Module 2:
FINANCIAL ANALYSIS

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1. Introduction

The purpose of this module is to introduce you to financial analysis. Financial analysis is a tool that is used by financial managers and analysts to assess a company's financial condition and performance. Financial analysis is also used to forecast or predict the future course of a company's condition and performance.

Financial analysis has become increasingly important as investors, regulators, and corporate management grapple with the recent corporate scandals. Many of these scandals involve manipulating accounting numbers, outright corporate fraud, and shifting information off the financial statements and into the footnotes.

The Securities and Exchange Commission and the Attorney General of New York, among other regulators, have been pursuing investigations involving a wide range of corporate misdeeds, but most of these misdeeds relate to the accounting information that is provided to investors and shareholders. Examples include:

- Shifting debt off the balance sheet and into special purpose entities [Enron];
- Inflating revenues [Krispy Kreme; Worldcom; Sunbeam; AOL Time Warner; Global Crossing; Peregrine Systems]
- Hiding debt off-balance sheet [Adelphia]

Many companies have restated their financial results after having the “errors in their ways” pointed out to them by the SEC. The passage of the Sarbanes Oxley Act of 2002 and related rules and regulations are a direct result of these scandals.

These scandals make it even more important that investors understand how to interpret financial data and to understand how much “wiggle room” companies have within generally accepted accounting practices.

In this module we introduce you to financial analysis. We begin with a review of financial accounting, and then learn the tools of analysis, which include financial ratio analysis.
2. **Learning Outcomes**

LO2.1 Analyze a company's financial statements
LO2.2 Infer a company's financial health from the information provided in the statement of cash flows.
LO2.3 Explain how companies may be able to manage financial information
LO2.4 Identify the role of accounting principles in the quality of financial statements
LO2.5 Explain the purpose of performing financial analysis
LO2.6 Relate the a firm's operating cycle to its liquidity
LO2.7 Differentiate the profit margins and identify how each is used to interpret a firm's financial health
LO2.8 Calculate measure of a firm's effectiveness in using assets and relate these to components of a firm's operating cycle
LO2.9 Apply the Du Pont system to interpret trends in return ratios
LO2.10 Calculate ratios that express financial information on a per share basis
LO2.11 Explain the tools used to use financial ratios effectively
LO2.12 Recognize and list problems and dilemmas of financial analysis

3. **Module 2 tasks**

A. **Readings**

   i) Required reading

      (a) Financial accounting information
      (b) Financial ratios
      (c) Financial analysis

   ii) Other resources

      (a) Understanding financial statements. A detailed explanation of many of the accounts typically found on the financial statements of a publicly traded corporation. Procter & Gamble is used as an example.

      (b) Financial ratio formulas, for reference purposes.

      (c) The Du Pont system applied to Sears Roebuck & Co.; an example of how to use the Du Pont system applied to actual financial data.

      (d) Other links.

   iii) Optional reading

      Fabozzi and Peterson text, Chapter 5 (Financial Statements) and Chapter 22 (Financial Analysis)

B. **Problem sets**
These problems sets are non-graded tasks. It is recommended that you complete these problem sets prior to attempting the graded online quiz.

- Using financial accounting information
- Accounting review crossword puzzle
- Financial ratio problems
- Financial ratio practice quiz (non-credit)
- StudyMate activity

4. Module 2 overview and discussion

A. Financial accounting information

Financial analysis requires a good understanding of financial accounting information. Without this understanding, the financial information that we use in analysis is meaningless. In this review of accounting, we cover the basics of the balance sheet, the income statement, and the statement of cash flows. In addition, we discuss other sources of company information, such as the notes to the financial statements.

B. Financial ratios

Financial ratios are tools that we use to help us to use accounting information to describe a company's financial condition and performance. There are hundreds of ratios that could be calculated and we look at a small subset of these ratios.

We cover ratios that capture a company's liquidity, profitability, and financial leverage. In addition, we introduce to shareholder ratios that are, basically, restatements of financial data on a per share basis.

C. Financial analysis

The calculation of ratios is straightforward. The tough part is making sense out of all the information, both the raw data and the ratios. Financial analysis is the process of taking all the data and interpreting that data to tell us something about the company's financial condition (Is it healthy? Can it satisfy its financial obligations in the future?) and performance (Is it profitable? Will it continue to be profitable?).

In financial analysis, we use financial data in many different ways: Du Pont analysis, common size analysis, and trend analysis.

In performing financial analysis, we must be aware of problems that go along with using accounting information. We also have to be aware of what a ratio can tell us ... and what it doesn't tell us; we can't read much into a single ratio, but rather must put it in perspective in three dimensions: other ratios of the same firm, the same ratio for benchmark (i.e., comparable) firms, and trends over time.

D. What's next?

The next two modules involve the mathematics of finance. Once you master the mathematics of finance in the context of valuation, we'll put those tools together with the information from the first two modules in the modules on capital budgeting and capital structure.