BUAD 340 Principles of Finance Fall 2018/Dr. Minor Risk and Return Handout 181105

Van Horne Chapter 6. Financial Statement Analysis

What is financial statement analysis? It's "tearing apart" the financial statements and looking at the relationships. The objective is to show how to rearrange information from financial statements into financial ratios that provide information about five areas of financial performance:

1.Short-term solvency
2. Activity
3. Financial Leverage
4. Profitability
5. Value

Who analyzes financial statements?

- ☐ Internal users (i.e., management)
- ☐ External users (emphasis of chapter)

Examples of Internal Uses of Statement Analysis

Planning, evaluating and controlling company operations

- ☐ Plan – Focus on assessing the current financial position and evaluating potential firm opportunities.
- ☐ Control – Focus on return on investment for various assets and asset efficiency.
- ☐ Understand – Focus on understanding how suppliers of funds analyze the firm.

Examples of External Uses of Statement Analysis

Assessing past performance and current financial position and making predictions about the future profitability and solvency of the company as well as evaluating the effectiveness of management

- ☐ Trade Creditors – Focus on the liquidity of the firm.
- ☐ Bondholders – Focus on the long-term cash flow of the firm.
- ☐ Shareholders – Focus on the profitability and long-term health of the firm.
- ☐ Regulators – Focus on all areas of the financial health of the firm

Global Accounting Standards

Convergence of Accounting Standards: Aims to narrow or remove differences so that investors can better understand financial statements prepared under different accounting frameworks

IASB – International Accounting Standards Board has the responsibility of IFRS
IFRS – International Financial Reporting Standards (EU countries adopted)
US GAAP – US Generally Accepted Accounting Principles determined by FASB
FASB – Financial Accounting Standards Board determines accounting standards for financial statements

What are the types of Financial Statements?

- ☐ Balance Sheet
- ☐ Income Statement
- ☐ Statement of Cash Flows
- ☐ Statement of Stockholders' Equity

The big three are the balance sheet, income statement, and statement of cash flows or cash flow statement.

The "Big Three" Financial Statements

Balance Sheet

Balance Sheet: A summary of a firm's financial position on a given date that shows:

Total Assets = Total Liabilities + Owners' Equity.

The balance sheet is a snapshot in time of the firm's financial position. It answers the question: *"Does my firm have enough assets to cover its debts?"*

Assets			Liabilities
Existing Investments Generate cashflows today Includes long lived (fixed) and short-lived(working capital) assets	Assets in Place	Debt	Fixed Claim on cash flows Little or No role in management *Fixed Maturity* *Tax Deductible*
Expected Value that will be created by future investments	Growth Assets	Equity	Residual Claim on cash flows Significant Role in management *Perpetual Lives*

Income Statement

The income statement is a summary of a firm's revenues and expenses over a specified period, ending with net income or loss for the period. It answers the question: *"Is my firm profitable or not?"*

Gross revenues from sale of products or services	Revenues
Expenses associates with generating revenues	- Operating Expenses
Operating income for the period	= Operating Income
Expenses associated with borrowing and other financing	- Financial Expenses
Taxes due on taxable income	- Taxes
Earnings to Common & Preferred Equity for Current Period	= Net Income before extraordinary items
Profits and Losses not associated with operations	- (+) Extraordinary Losses (Profits)
Profits or losses associated with changes in accounting rules	- Income Changes Associated with Accounting Changes
Dividends paid to preferred stockholders	- Preferred Dividends
	= Net Income to Common Stockholders

Cash Flow Statement

A summary of the actual or anticipated incomings and outgoings of cash in a firm over an accounting period (month, quarter, year). Cash flow statements assess the amount, timing, and predictability of cash-inflows and cash-outflows and are used as the basis for budgeting and business-planning. These answer the important managerial question: *"Do I have enough cash to run my business?"*

Cash Flow Statement Format

for the period x through y

BEGINNING CASH BALANCE	a
CASH RECEIPTS	b
CASH DISBURSEMENTS	c
CASH FROM OPERATIONS	b – c = d
FIXED ASSET PURCHASES	e
NET BORROWINGS	f
INCOME TAXES PAID	g
SALE OF STOCK	h
ENDING CASH BALANCE	a + d – e + f – g + h = i