Financial Statements and Ratio Analysis

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Outline

- Filling in your Financial Statements
  - Income Statement
  - Balance Sheet
  - Cash Flow Statement
- Purpose of a Ratio Analysis
- Types of Ratios
- Analyzing your Business with Financial Ratios

Filling in Your Financial Statements

- Filling in your financial statements can be very easy if you keep good records of your financial and accounting activities. If it is your first time filling them out for your company then you could easily pull a sample spreadsheet for the internet to show you what you will have to fill out, or you can use the excel link provided. If you have already made financial statements, then you can fill them out for each year but simply imputing your current data where your old data was.
- Building/using a ratio analysis allows you to have all your financial statements and the ratio analysis all in one spreadsheet
- By building proper spreadsheets for financial statements, you will be able to update it every year by imputing your financials
    - Updates calculations automatically
    - Makes this process easier for you!
- Or if you want to use the Ratio Analysis provided, then just fill in your information!
    - This provides you with in-depth financial statements as well as a simplified version
    - Since the Ratio Analysis provided was simplified from a spreadsheet made for publically listed companies, there may be come accounts that you do not even have to fill in

To get a better understanding of financial statements, we're going to take a look at a local start-up business to see how they can utilize the financial statements/ratio analysis

- Income Statement

American Joe's Breath of Life- Income Statement Fiscal year ends in December	2015	2016	2017	2018	2019	TTM
Revenue / Sales	1000	1000	166430	64957	71453	1000
Cost of revenue	0	0	95821	10348	11384	0
Gross profit	1000	1000	70609	54609	60069	1000
Gross Margin %	100.00%	100.00%	42.43%	84.07%	84.07%	100.00%
Operating expenses						
Payroll	0	0	201096	205893	210834	0
Marketing/Promotion	0	0	0	0	0	0
Rent	0	0	3300	3300	3300	0
Utilities	0	0	7500	7500	7500	0
Insurance	0	0	1584	1584	1584	0
Depreciation and amortization	0	0	0	0	0	0
Payroll Taxes	0	0	30164	30884	31625	0
Other operating expenses	0	0	1711	1638	1682	0
Total operating expenses	0	0	245355	250799	256525	0
Operating income	1000	1000	-174746	-196190	-196456	1000
EBITDA	1000	1000	-174746	-196190	-196456	1000
Interest Expense	1500	1500	10279	10279	10279	0
Income before income taxes	-500	-500	-185025	-206469	-206735	1000
Taxes Incurred	0	0	0	0	0	0
Net Profit	-500	-500	-185025	-206469	-206735	1000
Net Profit/Sales	-50.00%	-50.00%	-111.17%	-317.85%	-289.33%	100.00%

This income statement provides past years information, current information, and projected information to allow a business to be able to see how they have performed over the years. Since you do not have all the accounts that publically listed companies include into their financial statements, your financials will look much cleaner and easier to use.

If you are not quite clear on what the accounts are that are used in an income statement then hopefully we can give that a little more clarification.

- Revenue/Sales- the amount of money that a company actually receives during a specific period, including discounts and deductions for returned merchandise. It is the "top line" or "gross income" figure from which costs are subtracted to determine net income
- Cost of Revenue- the total cost of manufacturing and delivering a product or service, designed to represent the direct costs associated with the goods and services the company provides
- Gross Profit- a company's total revenue (equivalent to total sales) minus the cost of goods sold. Gross profit is the profit a company makes after deducting the costs associated with making and selling its products, or the costs associated with providing its services

- Gross Margin- a company's total sales revenue minus its cost of goods sold (COGS) (also known as cost of revenue), divided by total sales revenue, expressed as a percentage
- Operating Expenses- expenditures that a business incurs to engage in any activities not directly associated with the production of goods or services (see an alternative definition at the bottom). These expenditures are the same as selling, general and administrative expenses
- EBITDA- (Earnings Before Interest, Taxes, Depreciation, and Amortization) - a measure of a company's operating performance. Essentially, it's a way to evaluate a company's performance without having to factor in financing decisions, accounting decisions or tax environments
    - EBITDA = Net Profit + Interest +Taxes + Depreciation + Amortization
- Interest Expense- a non-operating expense shown on the income statement. It represents interest payable on any borrowings – bonds, loans, convertible debt or lines of credit. It is essentially calculated as the interest rate times the outstanding principal amount of the debt
- Net Profit- the actual profit after working expenses not included in the calculation of gross profit have been paid
- Net Profit/Sales (Net Profit Margin) - this is a formula added into the income statement that is known as a financial leverage ratios. Net profit margin is the ratio of net profits to revenues for a company or business segment. Typically expressed as a percentage, net profit margins show how much of each dollar collected by a company as revenue translates into profit. The equation to calculate net profit margin is: net margin = net profit / revenue

