**Financial Analysis (Part 2) Script**

Slide 1: Welcome to Financial Analysis Part 2. In the part 1 video, we looked at Trend or Horizontal Analysis, Vertical Analysis and Common Size Statements. In this presentation, we will devote our time to Ratio Analysis.

Slide 2: This is a repeat of Slide 2 from the Part 1 presentation, so that we can see the types of Ratio Analysis that will be covered.

Liquidity analysis is concerned with short-term bill paying ability (within a 12 month period).

Profitability analysis is concerned with various measures of, not surprisingly, profitability.

Companies invest in assets and use those assets to generate revenues. We want to see how well these assets are being used to do just that with these ratios.

Whereas Liquidity measures are concerned with short-term bill paying ability, Solvency ratios are concerned with Total bill-paying ability.

Market Prospects ratios are used by current and potential investors, as well as stock analysts and the like. Companies want to maximize shareholder value, and one of the things that can make that happen is to have a strong stock price.

Slide 3: For most of the following ratios, I will be pulling numbers from these financials, and some from Analysis Part 1. I suggest you print this page out before you work along. If you viewed the Cash Flow presentation, you might recognize these numbers…

Slide 4: The easiest measure of Liquidity to calculate is Working Capital. We do this by subtracting Current Liabilities from Current Assets. If there are more Current Assets that Current Liabilities, there is positive Working Capital. What is wanted here is greater working capital; therefore Year 2 liquidity is preferable to Year 1, relative to working capital.

Another measure is the Current Ratio. Over the years and throughout many text books in Accounting, Managerial Accounting and Finance, a ratio of 2 or better is preferable. The reason for this is that the liquidation value for current assets is usually less than the cost of assets. For example, 20,000 of office supplies probably can’t be converted to 20,000 in cash…

…just as working capital indicated, the Current Ratio shows liquidity improving in Year 2 as well.

A more stringent measure of liquidity is the Quick Ratio. To eliminate and liquidation uncertainties, only “Quick Assets” are used – Cash, Marketable Securities (highly liquid, short term investments) and A/R are included. The general rule is for this ratio to be greater than 1. According to this, we can see that, again, Year 2 has improved over the prior year.

Slide 5: These first three Profitability ratios – Gross Margin Ratio, Op. Income Ratio and Profit Margin – can all be figured when performing your vertical analysis. Or, you can do the calculations as shown here. As with Liquidity, we can see that Year 2 is an improvement over Year 1 in each measure.

Slide 6: We can employ a few other profitability measures shown here – Return on Investment (ROI), Return on Equity (ROE) and Earnings Per Share (EPS).

We use ROI to gauge how much Net Income was generated from the average investment in assets (in fact, this can also be referred to as Return on Assets). In this case, the 8.1% return basically tells us that for every dollar invested in assets, an 8.1 cent return is realized.

We use ROE to gauge how much Net Income was generated from the investment of owners plus retained earnings. In this case, the return is 13.8%. Owners can compare that return to other investment opportunities.

EPS is pretty self-explanatory – we wish to see how much net income is allocated to each share of stock. Investors can then make comparisons to other stock investment opportunities. Don’t confuse this with Dividends per Share (DPS), which we will cover shortly.

Slide 7: As part of this slide, we’ll look at Asset Utilization measures. Again, we wish to see what kind of return the company is earning, given the investment in these specific assets.

First, let’s look at A/R Turnover. Basically, this tells us how many times we ‘turn over’ Accounts Receivable. This figure of 7.4 is telling us that amassed accounts receivable, collected the cash, amassed more, collected the cash, etc., 7.4 times this year.

# Days Uncollected is a complimentary measure – it basically tells us how many days, on average, it takes to collect a receivable. In this case, 53 days. If the company’s terms are for 30 days, they need to tighten-up collection practices. If the terms are 60 days, they are doing great.

Inventory Turnover is similar to A/R turnover –the 3.2 we see here indicated the purchased inventory and sold it all 3.2 times in the last year. We like to see this number increasing from period to period – that indicated the company is better utilizing their investment in inventory as time goes on.

# Days in Ending Inventory tells us that if the company continues to sell at the same pace, and doesn’t purchase any more inventory, they will run out in 109 days. This is important if it take 120 days to order and receive new inventory. If it takes 80 days, they are in good shape.

Slide 8: Solvency looks at, as mentioned earlier, overall bill paying ability. Debt Ratio compares total Liabilities to Total Assets – in this case, 37% of assets are financed through borrowing. Equity Ratio similarly tells us the percent of assets financed through Owners’ Equity – in this case, 63%. If we know one of these ratios, we could also use the Accounting Equation to solve for the other. Assets = Liabilities + Equity; 100%- 37% = 63%.

These ratios are helpful to investors, some of whom don’t like debt and others who are less risk averse. The higher the debt percentage, the riskier the company appears.

Another measure to help with this is the Debt to Equity Ratio. We divide total Liabilities by total Equity to arrive at this measure. If equal amounts of debt and equity are used, this ratio would be 1.0 or 100%. In our case here, the ratio is less than one; debt is 58.8% of equity. A number greater than one or greater than 100% indicates that more debt is employed.

Slide 9: Finally, we will look at a couple Market Prospect ratios. The first, known as the Price Earnings Ratio or P/E Ratio indicates the dollar amount an investor can expect to invest in a company in order to receive one dollar of that company’s earnings. In our case, an investor would pay $5.80 for a share of stock in order to receive $1.00 in earnings (again, earnings, not dividends).

The Dividend Yield tells us how much a company pays out in dividends relative to its share price. In our case, if we assume shares have a market price of $10.00, 2.9% or 29 cents is paid out in dividends.

Slide 10: AS part of this presentation, we looked at a number of different ratios that managers, investors and others can use to evaluate a company’s financial statements.

In addition to the measures and approaches covered in the part 1 presentation, there are other ratios that can be applied. Financial Accounting, Managerial Accounting and Finance textbooks are a good source, as are internet sites.

Some companies will even tailor existing ratios and/or create their own ratios for use in their own unique businesses.

I hope this has proved helpful to you; good luck with your studies.