cash flow statement. In this chapter we applied these tools to TJX and Nordstrom in order to compare the two firms' performance on both an As Reported and As Adjusted (for the use of off–balance sheet operating leases) basis.

The starting point for ratio analysis is the company's ROE. The next step is to evaluate the three drivers of ROE, which are net profit margin, asset turnover, and financial leverage. Net profit margin reflects a firm's operating management, asset turnover reflects its investment management, and financial leverage reflects its financing policies. Each of these areas can be further probed by examining a number of ratios. For example, common-sized income statement analysis allows a detailed examination of a firm's net margins. Similarly, turnover of key working capital accounts such as accounts receivable, inventory, and accounts payable, and turnover of the firm's fixed assets, allow further examination of a firm's asset utilization. Finally, short-term liquidity ratios, debt policy ratios, and coverage ratios provide a means of examining a firm's financial leverage.

A firm's sustainable growth rate—the rate at which it can grow without altering its operating, investment, and financing policies—is determined by its ROE and its dividend policy. The concept of sustainable growth provides a way to integrate the different elements of ratio analysis and to evaluate whether or not a firm's growth strategy is sustainable. If a firm's plans call for growing at a rate above its current sustainable rate, then one can analyze which of the firm's ratios is likely to change in the future.

Cash flow analysis supplements ratio analysis in examining a firm's operating activities, investment management, and financial risks. Firms in the United States are currently required to report a cash flow statement summarizing their operating, investment, and financing cash flows. Firms in other countries typically report working capital flows, but it is possible to use this information to create a cash flow statement.

Since there are wide variations across firms in the way cash flow data are reported, analysts often use a standard format to recast cash flow data. We discussed one such cash flow model in this chapter. This model allows the analyst to assess whether a firm's operations generate cash flow before investments in operating working capital, and how much cash is being invested in the firm's working capital. It also enables the analyst to calculate the firm's free cash flow after making long-term investments, which is an indication of the firm's ability to meet its debt and dividend payments. Finally, the cash flow analysis shows how the firm is financing itself, and whether its financing patterns are too risky.

The insights gained from analyzing a firm's financial ratios and its cash flows are valuable in forecasting the firm's future prospects.

DISCUSSION QUESTIONS

1. Which of the following types of firms do you expect to have particularly high or low asset turnover? Explain why.
   - a supermarket
   - a pharmaceutical company
   - a jewelry retailer
   - a steel company
2. Which of the following types of firms do you expect to have high or low sales margins? Why?
   - a supermarket
   - a pharmaceutical company
   - a jewelry retailer
   - a software company

3. James Broker, an analyst with an established brokerage firm, comments: "The critical number I look at for any company is operating cash flow. If cash flows are less than earnings, I consider a company to be a poor performer and a poor investment prospect." Do you agree with this assessment? Why or why not?
4. In 2005 IBM had a return on equity of 26.7 percent, whereas Hewlett-Packard's return was only 6.4 percent. Use the decomposed ROE framework to provide possible reasons for this difference based on the data below:

	IBM	HP
NOPAT/Sales	9.0%	2.7%
Sales/Net Assets	2.16	2.73
Effective After Tax Interest Rate	2.4%	1.1%
Net Financial Leverage	0.42	−0.16

Source: Thomson One

5. Joe Investor asserts, "A company cannot grow faster than its sustainable growth rate." True or false? Explain why.
6. What are the reasons for a firm having lower cash from operations than working capital from operations? What are the possible interpretations of these reasons?
7. ABC Company recognizes revenue at the point of shipment. Management decides to increase sales for the current quarter by filling all customer orders. Explain what impact this decision will have on
   - Days' receivable for the current quarter
   - Days' receivable for the next quarter
   - Sales growth for the current quarter
   - Sales growth for the next quarter
   - Return on sales for the current quarter
   - Return on sales for the next quarter
8. What ratios would you use to evaluate operating leverage for a firm?
9. What are the potential benchmarks that you could use to compare a company's financial ratios? What are the pros and cons of these alternatives?
10. In a period of rising prices, how would the following ratios be affected by the accounting decision to select LIFO, rather than FIFO, for inventory valuation?
    - Gross margin
    - Current ratio
    - Asset turnover
    - Debt-to-equity ratio
    - Average tax rate

NOTES

1. Both TJX and Nordstrom end their fiscal years on the last Saturday in January. TJX calls the fiscal year ending January 30, 2011, fiscal year 2011, while Nordstrom calls that same time period fiscal year 2010. For clarity, we will call the fiscal year ending January 30, 2010, as fiscal year 2009, and the fiscal year ending January 29, 2011, as fiscal year 2010.
2. TJX and Nordstrom financial statements used as the source for creating the standardized statements accessed via Thomson ONE.
3. Financial statement data for all publicly traded U.S. companies between 1991 and 2010, listed in Standard & Poor's Compustat database, accessed October 2011.