- Balance Sheet

American Joe's Breath of Life- Balance Sheet Fiscal year ends in December	2015	2016	2017	2018	2019
Assets					
Current assets					
Cash and cash equivalents	1000	1000	-132724	-346392	-552977
Receivables	0	0	0	0	0
Inventories	0	0	0	0	0
Prepaid expenses	0	0	0	0	0
Other current assets	0	0	100	100	100
Total current assets	1000	1000	-132624	-346292	-552877
Non-current assets					
Property, plant and equipment					
Gross property, plant and equipment	0	0	0	0	0
Accumulated Depreciation	0	0	0	0	0
Net property, plant and equipment	0	0	0	0	0
Other long-term assets	0	0	400	400	400
Total non-current assets	0	0	400	400	400
Total assets	1000	1000	-132224	-345892	-552477
Liabilities and stockholders' equity					
Liabilities					
Current liabilities					
Current Borrowing	0	0	0	0	0
Accounts Payable	1000	1000	12585	5386	5536
Taxes Payable	0	0	0	0	0
Other current liabilities	0	0	0	0	0
Total current liabilities	1000	1000	12585	5386	5536
Non-current liabilities					
Long-term debt	1000	1000	102787	102787	102787
Deferred taxes liabilities	0	0	0	0	0
Regulatory liabilities	0	0	0	0	0
Other long-term liabilities	0	0	0	0	0
Total non-current liabilities	1000	1000	102787	102787	102787
Total liabilities	2000	2000	115372	108173	108323
Stockholders' equity					
Paid-in capital	0	0	0	0	0
Retained earnings	0	0	-62571	-247597	-454065
Accumulated other comprehensive income	0	0	-185025	-206468	-206735
Total stockholders' equity	0	0	-247596	-454065	-660800
Total liabilities and stockholders' equity	2000	2000	-132224	-345892	-552477

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- Assets- sometimes defined as resources or things of value that are owned by a company. Some examples of assets which are obvious and will be reported on a company's balance sheet include: cash, accounts receivable, inventory, investments, land, buildings, and equipment
- Current Assets- any asset which can reasonably be expected to be sold, consumed, or exhausted through the normal operations of a business within the current fiscal year or operating cycle (whichever period is longer)
- Non-Current Assets- an asset that is not likely to turn to unrestricted cash within one year of the balance sheet date. (This assumes that the company has an operating cycle of less than one year.) A noncurrent asset is also referred to as a long-term asset
- Liabilities- a company's financial debt or obligations that arise during the course of its business operations. Liabilities are settled over time through the transfer of economic benefits including money, goods or services
- Current Liabilities- a company's debts or obligations that are due within one year, appearing on the company's balance sheet and include short term debt, accounts payable, accrued liabilities and other debts. Essentially, these are bills that are due to creditors and suppliers within a short period of time
- Non-Current Liabilities- long-term financial obligations listed on a company's balance sheet that are not due within the present accounting year, such as long-term borrowing, bonds payable and long-term lease obligations
- Stockholder’s Equity (Owner’s Equity) - owner's ownership (equity) in the business, or the amount of the business assets owned by the business owners. Another way to look at this concept is to say that owner's equity in a business is the amount the owner has invested in the business minus any money the owner has taken out of the business in the form of a draw (not as salary)
- Paid-in-Capital- the amount of capital "paid in" by investors during common or preferred stock issuances, including the par value of the shares (stake) themselves

- Retained Earnings- the percentage of net earnings not paid out as dividends, but retained by the company to be reinvested in its core business, or to pay debt. It is recorded under shareholders' equity on the balance sheet. The formula calculates retained earnings by adding net income to, or subtracting any net losses from, beginning retained earnings, and subtracting any dividends paid to shareholders
- Accumulated other Comprehensive Income- a general ledger account that is classified within the equity section of the balance sheet. It is used to accumulate unrealized gains and unrealized losses on those line items in the income statement that are classified within the other comprehensive income category

