

2.4: Putting it All Together

One of the big challenges in financial statement analysis is that there are many factors that do not “follow the rules” and there are exceptions to everything. For example, a common rule of thumb for the liquidity ratios is that we want to see the current ratio at 2.0 or higher and the quick (acid test) ratio at 1.0 or higher. If these numbers are too low, it could be a sign that the firm is suffering liquidity issues and may have problems meeting its current liability obligations.

Now, consider Wal-Mart. As of the Jan 31st, 2021 Annual Balance Sheet, Wal-Mart had a current ratio of 0.97 and a quick ratio of 0.49 (see financial ratios table in [Financial Statement from Walmart and Target](#), in Appendix B. At first glance, it would appear that Wal-Mart is on the verge of bankruptcy as they will not be able to pay their current liabilities. However, does anyone really believe Wal-Mart is in a financial crisis? I didn’t think so. Instead, they know that their inventory will turn over quickly and they have access to capital so they don’t need to hold much in current assets (beyond their inventory). This is a strategy that allows them to earn higher rates of return.



Another firm with slower inventory turnover, less favorable relationships with suppliers, or less access to capital may be in severe problems with the same (or even slightly higher) ratios. Also, consider that when liquidity ratios are too high, that can also be considered a problem as it indicates firms are being inefficient in allocating their resources (long-term assets generally offer higher returns than current assets). However, Facebook has a current (and quick since they don’t have any inventory listed) ratio of over 5 at the end of their 2020 fiscal year. Does that imply that Facebook is not smart enough to properly allocate their capital or might there be other explanations for their high liquidity ratios? The key here is that it can be harder than it may seem to identify “good” or “bad” levels for ratios.

Another problem is identifying what a significant change is. For example, let’s say that our Return on Equity is 14.3% and the industry average is 14.5%. We are below the industry average, but only by a very small amount. Obviously we’d like it to be higher, but is this a weak spot or is it an average spot? How much below the industry average do we need to be before we get concerned? Let’s say that last year our Return on Equity was 14.0% and industry average last year was still 14.5%. Now we have increased our ROE (marginally), but it is still slightly below the industry average. Is it a strength (because it is improving), a weakness (because it is below the industry average), or neutral (because there was little change and we are close to the average). Again, how much different do the numbers need to be before we are concerned? These are judgment calls without clear answers.

Another issue is that while financial statement analysis might help us identify potential strengths and weaknesses, it doesn’t tell us what to do about them. For example, let’s say our net profit margin is rising and significantly higher than the industry average. This is good, but how does it help management? Can they ignore it and focus their attention elsewhere? If so, will it stay a strength? From an investor’s perspective, does this make us want to buy the stock? Maybe it’s a plus, but what if the stock price is high enough that it already captures this strength? Or is overvalued because of this? Ratio analysis should not be confused with stock valuation or an investment decision making tool, but instead a piece of the puzzle. Alternatively, what if our inventory turnover is significantly below the industry average and declining? We may know we have a problem, but we still have to figure out how to fix it. From an investor’s perspective, is this a reason to avoid the stock or is it offset by other strengths? Again, ratios will not tell us by themselves whether or not a stock is a good or poor investment.

Another item to remember is that when we go through our financial statement analysis, we are typically not identifying problems/strengths, but POTENTIAL problems/strengths. Think of the process as flagging areas for further investigation. When you visit a doctor, she checks your vital stats and asks you about symptoms. This is where the doctor generates an initial diagnosis, but then usually a series of tests are done to confirm what is wrong. Financial statement analysis is the initial diagnosis stage. Once you identify areas of concern, then you need to dig deeper to see what is going on and why. Once you have this additional information, then you can decide if it needs fixed and if so, how to proceed.

I’ll close with a comment that was raised earlier. In financial statement analysis, context is everything. We can’t look at a single ratio in isolation. A company may have a great inventory turnover ratio, but not be doing so profitably or be having problems meeting their debt obligations. A firm may be seeing profitability rise, but slower than the industry average. A company may have abnormally high or low ratios (or items in common size statements) relative to the industry, but be pursuing a different strategy than the industry. For example, one firm may have a higher inventory turnover with lower profit margin while another may have a lower inventory turnover with a higher profit margin. Both strategies may be successful and allow the firms to differentiate their target market. It does not mean one firm needs to increase their profit margin and the other needs to improve their inventory

turnover. Because of the importance of context and other issues raised above, financial statement analysis is a useful, but very challenging, tool to apply.

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