say Inventory has changed as a percentage of Assets. In our example, there has been a decrease – this can be a good thing, is sales have increased, for example, as the company is earning a higher level of sales on a lower investment in inventory. Again, this is a good question to ask, and we ask it as a result of our analysis.

Slide 10: I hope this has helped you to understand a couple of the approaches we can take to analyze our financial statements. In part 2, as previously mentioned, we will look at ratio analysis to round out our analysis “tool box,” if you will.