- Cash Flow Statement

American Joe's Breath of Life- Cash Flow Statement Fiscal year ends in December	2015	2016	2017	2018	2019	TTM
Cash Flows From Operating Activities						
Net income	0	0	166430	64957	71453	0
Depreciation & amortization	0	0	0	0	0	0
Amortization of debt discount/premium and issuance costs	0	0	0	0	0	0
Investment/asset impairment charges	0	0	0	0	0	0
Deferred income taxes	0	0	0	0	0	0
(Gain) Loss from discontinued operations	0	0	0	0	0	0
Extraordinary items	0	0	0	0	0	0
Accounts receivable	0	0	0	0	0	0
Inventory	0	0	0	0	0	0
Accounts payable	0	0	0	0	0	0
Accrued liabilities	0	0	0	0	0	0
Income taxes payable	0	0	0	0	0	0
Other working capital	0	0	0	0	0	0
Other non-cash items	0	0	0	0	0	0
Net cash provided by operating activities	0	0	166430	64957	71453	0
Cash Flows From Investing Activities						
Investments in property, plant, and equipment	0	0	0	0	0	0
Property, plant, and equipment reductions	0	0	0	0	0	0
Acquisitions, net	0	0	0	0	0	0
Other investing activities	0	0	0	0	0	0
Net cash used for investing activities	0	0	0	0	0	0
Cash Flows From Financing Activities						
Debt issued	0	0	0	0	0	0
Debt repayment	0	0	137774	72732	67204	0
Other financing activities	0	0	201096	205893	210834	0
Net cash provided by (used for) financing activities	0	0	338870	278625	278038	0
Cash at beginning of period	0	0	0	-338870	-617495	-895533
Net change in cash	0	0	-338870	-278625	-278038	
Cash at end of period	0	0	-338870	-617495	-895533	-895533
Free Cash Flow						
Operating cash flow	0	0	0	0	0	0
Capital expenditure	0	0	0	0	0	0
Free cash flow	0	0	0	0	0	0

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- Operating Activities- these are the company's core business activities, such as manufacturing, distributing, marketing and selling a product or service. Operating activities should generally provide the majority of a company's cash flow and largely determine whether a company is profitable
- Investing Activities- the second main category of net cash activities listed on the statement of cash flows and consist of buying and selling long-term assets and other investments. In other words, this is the net amount of cash

received and paid during an accounting period for long-term assets and investments

- Financing Activities- transactions with creditors or investors used to fund either company operations or expansions. These transactions are the third set of cash activities displayed on the statement of cash flows

Purpose of a Ratio Analysis

A ratio analysis is used to evaluate various aspects of a company's operating and financial performance such as its efficiency, liquidity, profitability and solvency. The trend of these ratios over time is studied to check whether they are improving or deteriorating.

Ratio analysis is a useful management tool that will improve your understanding of financial results and trends over time, and provide key indicators of organizational performance. Managers will use ratio analysis to pinpoint strengths and weaknesses from which strategies and initiatives can be formed.

Typically, financial analysis is used to analyze whether an entity is stable, solvent, liquid or profitable enough to warrant a monetary investment. When looking at a specific company, a financial analyst conducts analysis by focusing on the income statement, balance sheet and cash flow statement

• Types of Ratios/ Analyzing your Business with Financial Ratios

- Liquidity Ratios
  - Current Ratio
    - = Current Assets/Current Liabilities
    - The current ratio helps investors and creditors understand the liquidity of a company and how easily that company will be able to pay off its current liabilities. This ratio expresses a firm's current debt in terms of current assets. So a current

ratio of 4 would mean that the company has 4 times more current assets than current liabilities.

