

Study Plan

Chapter 2

Learning Objectives

After studying this chapter you should be able to:

- List and define the key financial statements that firms are required to provide to their shareholders;
- Evaluate a firm's cash flows using its financial statements, including the statement of cash flows;
- Calculate and interpret liquidity, activity, and debt ratios;
- Review the popular profitability ratios and the role of the DuPont system in analyzing the firm's returns;
- Compute and interpret the price/earnings and market/book ratios;
- Discuss the basics of corporate taxation of both ordinary income and *capital gains*.

Summary and Conclusions

- The four key financial statements are (1) the balance sheet, (2) the income statement, (3) the statement of retained earnings, and (4) the statement of cash flows. Notes describing the technical aspects of the financial statements are normally included with them.
- Depreciation is the most common noncash charge on income statements; others are amortization and depletion allowances. Depreciation is added back to *EBIT* after taxes to find a firm's operating cash flow. A measure of cash flow that is important to financial analysts is free cash flow, the cash flow available to investors. Free cash flow equals operating cash flow less the firm's net investment in fixed and current assets.
- The statement of cash flows, in effect, summarizes the firm's cash flows over a specified period of time, typically one year. It presents cash flows divided into operating, investment, and financing flows. When interpreting the statement, an analyst typically looks for unusual changes in either the major categories of cash flow or in specific items to find clues to problems that the firm may be experiencing.
- Financial ratios are a convenient tool for analyzing the firm's financial statements to assess its performance over the given period. A variety of financial ratios are available for assessing various aspects of a firm's liquidity, activity, debt, profitability, and market value. The DuPont system is often used to assess various aspects of a firm's profitability, particularly the returns earned on both the total asset investment and the owners' share equity in the firm.
- Financial decision makers must be conversant with basic corporate tax concepts, because taxes are a major measurement challenge that affect both benefits and costs. Taxes are a major outflow of cash to the profitable firm; they are levied on both ordinary income and capital gains. The marginal tax rate is more relevant than the average tax rate in financial decision making.