

## 5.1.1: Financial Statements

This page is a draft and is under active development.

The facts of a business are summarized in financial statements that for public companies are included in annual reports to shareholders and filings with regulatory agencies (in the U.S., look especially for Form 10-K of the U.S. Securities and Exchange Commission). These reports and filings can usually be found in the investor area of the public firm's website. Beginners in the art of business analysis may see nothing interesting in the numbers. For professionals, however, those numbers are more interesting than what people say, for numbers can lie, but people are worse.

When reviewing financial statements, first, look for trends in the income statement and the balance sheet. Has revenue, gross margin, and net income been rising or falling? Has cash, receivables, inventory, and other items of the balance sheet been rising or falling? Next, look for exceptions to the trend. Exceptions may be caused by notable environmental effects, strategic actions, or both. Raise questions about the exceptions. Recall Screening Principle 4: When exceptions to a trend in results can be satisfactorily explained, solutions based upon the trend should be selected for further consideration.

Examine also the relationships among the items of the financial statement. Examine ratios. The formulas for computing common financial ratios are shown in Table 5.1.1.1.

Table 5.1.1.1: Common Financial Ratios

Name	Formula
<b>Liquidity</b>	
Current Ratio*	$\frac{\text{Current Assets}}{\text{Current Liabilities}}$
Quick Ratio	$\frac{\text{Current Assets} - \text{Inventories}}{\text{Current Liabilities}}$
<b>Leverage</b>	
Long Term Debt to Total Assets	$\frac{\text{Long Term Debt}}{\text{Total Assets}}$
Long Term Debt to Equity*	$\frac{\text{Long Term Debt}}{\text{Total Shareholder's Equity}}$
Non-Current Debt to Equity	$\frac{\text{Total Liabilities} - \text{Current Liabilities}}{\text{Total Shareholder's Equity}}$
<b>Activity</b>	
Inventory Turnover*	$\frac{\text{Cost of Sales}}{\text{Average Inventory}}$
Accounts Receivable Turnover	$\frac{\text{Credit Sales}}{\text{Average Accounts Receivable}}$
<b>Profitability</b>	
Gross Profit Margin	$\frac{\text{Gross Income}}{\text{Sales}}$

Name	Formula
Operating Profit Margin	$\frac{\text{Operating Income}}{\text{Sales}}$
Net Profit Margin	$\frac{\text{Net Income After Taxes}}{\text{Sales}}$
Return on Assets (ROA)	$\frac{\text{Net Income After Taxes}}{\text{Average Total Assets}}$
Return on Equity (ROE)*	$\frac{\text{Net Income After Taxes}}{\text{Average Total Shareholder's Equity}}$
Earnings per Share (EPS)	$\frac{\text{Net Income After Taxes}}{\text{Average Number of Shares Outstanding}}$
Price-Earnings Ratio	$\frac{\text{Net Income After Taxes}}{\text{Average Market Capitalization Value}} = \frac{\text{Net Income After Taxes per Share}}{\text{Average Market Price per Share}}$

#### \* Key Ratios

Examine the firm's financial ratios over time, especially the key ratios asterisked in Table 5.1.1.1. At the first pass, precision is unnecessary. The objective is to get a quick feel for the numbers and to locate exceptions for further investigation. Compute ratios mentally, to develop a useful top-executive skill that improves with practice. Write down results. They say you can tell a person's rank in an organization by how she gets numerical results. If she uses a computer, she's an administrative aide; if she uses a hand calculator, she's a middle manager; but if she uses the back of an envelope, she heads the firm.

Finally, the most informative ratio is the one nobody expected, for the informative value of facts is the difference between actual and expected facts. For this reason, always go beyond the common ratios to look for relationships that others may have missed. A missed relationship can be the basis of a strategy that has not occurred to others. The best strategy is usually among those that have not occurred to others, because if it had, it would likely have already been adopted, and the problem would already have been solved.

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