- Quick Ratio/Acid Test Ratio
  - = (Current Assets-Inventory)/Current Liabilities
  - The acid test ratio measures the liquidity of a company by showing its ability to pay off its current liabilities with quick assets. If a firm has enough quick assets to cover its total current liabilities, the firm will be able to pay off its obligations without having to sell off any long-term or capital assets
- Net Working Capital/To Total Asset Ratio
  - Net Working Capital (NWC)= Current Assets-Current Liabilities
  - NWC-to-Total Assets= (NWC/Total Assets)x100
  - This makes the number a percentage relating how much of your NWC makes up your amount of Total Assets
- Time Interest Earned Ratio
  - =EBIT (Earnings Before Interest and Taxes)/Interest Expense
  - The times interest ratio is stated in numbers as opposed to a percentage. The ratio indicates how many times a company could pay the interest with its before tax income, so obviously the larger ratios are considered more favorable than smaller ratios

- Solvency/Financial Leverage Ratios
  - Debt-to-Equity Ratio
    - =Total Liabilities/Total Equity
    - Each industry has different debt to equity ratio benchmarks, as some industries tend to use more debt financing than others. A debt ratio of .5 means that there are half as many liabilities as there is equity. In other words, the assets of the company are funded 2-to-1 by investors to creditors. This means that investors own 66.6 cents of every dollar of company assets while creditors only own 33.3 cents on the dollar.

        - A debt to equity ratio of 1 would mean that investors and creditors have an equal stake in the business assets
    - Equity Ratio
        - =Total Equity/Total Assets
        - In general, higher equity ratios are typically favorable for companies. This is usually the case for several reasons. Higher investment levels by shareholders shows potential shareholders that the company is worth investing in since so many investors are willing to finance the company. A higher ratio also shows potential creditors that the company is more sustainable and less risky to lend future loans
        - Equity financing in general is much cheaper than debt financing because of the interest expenses related to debt financing. Companies with higher equity ratios should have less financing and debt service costs than companies with lower ratios
    - Debt Ratio
        - =Total Liabilities/Total Assets
        - The debt ratio is shown in decimal format because it calculates total liabilities as a percentage of total assets. As with many solvency ratios, a lower ratios is more favorable than a higher ratio.
        - A lower debt ratio usually implies a more stable business with the potential of longevity because a company with lower ratio also has lower overall debt. Each industry has its own benchmarks for debt, but .5 is reasonable ratio.
        - The debt ratio is a fundamental solvency ratio because creditors are always concerned about being repaid. When companies borrow more money, their ratio increases creditors will no longer loan them money. Companies with higher debt ratios are better off looking to equity financing to grow their operations
- Efficiency Ratios
    - Accounts Receivable Turnover

    - =Sales/Average Accounts Receivables
    - Since the receivables turnover ratio measures a business' ability to efficiently collect its receivables, it only makes sense that a higher ratio would be more favorable. Higher ratios mean that companies are collecting their receivables more frequently throughout the year. For instance, a ratio of 2 means that the company collected its average receivables twice during the year. In other words, this company is collecting is money from customers every six months.
    - Higher efficiency is favorable from a cash flow standpoint as well. If a company can collect cash from customers sooner, it will be able to use that cash to pay bills and other obligations sooner.
    - Accounts receivable turnover also is an indication of the quality of credit sales and receivables. A company with a higher ratio shows that credit sales are more likely to be collected than a company with a lower ratio. Since accounts receivable are often posted as collateral for loans, quality of receivables is important.
  - Working Capital Ratio
    - =Current Assets/Current Liabilities
    - Since the working capital ratio measures current assets as a percentage of current liabilities, it would only make sense that a higher ratio is more favorable. A WCR of 1 indicates the current assets equal current liabilities. A ratio of 1 is usually considered the middle ground. It's not risky, but it is also not very safe. This means that the firm would have to sell all of its current assets in order to pay off its current liabilities.
  - Asset Turnover Ratio
    - =Net Sales/Average Total Assets
    - This ratio measures how efficiently a firm uses its assets to generate sales, so a higher ratio is always more favorable. Higher turnover ratios mean the company is using its assets more efficiently. Lower ratios mean that the company isn't

using its assets efficiently and most likely have management or production problems.

        - For instance, a ratio of 1 means that the net sales of a company equals the average total assets for the year. In other words, the company is generating 1 dollar of sales for every dollar invested in assets.

    - Inventory Ratio

        - =Cost of Goods Sold/Average Inventory

        - Inventory turnover is a measure of how efficiently a company can control its merchandise, so it is important to have a high turn. This shows the company does not overspend by buying too much inventory and wastes resources by storing non-salable inventory. It also shows that the company can effectively sell the inventory it buys.

