



Financial Statement Analysis

Financial statement analysis is important from both an internal and external business perspective. Managers will want to evaluate how a company is performing against itself in time (year to year), or other companies, or an industry average. Managers of the company, as well as short-term and long-term creditors and stockholders, will be evaluating a company's performance in three key areas: liquidity, profitability, and solvency.

Liquidity is the ability of a business to convert assets to cash quickly. This is a key concern for short-term creditors who want to know that a business can pay a short-term loan when the balance is due.

Profitability is the ability of a business to earn a profit. Both long-term creditors and stockholders care about the success of a business from a profit perspective.

Solvency is the ability of a business to meet its long-term debts and to achieve expansion and growth (or more simply, to survive in the long run). If a company is insolvent, it's going bankrupt! Both long-term creditors and stockholders are interested in the solvency of a company.

There are three types of tools used for financial statement analysis:

- (1) Horizontal analysis (used for intracompany comparisons - comparing between years): finding the dollar difference and percentage difference in the line items of two financial statements from different time periods.
- (2) Vertical analysis (used for intra- and intercompany comparisons, one year only): finding every line item as a percentage of the base amount. For income statements, the base amount is revenue; for balance sheets, the base amount is total assets.
- (3) Ratio analysis (used for intra- and intercompany comparisons): expresses the relationship among selected items of the financial statement. There are 3 types of ratios: liquidity ratios, profitability ratios, and solvency ratios.

The goal of financial statement analysis is not only to know how to prepare the numbers in the analysis but also to comment on what the numbers in them mean. For instance, is a short-term creditor more likely to invest in a company whose current ratio (current assets : current liabilities) is 0.8 : 1 or 0.9 : 1?

The current ratio expresses the value of current assets available per dollar of current liabilities. A current ratio of 0.8 : 1 means there is \$0.80 of current assets available for every dollar of current liability. A short-term investor will be much more likely to invest with a company whose current ratio is 0.9 : 1 – they have \$0.90 of current assets available per dollar of current liability and will be more capable of paying off short-term debt.