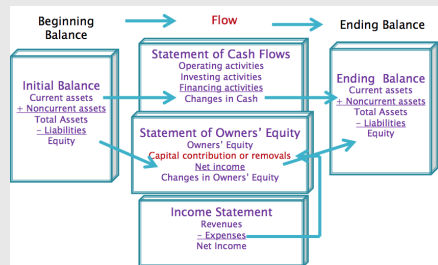


Links Between Financial Statements



Solvency Ratios

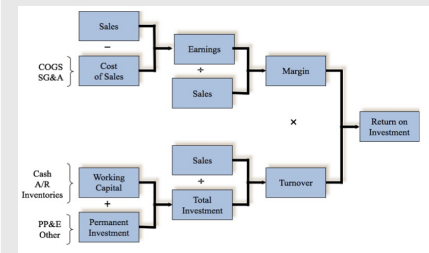
Times Interest Earned = $\frac{\text{Net Income} + \text{Interest Exp.} + \text{Tax Exp.}}{\text{Interest Exp.}}$

Shows the firm's ability to pay the cost of financing

Debt-to-Equity Ratio = $\frac{\text{Total Liabilities}}{\text{Shareholder's Equity}}$

Proportion of debt for each "dollar" invested by shareholders

ROA (Dupont Chart)



Liquidity Ratios

Current Ratio = $\frac{\text{Current Assets}}{\text{Current Liabilities}}$

Ability of the firm to cover its short term debts

Quick Ratio = $\frac{\text{Cash} + \text{cash equiv} + \text{receivables}}{\text{Current Liabilities}}$

Ability of the firm to cover its immediate short term debts

Cash Ratio = $\frac{\text{Cash} + \text{Cash Equivalents}}{\text{Current Liabilities}}$

Measures cash available to pay short term debts

Working capital :

Margin of safety to pay current obligations

Current assets – current liabilities

Balance Sheet

Liquid Assets	Current Liabilities
Other Current Assets	Long-term Liabilities
Noncurrent Assets	Equity

Income Statement

Profit Margin = $\frac{\text{Net Income}}{\text{Sales Revenue}}$

% of each "dollar" of sales that remains as net income.

Quality of Income = $\frac{\text{Cash Flow from Operating Activities}}{\text{Net Income}}$

Compares the cash flows earned (real) to net income declared (accounting principles!)

Fixed Assets Turnover = $\frac{\text{Net Sales Revenue}}{\text{Average Net Fixed Assets}}$

Shows the ability of the firm to use its fixed assets to generate revenue.

Return on Equity = $\frac{\text{Net Income}}{\text{Average Shareholders' Equity}}$

How much income was earned for every "dollar" invested by owners?

SCF

Cash flows from operating activities	Net Income + Depreciation + Changes in ST balance sheet accounts
+ Cash flows from investing activities	Purchase and Sale of Fixed Assets
+ Cash flows from financing activities	Increase in Capital Contribution or Debt - Debt Reimbursement - Distribution to Shareholders (Treasury Stock or Dividends)
= Changes in Cash	
+ Cash, beginning balance	
= Cash, ending balance	

Structure of Income Statement

Income Statement (summary of the operating results for a period)

Revenues or Sales
- Operating Expenses
= Operating Income
- Functional Expenses (Undistributed Expenses)
= Gross Operating Profit (GOP)
- Fixed Charges
= Earnings Before Interest, Tax, Depreciation and Amortization (EBITDA)
- Depreciation and Amortization Expenses
= Earnings Before Interest and Tax (EBIT) or Net Operating Income
- Interest Expense
= Earnings Before Tax (EBT)
- Income Tax
= Net Income

FCF

Free Cash Flow for a project or a firm:

= Earnings Before Interest and Taxes (EBIT) x (1 - tax rate)

+ Depreciation

- Changes in working capital (without cash)

- Replacement Investments (Capex) (+ Receipt from asset sale)

(Note: you can also get free cash flows from operating cash flows + investing cash flows – interest (1-tax%) and adjustment for dividends).

Return on Asset Ratios

Profit Margin = $\frac{\text{EBIT} \times (1 - \text{tax})}{\text{Net Sales}}$

Asset Turnover = $\frac{\text{Net Sales}}{\text{Average Assets}}$

ROA = Profit margin x Asset turnover

= $\frac{\text{EBIT} \times (1 - \text{tax})}{\text{Average Assets}}$

ROCE (return on capital employed) = $\frac{\text{EBIT} \times (1 - \text{tax})}{\text{Capital Employed}}$

Capital employed

= Total assets – short term liabilities OR

= Long term liabilities + Equity

Financial leverage: ROE – ROA

Shows the relationship between the return on assets (all forms of funding) and the return on equity (only shareholder's investment).

Should be positive (indicates that the company creates a bigger return than the cost of borrowing).

Return on Asset Ratios (cont)

When return on capital employed is more than the expected return on investment => Value Creation

Investor Ratios

$EPS = \frac{\text{Net Income}^*}{\text{Average Number of Shares Outstanding For The Period}}$

Measures return on investment for shareholders.

*If there are preferred dividends, the amount is subtracted from net income.

$\text{Price-to-earnings ratio} = \frac{\text{Current Market Price Per Share}}{\text{Earnings Per Share}}$

Measures the relationship between the current share price and the earnings per share. Indicates market expectations.



By O (kiol98)
cheatography.com/kiol98/

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