        - This measurement also shows investors how liquid a company's inventory is. Think about it. Inventory is one of the biggest assets a retailer reports on its balance sheet. If this inventory can't be sold, it is worthless to the company. This measurement shows how easily a company can turn its inventory into cash

    - Days' sales in Inventory

        - =365/Inventory Turnover

        - The days sales in inventory is a key component in a company's inventory management. Inventory is expensive for a company to keep, maintain, and store. Companies also have to be worried about protecting inventory from theft and obsolescence.

        - Management wants to make sure its inventory moves as fast as possible to minimize these costs and to increase cash flows. Remember the longer the inventory sits on the shelves, the longer the company's cash can't be used for other operations.

- Profitability Ratios

    - Gross Margin Ratio

        - =Gross Margin/Net Sales
        - Gross margin ratio is a profitability ratio that measures how profitable a company can sell its inventory. It only makes sense that higher ratios are more favorable. Higher ratios mean the company is selling their inventory at a higher profit percentage.
        - High ratios can typically be achieved by two ways. One way is to buy inventory very cheap. If retailers can get a big purchase discount when they buy their inventory from the manufacturer or wholesaler, their gross margin will be higher because their costs are down
    - Profit Margin
        - =Net Income/Net Sales
        - The profit margin ratio directly measures what percentage of sales is made up of net income. In other words, it measures how much profits are produced at a certain level of sales.
        - This ratio also indirectly measures how well a company manages its expenses relative to its net sales. That is why companies strive to achieve higher ratios. They can do this by either generating more revenues why keeping expenses constant or keep revenues constant and lower expenses
    - Return on Assets (ROA)
        - =Net Income/Total Assets
        - The return on assets ratio measures how effectively a company can earn a return on its investment in assets. In other words, ROA shows how efficiently a company can convert the money used to purchase assets into net income or profits.
        - Since all assets are either funded by equity or debt, some investors try to disregard the costs of acquiring the assets in the return calculation by adding back interest expense in the formula.
    - Return on Equity (ROE)
        - =Net Income/Total Equity

- Return on equity measures how efficiently a firm can use the money from shareholders to generate profits and grow the company. Unlike other return on investment ratios, ROE is a profitability ratio from the investor's point of view—not the company. In other words, this ratio calculates how much money is made based on the investors' investment in the company, not the company's investment in assets or something else.
- That being said, investors want to see a high return on equity ratio because this indicates that the company is using its investors' funds effectively. Higher ratios are almost always better than lower ratios, but have to be compared to other companies' ratios in the industry. Since every industry has different levels of investors and income, ROE can't be used to compare companies outside of their industries very effectively.

