How to analyze a financial statement

It's obvious financial statement have a lot of numbers in them and at first glance it can seem unwieldy to read and understand. One way to interpret a financial report is to compute ratios, which means, divide a particular number in the financial report by another. Financial statement ratios are also useful because they enable the reader to compare a business's current performance with its past performance or with another business's performance, regardless of whether sales revenue or net income was bigger or smaller for the other years or the other business. In order words, using ratios can cancel out difference in company sizes.

There aren't many ratios in financial reports. Publicly owned businesses are required to report just one ratio (earnings per share, or EPS) and privately-owned businesses generally don't report any ratios. Generally accepted accounting principles (GAAP) don't require that any ratios be reported, except EPS for publicly owned companies.

Ratios don't provide definitive answers, however. They're useful indicators, but aren't the only factor in gauging the profitability and effectiveness of a company.

One ratio that's a useful indicator of a company's profitability is the gross margin ratio. This is the gross margin divided by the sales revenue. Businesses don't discose margin information in their external financial reports. This information is considered to be proprietary in nature and is kept confidential to shield it from competitors.

The profit ratio is very important in analyzing the bottom-line of a company. It indicates how much net income was earned on each $100 of sales revenue. A profit ratio of 5 to 10 percent is common in most industries, although some highly price-competitive industries, such as retailers or grocery stores will show profit ratios of only 1 to 2 percent.