Assessing Financial Performance



Topics

- Importance of Assessing Financial Performance
- Financial ratio analysis

Goals of The Corporation

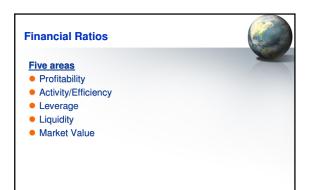
- Shareholders desire wealth maximization.
- Do managers (i.e. agents) maximize shareholder value?
- The managers will generally act in the shareholders' best
 - Interests.
 The shareholders can devise contracts that align the incentives of the managers with the goals of the shareholders.
 - The shareholders can monitor the managers behavior.
- However, this contracting and monitoring is costly.
- Agency Costs = Costs of Implementing Control Devices + Monitoring Costs

Role of Financial Manager

- To create value, the financial manager should:
 1. Make sound investment decisions.
 - 2. Make sound financing decisions.
- ➔ Importance of Assessing Financial Performance

Assessing Financial Performance

- Key issue in assessing the long-term financial health of a company is whether the corporate system of goals, product market strategies, investment requirements, and financing capabilities are in balance.
- Analysts try to understand
 - future industry structure and competitive behavior,
 - the competitive and operating characteristics of the business,
 the long-term goals and plans of management, and
 the soundness of management
- Most likely, initial assessment involves investigating published financial statements.
- → Financial statement analysis is only a part of a complete analysis of a company.



Profitability Ratios	
Net profit margin = net income sales	~
$\frac{\text{Return on assets}}{\text{total assets}} = \frac{\text{EBIT - tax}}{\text{total assets}}$	
Return on equity = $\frac{\text{net income}}{\text{equity}}$	
Payout ratio = <u>cash dividends</u> net income	

Activity/Efficiency Ratios	
$\frac{\text{Asset turnover ratio}}{\text{total assets}} = \frac{\text{sales}}{\text{total assets}}$	-
Fixed asset turnover = $\frac{\text{sales}}{\text{net fixed assets}}$	
Inventory turnover ratio = $\frac{\text{cost of goods sold}}{\text{inventory}}$	
Average collection period = $\frac{\text{account receivables}}{\text{average daily sales}}$	



Leverage Ratios	
Total debt ratio = total debt total assets	~
Total debt ratio at the market = $\frac{\text{total liabilities}}{\text{total liabilities} + market va}$	
$\frac{\text{Debt equity ratio}}{\text{total liabilities}}$	
Times interest earned = EBIT interest payments	

