

Introduction to Financial Statement Analysis

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Purpose: Understand how to read, interpret, and evaluate a company's financial reports to assess performance, financial health, and future prospects.

1. Why Analyze Financial Statements?

Goal	What It Reveals
Profitability	Ability to generate earnings (e.g., margins, ROE)
Liquidity	Short-term ability to meet obligations (e.g., current ratio)
Solvency	Long-term financial stability (e.g., debt-to-equity)
Efficiency	How well assets are used (e.g., asset turnover)
Valuation	Relative worth of the firm (e.g., P/E, EV/EBITDA)
Trend identification	Changes over time that signal improvement or risk

2. Core Financial Statements

Statement	Primary Focus	Key Line Items
Balance Sheet	Snapshot of resources & claims at a point in time	Assets, Liabilities, Equity
Income Statement	Performance over a period	Revenue, COGS, Operating Expenses, Net Income
Cash Flow Statement	Cash generation & usage	Operating, Investing, Financing cash flows
Statement of Changes in Equity	Movements in owners' interest	Issuance/repurchase of shares, dividends, retained earnings

3. The Analytical Process

- 1. Collect the data** – Obtain audited statements for at least 3–5 years and any interim reports.
- 2. Standardize** – Restate figures (e.g., common-size percentages) to enable comparison across periods or firms.

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3. **Compute ratios** – Use liquidity, profitability, leverage, and activity metrics.
 4. **Trend analysis** – Plot key ratios and line items over time to spot patterns.
 5. **Benchmark** – Compare with industry averages, peers, and historical performance.
 6. **Interpret** – Relate findings to business model, economic environment, and management strategy.
 7. **Report** – Summarize insights, highlight risks, and suggest actions.
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4. Key Ratio Categories & Sample Formulas

Category	Representative Ratios	Formula (basic)
Liquidity	Current Ratio, Quick Ratio, Cash Ratio	Current Ratio = Current Assets / Current Liabilities
Profitability	Gross Margin, Operating Margin, Net Margin, ROA, ROE	Net Margin = Net Income / Revenue
Leverage	Debt to Equity, Debt to Assets, Interest Coverage	Debt to Equity = Total Debt / Shareholders' Equity
Efficiency	Asset Turnover, Inventory Turnover, Receivables Days	Receivables Days = (Accounts Receivable / Revenue) × 365
Market	EPS, P/E, Price to Book, EV/EBITDA	P/E = Market Price per Share / Earnings per Share

Tip: Use **common-size** statements (e.g., each balance sheet item as % of total assets) to compare firms of different sizes.

5. Common Analytical Techniques

Technique	Description	Typical Use
Horizontal analysis	Compare line items across periods (year over year % change).	Detect growth trends, unusual spikes.
Vertical analysis	Express each item as a % of	