FINANCIAL RATIO ANALYSIS

Liquidity ratio - determines how much cash a company has on hand to pay it’s bills when they are due. You have to take a look at the firm’s Current Assets and approaching payment obligations.

Wouldn't be interesting to know if you can cover your current debts, like rent and electric, if suddenly your coworkers go on strike, and you lose your job and have no money comes in?

What do you think? 3 months? 6 months? How long can you last in your life on your savings, if you had no money coming in? It's a good idea to do some liquidity ratios regarding your life.

Liquidity ratios are quick measures of the firm’s ability to conduct business over the short term.

Current Ratio:

Current ratio = current assets/current liabilities

It shows that the current assets can cover the debt by that many times….

The industry average for the current ratio is 2.40 times , that for the average firm in American industries.

Many practitioners think that the current ratio of 1.5 as satisfactory for industrial firms. Public Utilities however, typically function with considerably lower ratios.

Public utility companies, they operate on even lower ratios than the 1.5 ratio? How are they able to do that?

Because their accounts recievables turn over each month. They are usually first to get paid when someone has no money, because they are a necessity. Therefore, the firm gets a big inflow of cash each month.

Accounts receivables turn over every month…better than an industrial firm’s accounts receivables.

Quick Ratio = current assets – inventories / current liabilities

The ratio is sometimes called the ‘acid test’ and is more stringent measure of liquidity than the current ratio.

The major limitation of the current ratio as a measure of liquidity is the inclusion in the current assets figure of some assets that may not be highly liquid, such as inventory and, in some cases, accounts receivable. The quick ratio, which does not consider inventories, helps to offset this problem.

Another limitation is the fact that it is a static (based on the balance sheet) measure of liquidity, whereas liquidity is a dynamic (flow) concept. Also, the current ratio may be easily manipulated by the firm. For example, a firm with a current ratio greater than 1x can increase that ratio by using cash to pay off some current liabilities. End-of-year balance sheet manipulation such as this is common among firms having current ratio constraints imposed as part of their financing agreements .

EREGO, RATIOS CAN BE MANIPULATED.

EFFICIENCY RATIOS -- OR ASSET MANAGEMENT RATIOS

How efficient the firm is:

Activity Ratios --- tell us how efficient the company is.

RATIO: AVERAGE COLLECTION PERIOD

What problems may be indicated by an average collection period that is substantially above the industry average?

 What if my company has an average collection period that is much longer than the average in my industry? What may be the problem?

too liberal a credit policy (maybe you should establish a late fee policy)

insufficient collection efforts

not writing off uncollectible accounts

Example:

I have 30 student who pay preschool tuition:

One person is 40 days late (due to personal problems which you are aware of and said, "it's ok")

All others pay in 5 days

what does that number do to my average?

That bad debt will skew my average and make my average collection period look much worse than it really is.

EREGO, RATIOS CAN BE DECEPTIVE. What they are good for is to point out things to you....they put you on the right track, to then, help you to ask the right questions about a firm's financial performance. They provides you with clues to investigate a company further.

FINANCIAL LEVERAGE RATIOS or DEBT RATIOs

Very commonly reviewed by banks when looking for a mortgage or a loan, or a credit card......these all are reviewed and part of your CREDIT SCORE.

BALANCE SHEET FORMULA: debt ratio = total debt / total assets

These measure the degree to which a company is employing financial leverage and as such are of interest to creditors and owners alike.

Both the balance sheet and the income statement can be used::; the balance sheet approach provides a static measure of one point in time….the income statement uses a more dynamic approach and relates required interest payments on debt the firm’s ability to pay….both are used widely in practice.

 FINANCIAL ANALYSTS USE 3 METHODS TO REVIEW RATIOS OF A FIRM:

1) Cross-sectional analysis compares the firm’s financial status to that of other firms in the industry. The importance of this information is to show the bank or investors how this particular firm is doing in comparison to the other firms in the same industry.

2) Benchmarking is a type of cross-sectional analysis, with the exception of the comparison to the entire industry, benchmarking uses a comparison of a select group of firms taken from the industry. The importance of this information is relatively similar to that of any cross-sectional analysis, but can be configured to a specific group whether it is those firms grouped by size, status, or many other criteria.

3) A time-series analysis evaluates financial performance over time. This type of analysis compares the current financial performance to that of the past allowing the firm to measure its financial progress. The importance of this information to the banks or investors is the ability to see the financial progress of the firm over a period of time and calculate its ability to perform.

FINANCIAL ANALYSTS ARE AWARE OF THE ISSUES RELATED TO RATIO ANALYSIS

BEWARE: Here are some of the limitations of ratio analysis as a technique of financial statement analysis --

a. Ratios are retrospective and do not directly incorporate forecasts of future performance of a firm. The past isn't always the best indicator of the future.

b. Ratios only indicate potential problem areas; You have to identify causes of problems.

c. A good financial manager has to select the set of ratios that is most appropriate for the type of firm being analyzed.

d. Ratios do not provide absolute measures for evaluation; rather they must be analyzed against some standard. It could sometimes be difficult to choose an appropriate standard for comparison.

e) Ratios for comparison need to be done for the same time period. Analyzing and comparing firms must be done for the same time frame.

f) Financial statements are not all developed in the same way, differing accounting treatments, relative to inventory and depreciation, for example.

CONCLUSION: Ratios are convenient summary measures but should be viewed with a dose of healthy skepticism. Before making any decision, do not just use ratios as the sole source of your actions.A student in our session, Michael Barthman, came up with this great analogy: "These quantitative tools are like gates, if you can get through them OK you then have to ask the real business questions. Does the company have the resources, the market opportunity, and the team that can execute."

Sidebar: Current ideas about one ratio that stands out among the ‘Wall St. pundits’.... PE ratios!

P/E RATIOS ---price/earnings, how much are people willing to pay for $1 worth of earnings from a company.

A RECENT ARTICLE ON PRICE TO EARNING RATIOS... Money Magazine, March 2009, states that Stocks are really undervalued, and it's not really a bad time to buy stocks. Historically, PE ratios have been averaging around 16....current data reveals that the average PE ratio for the companies in 2009 is 14 ----Not since 1991, have PE fallen below average. So, although the economy looks ugly, it might not be a bad time to buy at rock bottom prices, you just have to be willing to hold them for 5-10 years. It is a not a time for a quick turn-around. "You need to have a clear understanding that this might take years before it pays off".

In Conclusion, if you ever take a look at entering the stock market, make sure you look at a company's PE ratio.