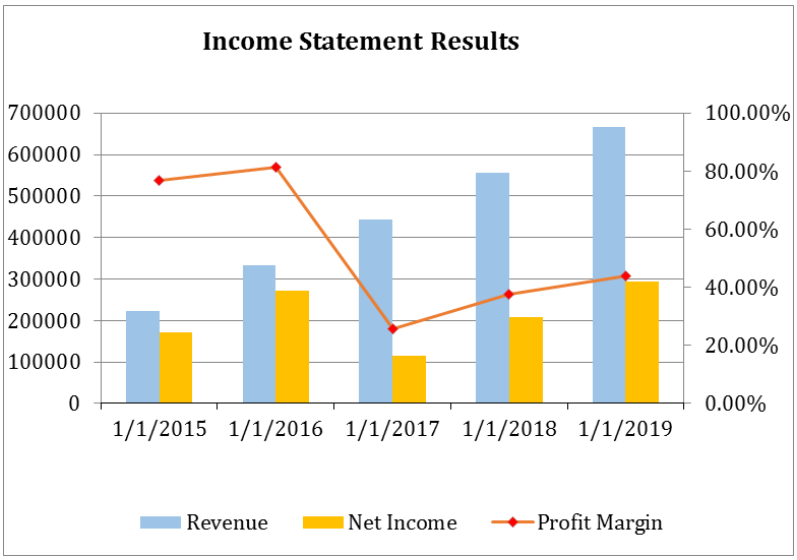
Understanding the Ratio Analysis

Ratio Analysis							
Stock Ticker:	-						
Company Name:	American Joe's Breath of Life						
Industry/Sector:	-						
Date of Analysis:	5/25/2017						
Measure	**2015**	**2016**	**2017**	**2018**	**2019**	**Avg 3-yr**	**Avg 5-yr**
Liquidity Ratios							
Current Ratio	1.03	1.03	-10.54	-64.29	-99.86	-58.23	-34.53
Quick Ratio	1.02	1.02	-10.54	-64.29	-99.87	-58.23	-34.53
Efficiency Ratios							
Inventory Turnover	0.0	0.0	15970.2	2587.0	5692.0	8083.06	4849.83
Accts Rec. Turnover	50.0	62.5	13869.2	8119.6	17863.3	13284.01	7992.91
Average Collection Period	7.3	5.8	0.0	0.0	0.0	0.03	2.65
Fixed Asset Turnover	NA	NA	NA	NA	NA	NA	NA
Total Asset Turnover	NA	NA	NA	NA	NA	NA	NA
Leverage Ratios							
Total Liabilities to Assets	194.2%	194.2%	-87.3%	-31.3%	-19.6%	-46.1%	50.0%
Long-term Debt Ratio	97.1%	97.1%	-77.8%	-29.7%	-18.6%	-42.0%	13.6%
Total Debt to Equity	NA	NA	-46.6%	-23.8%	-16.4%	-28.9%	NA
LTD to Equity	NA	NA	-41.5%	-22.6%	-15.6%	-26.6%	NA
Equity Multiplier	NA	NA	0.5	0.8	0.8	0.71	NA
Coverage Ratios							
Times Interest Earned	0.7	0.7	-17.0	-19.1	-19.1	-18.40	-10.77
Cash Coverage Ratio	-0.3	-0.3	-1.6	-1.9	-1.9	-1.81	-1.18
Profitability Ratios							
Gross Profit Margin	100.0%	100.0%	42.4%	84.1%	84.1%	70.2%	82.1%
Operating Profit Margin	100.0%	100.0%	-105.0%	-302.0%	-274.9%	-227.3%	-96.4%
Net Profit Margin	-50.0%	-50.0%	-111.2%	-317.9%	-289.3%	-239.5%	-163.7%
Return on Assets	-48.5%	-48.5%	140.0%	59.7%	37.4%	79.0%	28.0%
Return on Equity	#DIV/0!	#DIV/0!	74.7%	45.5%	31.3%	50.5%	#DIV/0!

- You can design to make your Ratio Analysis however you like/prefer, but to give you a better understanding were going to explain the one that is provided in our ratio analysis.
- Since your company is smaller than publically listed companies, you will not have to worry about the 'Ticker Symbol' or the 'Industry/Sector'
- As you can see in this Ratio Analysis, some of the calculations are represented as number or percentages. Typically when there is just a number, it means it is ###x. Or for a better sense of what it is, let's take a look at the Current Ratio for the year of 2015. This number is 1.03, or 1.03x, meaning that if you were to multiply the total amount of current liabilities by 1.03 you would get the amount of current assets for that year.
- By looking at the equations for your ratios, you can better understand how that thinking applies to the other number displayed in the ratio analysis.

- If you see things like ‘NA’ or ‘#DIV/0’, that means that you do not have any numbers listed for the account it uses, or you are trying to divide a number by 0 (which doesn’t work)
    - To fix that, look back at your financial statements and fill in the missing numbers if you forgot, or if there are no numbers to input then don’t worry about that ratio!

