Finance for Cultural Organisations

Lecture 2: Financial Statements

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Lecture 2: Financial Statements

Outline:

- Introduction to Financial Accounting
- Basic Financial Statements
  - The balance sheet
  - The income statement
  - The statement of cash flows

Reading

- RWJ Ch2, HBP Ch1,2 AMcL Ch1. 2,3,5,6.

Importance of Understanding Accounting

- Accounting is an organized way of summarizing the activities of business.
- Internal and external users of accounting information rely on accounting information to make decisions.
- A strong understanding of accounting is required of financial managers because they use that information to make significant management decisions that will affect the future financial reports of the organization.

Finance from a Personal Viewpoint

- All us own things and owe money
- If we own more than we owe – we are said to have a positive net worth.
- In Finance:
  - What we own are called Assets.
  - What we owe are called Liabilities.
  - If our Assets exceed our Liabilities then we have [positive] Equity.
  - Accordingly: Assets = Liabilities + Equity

The Balance Sheet

- The Balance Sheet answers two general questions:
  - How has the firm invested its capital (money)?
    - Current Assets (cash, receivables, inventory)
    - Fixed Assets (plant, property, equipment)
  - How has the firm financed its capital investment?
    - Borrowing: short-term (current liabilities) and long-term debt
    - Equity (stock) and Retained Earnings

Questions we would like answered…

Questions	**Assets**	**Liabilities**	Questions
What are the assets in place? How valuable are these assets? How risky are these assets?	Assets in Place	Debt	What is the value of the debt? How risky is the debt?
What are the growth assets? How valuable are these assets?	Growth Assets	Equity	What is the value of the equity? How risky is the equity?

Preparing the Balance Sheet

- The balance sheet is a financial ‘snapshot’ at one point in time (usually on the last day of the firm’s fiscal year)
- It is an ‘inventory’ of what the firm owns (assets) and how those assets were financed (liabilities and owners equity)
  - Left-hand side lists assets
  - Right-hand side list liabilities and owners equity
  - Top to bottom items are listed from most liquid, to least liquid
- Balance Sheet Identity
  - Assets = Liabilities + Stockholders’ Equity

Liquidity

- The speed and ease with which an asset can be converted to cash without significant loss of value.
- Current assets are liquid (e.g. debtors, inventory).
- Non-current assets are relatively non-liquid (e.g. building, equipment, goodwill).
- The more liquid a business is, the less likely it is to experience financial distress, but liquid assets are less profitable to hold.

The Balance Sheet

Figure 4.1: The Balance Sheet

	Assets	**Liabilities**	
Long Lived Real Assets	Fixed Assets	Current Liabilties	Short-term liabilities of the firm
Short-lived Assets	Current Assets	Debt	Debt obligations of firm
Investments in securities & assets of other firms	Financial Investments	Other Liabilities	Other long-term obligations
Assets which are not physical, like patents & trademarks	Intangible Assets	Equity	Equity investment in firm

Source: Aswath Damodaran / Corporate Finance - Theory and Practice, 2e

Debt versus Equity

- Creditors have first claim on a firm's cash flow; equity holders have a residual claim.
- This residual claim is represented in the equation:

  Shareholder's equity = Assets – Liabilities.
- Financial leverage or 'gearing' is the use of debt in a firm's capital structure.
- Financial leverage increases the potential reward to shareholders, but also increases the potential for financial distress and business failure.

Preparing the Income Statement

- Also known as the profit and loss statement
- The income statement, which reports on how much a firm earned in the period of analysis
  - Usually prepared to report on one fiscal year
  - Can be prepared for a quarter of a year (3 months) or even a month
- Reports expenses incurred in order to earn that income (application of the matching principle)
- The most important use is for determining how profitably a firm is operating.
- You generally report revenues first and then deduct any expenses for the period

The Income Statement

Figure 4.2: Income Statement

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 Change
Dividends paid to preferred stockholders	- Preferred Dividends
	= Net Income to Common Stockholders

Source: Aswath Damodaran / Corporate Finance - Theory and Practice, 2e

The Income Statement – Basic Structure

Basic Income Statement Structure

ABC Corporation Limited
Income Statement
for the year ended March 31, 200X

Revenues	$6,700,000
Cost of goods sold	4,020,000
Gross margin	2,680,000
Selling and administrative expenses	1,500,000
Earnings before Interest and Taxes	1,180,000
Interest expense	450,000
Earnings before tax	730,000
Income taxes	233,600
Net income	$496,400
Dividends	$100,000
Retained earnings	$396,400

Variable Costs including direct materials and direct labour.

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Fixed period costs including salaries, rent and depreciation.

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Financing costs. Interest expense is tax-deductible.

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Profit after tax may be retained in whole or in part to be reinvested in the firm and fuel the firm's growth.

The Statement of Cash Flows

- The statement of cash flows shows the financial analyst, stockholder, or other interested parties where the firm's cash came from and how it was used.
- The cash flow statement helps to provide a clearer picture of where cash is coming from and where it is going.
- Analysts are very interested in the cash flow realities of the firm because they realize that accounting profit is often not available to manage to pay bills.

The Statement of Cash Flows

The firm has 3 possible sources & uses of cash:

Figure 4.3: Statement of Cash Flows

Net cash flow from operations, after taxes and interest expenses	Cash Flows From Operations
Includes divestiture and acquisition of real assets (capital expenditures) and disposal and purchase of financial assets. Also includes acquisitions of other firms.	+ Cash Flows From Investing
Net cash flow from the issue and repurchase of equity, from the issue and repayment of debt and after dividend payments	+ Cash Flows from Financing
	= Net Change in Cash Balance

The Statement of Cash Flows

Sources of Cash

- Any decrease in an asset
- Any increase in a liability
- Any increase in common stock (capital account)
- Any increase in retained earnings

Uses of Cash

- Any increase in an asset
- Any decrease in a liability

The Statement of Cash Flows

Example of Sources and Uses of Funds

Sources and Uses of Funds for Jim's Widgets

Sources of Funds	
Increase in payables	$5,000
Increase in accruals	1,000
Increase in loans	10,000
Increase in deferred taxes	1,500
Increase in owner's equity	44,000
Increased retained earnings	2,000
Total sources of cash	63,500
Uses of Funds	
Increase in receivables	$5,000
Increase in inventory	2,000
Increase in prepaid expenses	3,500
Increase in machinery	28,000
Total uses of cash	38,500
Increase in cash	25,000

Basic Financial Statements

- The balance sheet, which summarizes what a firm owns and owes at a point in time.
- The income statement, which reports on how much a firm earned in the period of analysis
- The statement of cash flows, which reports on cash inflows and outflows to the firm during the period of analysis