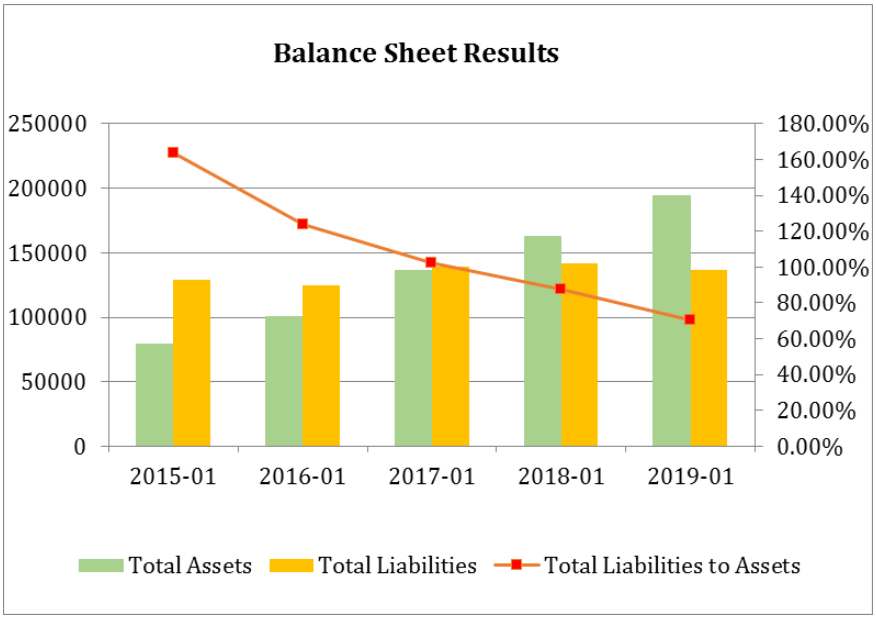
Understanding the Graphs



Income Statement Results

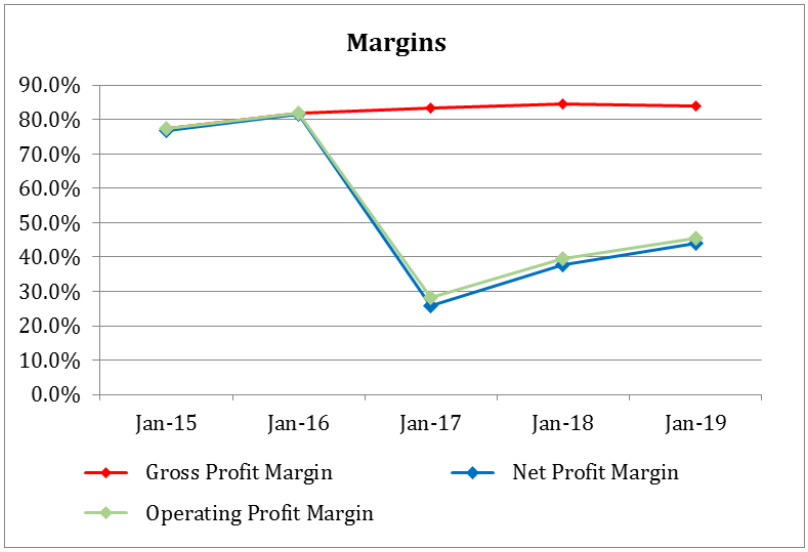
- This graph shows you how your revenue, net income, and profit margin have changed over the years depicted in your ratio analysis. This style of graph is a bar graph with the year on the X-Axis (horizontal) and the dollar value and percentage on the Y-Axis (vertical). This also shows you your profit margin (the red line), to indicate what percentage of revenue is profit.
- From this graph you can see that the revenue has increased steadily year-over-year but when we look at the net income and see it fluctuating, this could mean our expenses are fluctuating. You could then look at your expenses and try to find what has changed over the years.

Balance Sheet Results



- This graph shows the results of the balance sheet by showing you the amount of Total Assets (Green), the amount of Total Liabilities (Yellow), and your Total Liabilities to Assets. This graph's axis' are similar to the previous one.
- This helps you visualize the amount of assets and liabilities your business has so you can see if they are increasing or decreasing year-over-year. The red line indicates what percentage your total liabilities are compared to the amount of total assets.
- Here you can see in the first year that there were more liabilities than assets, show visibly by the graph and by the Total Liabilities to Assets line.

Margins



- Your margins graph is a little different from the first two. Here a line graph is used instead of a bar to depict how the percentages have changed year-over-year.
- To re-cap what each of these margins mean;
- Gross PM= Gross Profit/Revenue
- Net PM= Net Profit/Revenue
- Operating PM= Operating Income/Revenue

- This graph helps you see what percentage of your revenue each of the different profits are. This will help visually see your profit margins year-over-year.
- As you can see in the graph above, the GPM is fairly steady and slowly increasing over the years. But when we look at the NPM and OPM we can see that dissonance started in 2016 as the spread became much larger. To understand why, you would have to look at your financial statements to see what was taking away from profits.

With the idea of how to use and interpret these graphs in mind, you should be able to understand other graphs by piecing together what components they were composed of. We hope that this handout will help you better understand your financials, how to read, and interpret them.